平成２５年８月６日

各位

一般社団法人　日本投資顧問業協会

CREATE－Research 社の報告書

このたび CREATE-Research 社の“Investing in a Debt-Fuelled World（邦題：債務に煽られた世界における投資）”と題する調査報告書を、ホームページに掲載しました。同社は、英国の独立系のグローバルなコンサルティング会社であり、金融、航空宇宙、IT、石油、製薬、テレコム等の幅広い産業をカバーしています。

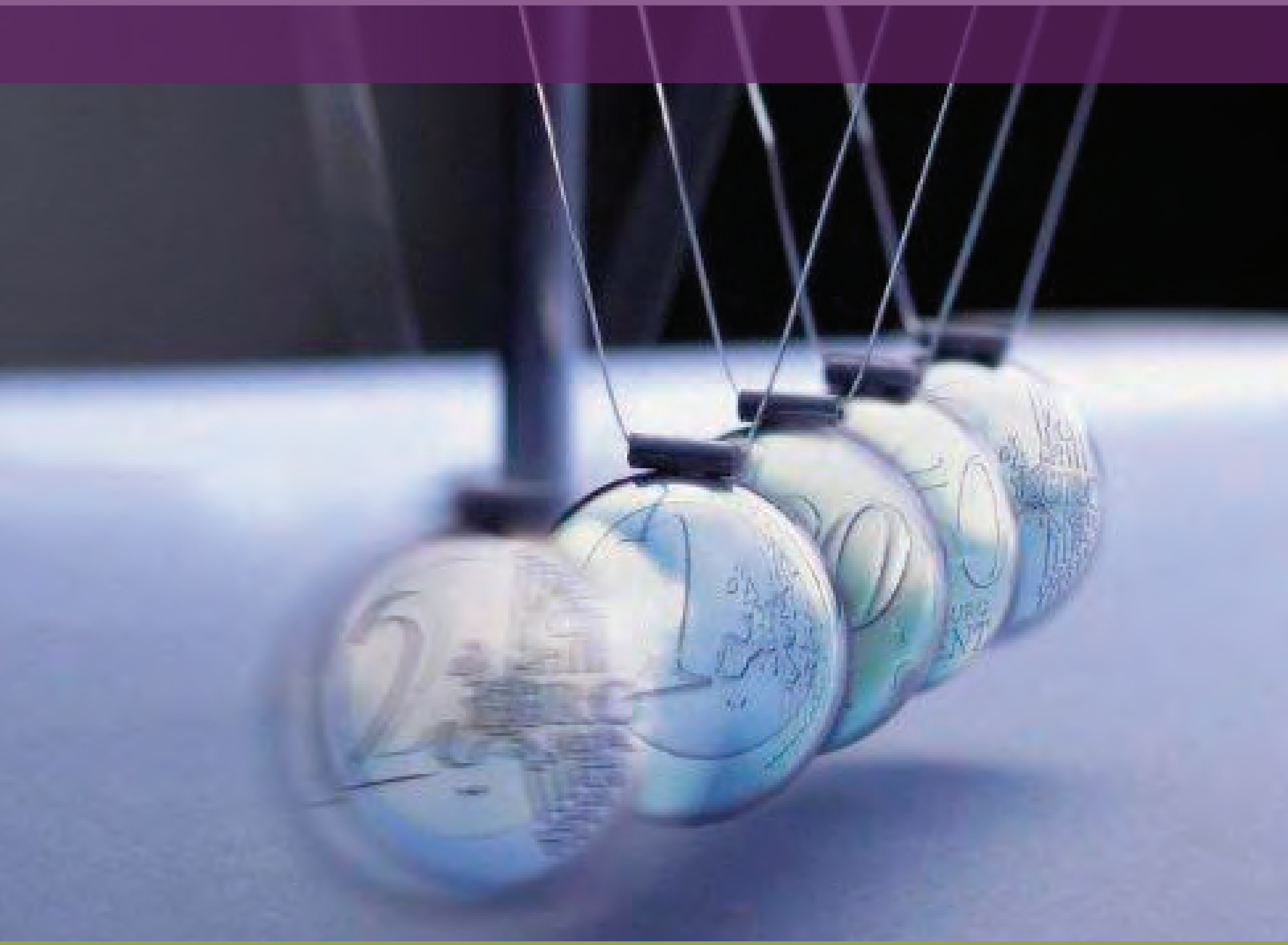
同報告書には、資産運用業の将来に対する多くの示唆が含まれており、また、同報告書の作成に際しては、当協会の一部の会員へのアンケートやインタビューの内容が反映されております。資産運用業に携わる方々にとって役立つものとなれば幸甚です。

以　上

create

Principal Global Investors

INVESTING IN A DEBT-FUELLED WORLD



As with previous reports in the Principal Global Investors/CREATE-Research annual series, our research relied on a global survey bolstered by structured interviews.

Over 700 asset managers, pension plans, pension consultants, fund distributors and fund administrators from 29 countries participated in the survey, with total assets under management (AUM) of US$27.4 trillion. The survey was followed by 100 interviews with senior executives from a cross-section of survey respondents. All the data presented in the report emanate from either the survey or the interviews.

Survey participants by geography and size of AUM

Australia
Austria
Belgium
Canada
China
Denmark
Finland
France
Germany
Hong Kong
India
Ireland
Italy
Japan
Kuwait
Luxembourg
Malaysia
Netherlands
Norway
Saudi Arabia
Singapore
South Africa
South Korea
Spain
Sweden
Switzerland
Taiwan
UK
US

AUM (US $ trillion)

27.4

Source: Principal Global Investors/CREATE-Research Survey 2013

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FOREWORD

Principal Global Investors is pleased to again partner with CREATE-Research in our fifth annual asset management research report. Professor Amin Rajan, chief executive of CREATE-Research, is one of the most respected commentators on the subject of asset management. This publication presents his most recent research on investing in today's debt-fuelled world.

Despite the notion that the global economy is running out of steam, neither Greece nor Germany exited the Economic and Monetary Union (EMU), and the euro did not implode; the Euro area is still holding together; calls for a US recession missed badly and the US Congress scaled the fiscal cliff; China's economy has not crash landed; local governments can still borrow; and US inflation is not raging.

But the recovery has been hard won and, in some cases, remains fragile. The quantitative easing programme of the US Federal Reserve, so spectacularly successful in the early years of the financial crisis, now looks to be a liability with interest rates affecting retiree savings and sapping purchasing power. The implications of low interest rates to Defined Benefit and Defined Contribution plans are evident. Add to that, the world's changing demographics due to aging populations and it adds up to a rapidly changing landscape. These challenging times open opportunities for combining the best of today's plans with new innovations in future pension products worldwide.

The net result is that global financial markets remain imbued with heavy uncertainty and many investors lack direction. This is evidenced in the findings in that the rising interest in real assets is the biggest change from last year's survey.

Against this backdrop, this year's research and resulting report seeks to address five critical questions, with the key findings contained in the report's Executive Summary:

- What policy actions are likely to be taken by governments on both sides of the Atlantic to reduce their spiralling debts in the wake of the 2008 global financial crisis?
- What secular shifts will be reshaping the investment landscape?
- How will they affect investor expectations worldwide?
- What approaches are likely to be adopted by investors of various stripes?
- What can asset managers do to help their clients to manage this transition?

We at Principal Global Investors recognize the need for state-of-the-art products that fit clients, beginning with the accumulation stage of investing and that seamlessly cross-over to decumulation as they enter the retirement phase of life. Given today's debt dynamic, we believe that it's never been more important to have a trusted investment partner, a long-term investment strategy and disciplined execution to help navigate these demanding times.

Jim McCaughan
CEO
Principal Global Investors

ACKNOWLEDGEMENTS

This report presents the results of the 2013 global survey in the annual research series started by Principal Global Investors and CREATE-Research in 2009. The details of the previous reports are given at the end of this report.

Each year, the survey topic has been chosen after consultations with thought leaders in the investment value chain around the world. This year, they wanted to know ***what investing means in today's debt-fuelled world.***

My foremost thanks go to 713 top executives from around the world who participated in our survey. One hundred of them were also involved in our post-survey interviews, providing the necessary depth, breadth, insights and foresight.

Many of them have provided unstinting support over the years towards creating an impartial research platform that is now widely used in all the fund markets around the world.

I would also like to thank Principal Global Investors, who has sponsored the publication of this report without influencing its findings in any way. This arms-length support has enabled us to identify all shades of opinion on the emerging challenges in global investment and the responses they require.

Finally, I would like to thank two colleagues: Lisa Rajan for managing the survey, conducting the data analysis and supervising the report preparation; and Dr Elizabeth Goodhew for editorial support.

After all the help I have received, if there are any errors and omissions in this report, I'm solely responsible.

Amin Rajan

Prof. Amin Rajan
Project Leader
CREATE-Research

CONTENTS

1 | EXECUTIVE SUMMARY

> “Past losses and ageing populations are driving investors away from conventional investing. Solutions alpha will be the most enduring legacy of the 2008 crash.”
>
> - AN INTERVIEW QUOTE

INTRODUCTION

The Eurozone has not broken up. America has not fallen off the fiscal cliff. China’s economy has not crash landed. The world has not suffered an oil spike. The dire predictions about the recent past have been confounded.

Markets have rallied due to receding worries as much as decisive action by central banks on both sides of the Atlantic.

The quantitative easing (QE) programme of the US Federal Reserve has reinforced the recovery and created some two million jobs out of five million since 2009.

Bold moves by the European Central Bank (ECB) have averted the demise of the Euro and given governments precious time to enact reforms to tackle the unsustainable levels of their debts.

The sentiment that the crisis may be over has itself served to ease it. Yet fear continues to lurk in the background, due to the exceptional market volatility sparked by the deleveraging now in progress.

Little is documented on the force of its undercurrents and their impact on investing in this decade. That is the main aim of this report.

This report addresses these five important questions:

- What policy actions are likely to be taken by governments on both sides of the Atlantic to reduce their spiralling debts in the wake of the 2008 global financial crisis?
- What secular shifts will be reshaping the investment landscape?
- How will they affect investor expectations worldwide?
- What approaches are likely to be adopted by investors of various stripes?
- What can asset managers do to help their clients to manage this transition?

The industry as a whole will have to adopt new time horizons and navigate shifting returns and yields. This will require new approaches and asset managers will need to help clients to adapt and advance.

Investors fear financial repression while deleveraging remains a slow-burn issue

The start of 2013 saw the return of the feel-good factor. Markets have rallied. The fear of another 2008-type meltdown has receded. But hopes of another 2009-type bounce remain slim. Despite a variety of policy actions on both sides of the Atlantic, progress on debt reduction will be slow and patchy.

In Europe, deleveraging will be led by low interest rates, rising inflation and austerity. The latter is already proving self-defeating. Most of Europe remains in recession.

By contrast, in the US, deleveraging will be led by economic growth, low interest rates and rising inflation. The economic recovery is already driving down the debt-to-gross domestic product (GDP) ratio in a positive chain reaction.

Yet the survey respondents remain guarded about the progress over the next three years: only 10% expect significant progress in Europe and only 29% expect significant progress in the US.

EXECUTIVE SUMMARY continued

Hence, questions persist. Will there be an accord on deficit reduction in the US? Will the Federal Reserve's exit strategy turn what is now a stabilising force into a destabilising force?

Likewise, will the ECB's actions merely prop up weak banks in the Eurozone? Will its member governments have the will to persist with unpopular measures against the populist tide?

Will the new leadership in China implement reforms, which improve the country's growth prospects and avoid asset bubbles?

Accordingly, politics, more than economics, will drive the markets. Investors are braced for market-moving events that may potentially result in big gains or big losses.

Investors are also worried about the revival of a long-forgotten phenomenon: financial repression. This is caused when central banks keep the rates artificially low for a long period of time in an effort to help governments finance their debts. It is feared that a combination of low rates and rising inflation will steadily vaporise public debt and erode the purchasing power of the underpinning assets.

Investors fear being on the losing side in this arbitrary redistribution of wealth that could last for at least 10 years, if history is any guide.

The pension promise will be rewritten

The pension promise was easy to make but hard to keep. It will be downsized.

In particular, the closure of Defined Benefits (DB) plans will accelerate in all the pension markets due to a double squeeze: low discount rates on the liability side and low returns on the asset side. Their persistent deficits require average annual returns in excess of 6.5% — a tall order by the standards of the last decade.

- Schemes will be closed to new members as well as to existing ones.
- Capital injections will become inevitable in order to retain plan solvency. In return, member benefits will be scaled back.
- Retirement age will continue to rise in line with life expectancy. Risk will be shared between sponsors and their employees, with the imminent rise of the Defined Ambition plans.
- In the private sector, the key aim will be progressive risk immunisation via liability driven investment (LDI).
- In the public sector, it will be capital growth, enabled by taxpayer backstops.

These changes will be accompanied by an unprecedented switch to Defined Contribution (DC) plans, which will hold the bulk of the global pension assets by the end of this decade.

Risk will be personalised.

Investors will lower their expectations about returns and pursue other goals

There is no free lunch with the quantitative easing (QE) programmes. They require exceptional foresight and luck.

QE programmes have stretched relative valuations in favour of risky assets to create the '*wealth effect*' that will boost the real economy, create new jobs and expand the price-earnings (P/E) multiples. The green shoots of this multiplier effect are more evident in the US than Europe. But opinions of those surveyed by this report differ:

- 40% of our respondents see QE as a tonic for reviving growth
- 35% see it as inflationary
- 25% see it as deflationary

These numbers mark an improvement over our 2012 survey results. But their message is clear — barring a sudden improvement, investors see themselves in a new era in which their expectations about growth, inflation and returns have to be reassessed.

Investors expect bond yields to remain low at least until 2015. Low yields can fuel equity markets. But they can also presage deflationary outcomes. In any event, equity valuations are expected to revert to their fundamentals, as successive rounds of QE generate diminishing outcomes.

High returns will no longer be the be-all and end-all. Investors will adopt eclectic approaches. Caution will prevail alongside opportunism. The chase for returns will prevail alongside the chase for other goals, for example: capital conservation, inflation protection and regular income.

Alpha will be in the eye of the beholder

The implied shift in pension risk from sponsors to employees will be marked, as will the convergence of the retail market and the retirement market in the West. Over the next five years, up to 75% of retail assets will be held by baby boomers born in the period 1945-1965. Many of them are not in DB plans.

Solutions will be in the eye of the beholder.

Both DC plan members and their retail peers will increasingly distinguish between '*product alpha*' and '*solutions alpha*.' Product alpha is about beating the markets, solutions alpha is about meeting investors' pre-defined needs. Solutions alpha will remain the epicentre of innovation.

Latest examples include LDI in the DB segment, life-cycle investing in the DC segment and advice-embedded investing in the mass market segment. A critical mass of early adopters is already there. Late adopters are not far behind.

Approximately 60% of the survey respondents expect further growth in each of these areas over the next three years.

Legacy assets will migrate towards solutions driven investing. The emerging trend will be as immutable as the momentum of a super tanker.

Today's peripherals will be tomorrow's mainstream.

Conventional investing will morph beyond recognition by the end of this decade.

> "We were selling cars in kit form. Baby boomers need assembled vehicles that get them from A to B, while pushing complexity under the bonnet."
>
> - AN INTERVIEW QUOTE

How asset managers help their clients navigate the transition will differentiate winners from losers

Personalisation of risk has a big downside. It transfers risk from those who couldn't manage it to those who don't understand it.

A lot is being done to improve financial literacy. But today's investing requires a degree of proficiency far in excess of what a typical investor can ever hope to attain. Asset managers need to make investors' worlds easier. Their product offerings need to embody advice mechanisms such that '*doing-nothing*' on the part of investors is itself financially savvy.

In addition three complementary actions that meet the challenges presented by deleveraging will be critical to those operating in the new financial landscape:

- They must develop new investment capabilities to help investors capitalise on the opportunities created by the debt dynamic (according to 67% of survey respondents)
- They must improve client engagement to better understand clients' needs, liabilities and risk tolerances (60%)
- They must improve the alignment of interest so they can deliver products that better fit the purpose within a value-for-money fee structure (45%)

Overall, deleveraging will leave a lasting impact. This is further developed in the eight themes that follow.

2 | REPORT SYNOPSIS

> The credit crisis has been a turning point. It is forcing changes that can benefit investors in the long run.
>
> - AN INTERVIEW QUOTE

OVERVIEW

The previous section provided the key findings from the research via five headline messages.

This section proceeds to provide a synopsis of this report through eight core themes.

They add further colour to the findings as well as provide the underpinning data.

THEME 1:

A catch-22 will characterise the dynamics of deleveraging

Since the 2008 crisis, financial markets around the world have been largely influenced by the debt crisis on both sides of the Atlantic. Macro considerations have overwhelmed micro factors.

The deleveraging now in progress in Europe and America is part of a bigger narrative that goes beyond cutting the public debt. When banking losses were socialised after the Lehman crisis, what started as a financial problem turned into a structural one. Big government deficits dented confidence and hit growth. The resulting cuts in public expenditure made matters worse.

Had growth been maintained at its average level between1990 and 2007, GDP would have been some 15% higher by 2013, as would the tax revenues. Austerity, or reforms of public finances, has proven to be self-defeating in the short-term. Yet, without them, investors fear financial repression.

So, governments will use a mix of five factors to drive down their debts (Figure 2.1). In Europe, the main thrust will be led by cuts in public spending, low interest rates and reform of public finances. In the US, it will be led by economic growth, low interest rates and rising inflation.

The fundamentals of the US economy look good due to a pick-up in the housing market, job market and energy production. With its budget deficit already on a downward path, it appears that the US economy may soon be reaching 'escape velocity.' It holds surprises on the upside.

After the 2008 crisis, emerging markets lifted the global economy. After the steep downturn in 2011, that locomotive role has fallen on the US. At around 2%, though, the economic growth in the US will not be stellar enough to make a big dent in its own budget deficit.

That the US managed to avoid a double-dip recession despite the political hiatus around the debt ceiling and 'fiscal cliff' speaks to its inherent resilience. That it has yet to produce a long-term plan to reform its finances speaks to its continuing political paralysis. Investors are unsure whether the current market rally can outlive central bank action.

In contrast, Europe will remain caught in a vicious cycle, triggered by two slow-burn issues: austerity and reforms. Both are taking their toll on growth, jobs and tax revenues. Only Germany, the Netherlands and Sweden have avoided them. Europe's will be a jagged recovery, fraught with policy errors and negative surprises.

The view from the survey is that the global economy will thus experience a two-speed recovery with Europe in the slow lane, and the US and emerging markets in the fast lane. Economic growth in the fast lane, however, will still be below historic averages. Countries like China, Taiwan and South Korea are maturing into developed economies, after a long period of double digit growth. Others like India and Brazil are running into structural barriers which require governance reform. As a result, key commodity suppliers like Australia and Canada will experience sub-par growth. The implied transition will not be easy, however, while their major markets — Europe and the US — continue to wrestle with deleveraging.

INTERVIEW QUOTES:

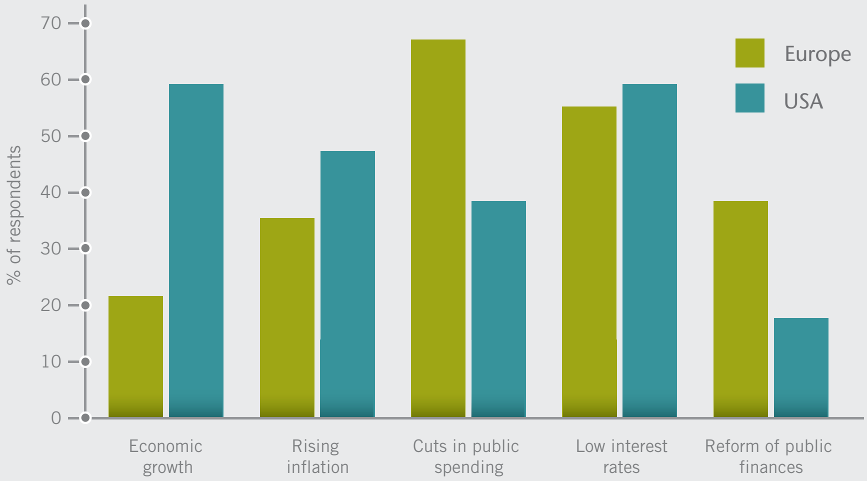
"Europe accounts for 7% of the world population, 25% of its output and 48% of its welfare expenditure."

"The US health care budget accounts for 18% of GDP, eight percentage points higher than the OECD average."

"Inflation is a polite way of reneging on promises made by governments."

FIGURE 2.1

Which avenues are most likely to be used by governments on both sides of the Atlantic to tackle their debt problems over the next 3 years?



Source: Principal Global Investors/CREATE-Research Survey 2013

When asked whether governments will be able to make significant progress in reducing their debts over the next three years, once again a trans-Atlantic divide emerged in our respondents' assessment.

Responses for Europe err on the side of pessimism:

- 12% 'Yes'
- 19% 'Maybe'
- 39% 'No'
- 30% 'Not sure'

Responses for the US err on the side of cautious optimism:

- 30% 'Yes'
- 23% 'Maybe'
- 18% 'No'
- 29% 'Not sure'

Behind these numbers lie a number of salient points.

First, it took 20 years to build up the excessive leverage that caused the 2008 crisis. It is too much to expect it to be rolled back within five years. The visceral populist anger against banks has made it ever harder to drive reforms that affect the general public. Elections, too, have gotten in the way of serious debates on spiralling welfare costs in the face of ageing populations. Even so, some progress has been made at the European Union's (EU) periphery: Greece, Ireland, Italy and Portugal.

Second, central bank action has prevented a global disaster. But it is no substitute for reform. Even before the crisis, demographic trends were having dramatic effects on health care, welfare budgets, labour markets and national competitiveness in all the Organization for Economic Co-operation and Development (OECD) countries. The pre-occupation with the financial crisis has diverted policy attention from the important to the urgent.

Third, central banks have their own detractors. The current QE programmes of the US Federal Reserve, Bank of England, Bank of Japan and Bank of Switzerland are the biggest monetary experiments in history, essentially journeys into the unknown. Their possible outcomes range from a big economic turnaround to a 10-year flat line.

They have already succeeded in their early intent: to stimulate demand for risky assets. Whether they will create a lasting '*wealth effect*' that ramps up growth and jobs remains an open question. The conventional monetary multipliers appear less potent.

The feel-good factor is returning. But fear will continue to lurk in the background until monetary stimulus is complemented by supply-side reforms in the West.

INTERVIEW QUOTES:

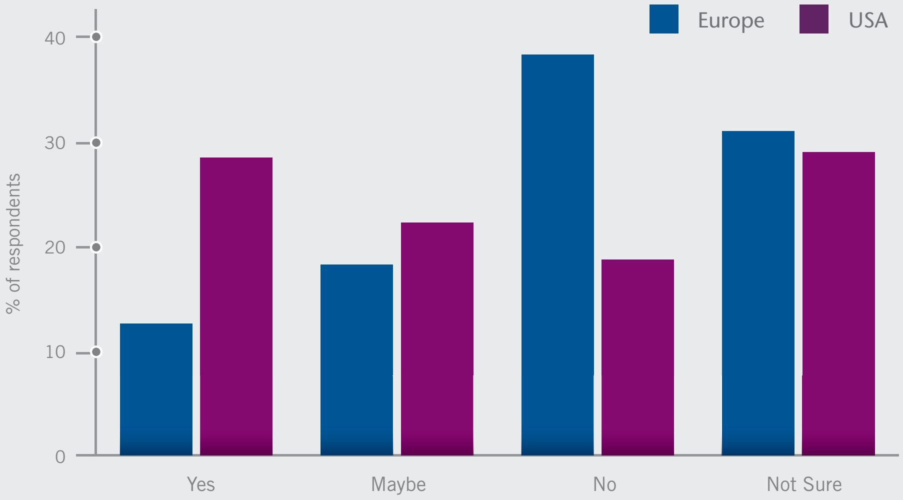
"Investors will continue to keep their powder dry until they see improvements in the real economy."

"Central banks don't have many bullets left in the gun. They've won time for governments. They've not won the game."

"Will politicians stop kicking the can down the road and adopt sensible deficit reduction plans?"

FIGURE 2.2

Do you expect governments on both sides of the Atlantic to make significant progress in reducing their debts over the next three years?



Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 2:

The 2008 crisis and ultra-low rates have proved the final straw for pension plans

A lethal mix of market losses, ultra-low interest rates, marked-to-market accounting rules and ageing populations has made DB plans ruinously expensive for their sponsors.

They are being closed to existing members as well as new members, as sponsors switch to DC plans. 63% of asset managers and 56% of pension plans in our survey expect the closure rate to accelerate.

By the end of this decade, DB plans may well be the preserve of the public sector. Even in rock-solid DB markets like Canada, Japan, the Netherlands and South Korea, the pension promises have been hard to honour.

Only 24% of all plans have a funding level in excess of 100% (Figure 2.3, left-hand chart). That figure was 40% in 2011, according to results of our 2011 survey. The drop reflects falling discount rates on the liabilities side and falling returns on the asset side.

The annual returns required for plans to stay open seem overly optimistic in the low-yield environment of this decade (right-hand chart): 81% of the plans require returns in excess of 5% and the remaining 19% require over 8%. These targets appear ambitious in the light of the actual outcomes in the last decade. In general, plans with higher deficits require higher returns. Hence, apart from closures, a number of one-off changes are in the pipeline.

In the private sector, they include discretionary indexation, an increase in the retirement age and higher member contributions.

In addition, corporate plan sponsors will be making cash injections to raise funding levels in order to minimise risk via LDI. Buyouts will remain the end-game in the private sector.

In the public sector, plans will continue to benchmark assets, not liabilities. They will dial up risk and/or extend the duration of their recovery plans, thanks to taxpayer backstops. Before long, however, public sector plans will feel the squeeze as well. They will be obliged to adopt a market-based discount rate for calculating their future liabilities. This is already happening in Japan, South Korea and the US

Overall, around 25% of all plans will be on an LDI trajectory by 2020. For very one plan that dials up risk, there will be another that will dial it down.

The DB landscape will change irrevocably.

INTERVIEW QUOTES:

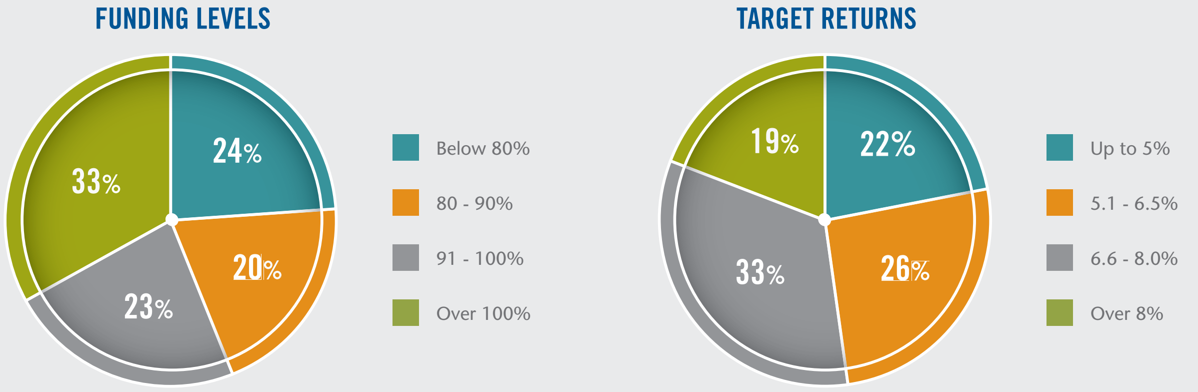
"Some state plans in the US have 60-year recovery periods, so low are their funding levels."

"In DB plans, the rate of inflows runs into single digits and the rate of outflows into double digits."

"It's very hard to get returns in excess of 5% without leverage or aggressive risk-taking."

FIGURE 2.3

What is the current funding level of your DB plan? What annual total returns on your assets would meet your long-term funding needs?



Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 3:

New diversification is targeting a multiplicity of goals in the DB space

In the face of unprecedented volatility and ultra-low yields since 2008, DB investors have been migrating from old style diversification that targeted returns to one that targets end-goals. The evolving approach seeks to minimise correlations at different market phases via dynamic investing.

The new approach has evolved from previous ones (Figure 2.4). In the 1990s, DB plans' asset allocation followed a formulaic path that favoured overweight positions in equities (box one).

After the losses in the 2000-2002 equity bear market, there was a significant switch to alternatives and exotic beta — the latter targeted new areas like commodities, forestry, currency and exchange-traded funds (ETF) (box two). But the losses in 2008, once again, led to another rethink.

So, by the beginning of this decade, three clear distinctions emerged in the portfolio (box three): between alpha and beta; between opportunistic investing and buy-and-hold investing; and between re-risking and smart-risking. While the first two distinctions had been evolving in the last decade, the third one came rapidly to the fore in this decade, when pension plans were left with three options to cut their deficits.

Options to Cut Deficits

The first option involves dialling up the risk by venturing further out on the risk curve in search of higher yielding assets. The second option involves getting more returns from existing risk budgets by using market indices to create non-cap-weighted smart beta to obtain cheap alpha. The third option involves going down the LDI route by hedging out unrewarded risks and using a variety of assets to enhance dedicated portfolio returns.

Going forward, a clear distinction has emerged between means (box three) and ends (box four). The ends include: capital growth, high income, regular cash flows, high liquidity and inflation protection. The numbers in the boxes are indicative and not definitive: they apply to large pension plans on both sides of the Atlantic.

Additionally, some plans also have a hedged portfolio to provide a glide path for the LDI, some make extensive use of smart beta and some use risk factors in asset allocation.

Early adopters of this outcome-oriented investing already exist in all the pension markets — in private and public sectors. Starting in Europe, the concept is already spreading to Canada and the US in the West, and Australia and Japan in the East.

INTERVIEW QUOTES:

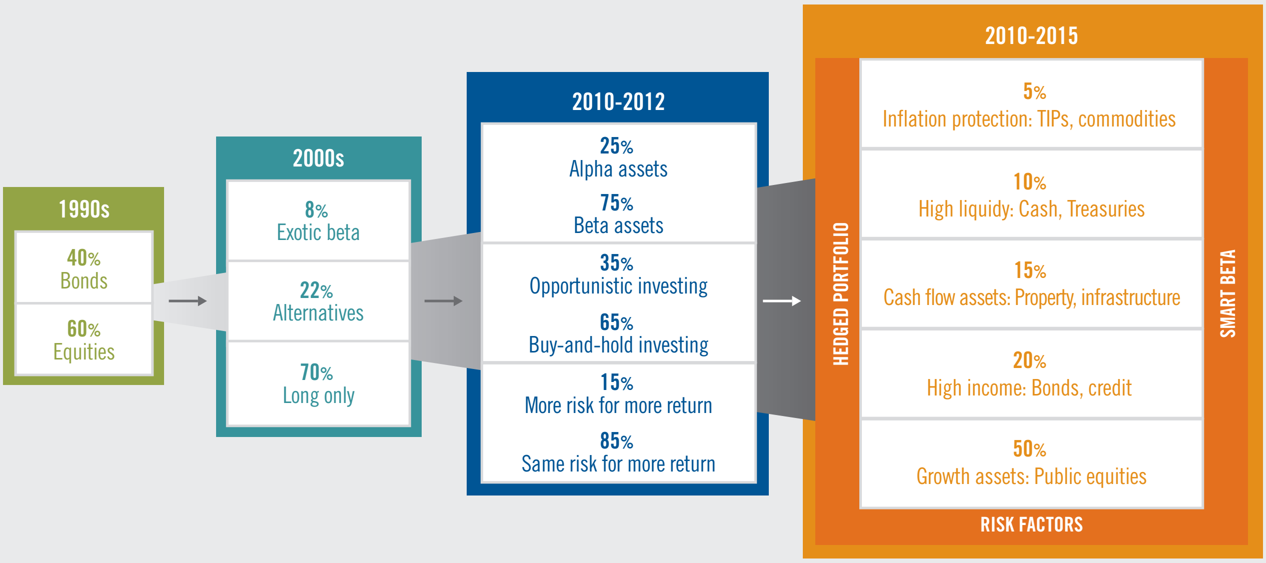
"Around 80% of our investments in equities rely on traditional indexed funds and smart beta."

"Investors prefer safety at the expense of returns due to the growing worries about the stability of the global financial system."

"As our liabilities mature, we need regular income and inflation protection to meet day-to-day needs."

FIGURE 2.4

How will DB plans go from static to dynamic allocation and from asset focus to liability matching over the next three years? (percentage of total assets)



Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 4:

Personalisation of risks is ushering in a new era for solutions alpha

In all the pension markets, governments are looking to reduce retirement benefits. Employers, too, are shedding spiralling pension liabilities to de-risk their balance sheets. Insurance companies are pulling out of the annuity markets due to low rates and rising life expectancy. Risk is being personalised. Individuals are being obliged to bear the brunt of all risks in retirement planning. They have to work longer, save more and spend less.

The emergence of solutions alpha is the flip side of this trend. It does not target market-beating returns, since they have proven elusive and expensive. Instead, it targets specific outcomes that meet investors' needs. It also aims to avoid the '*sequence of returns*' risk that can severely hurt retirement portfolios: after a big loss, the ability of the portfolio to catch-up during subsequent years is greatly diminished.

In the past, investors chased high returns in the belief that they would be enough to meet their eventual (often unquantified) retirement and other needs. This assumption only held in the raging bull market of the 1990s. Two punishing bear markets since then have fed risk aversion and solutions alpha in equal measures (Figure 2.5).

Starting with LDI in the DB space, it has spread to the other investor segments as well: for example, target date funds in the DC space and diversified income funds in the mass market space (Figure 2.5). In these and other cases, solutions alpha targets predefined outcomes mostly via beta, based on multi-asset classes and dynamic investing. It cuts across style boxes and asset classes, with embedded risk tools and distinct alpha sleeves in some cases. The complexity is kept under the bonnet.

In each market segment, the ranks of early adopters are growing. Ever more DB assets will migrate towards funds identified in the lower three boxes of Figure 2.5, aided by a combination of demographics, ultra-low rates and '*nudge economics*' that capitalise on investor foibles.

Even in BRIC economies, the main thrust of financial education will increasingly promote retirement planning via buy-and-hold investing. Chase for quick returns via momentum-driven investing has cost retail investors dearly. With the exception of India and Indonesia, ageing populations will continue to change investment approaches.

Solutions alpha will come of age.

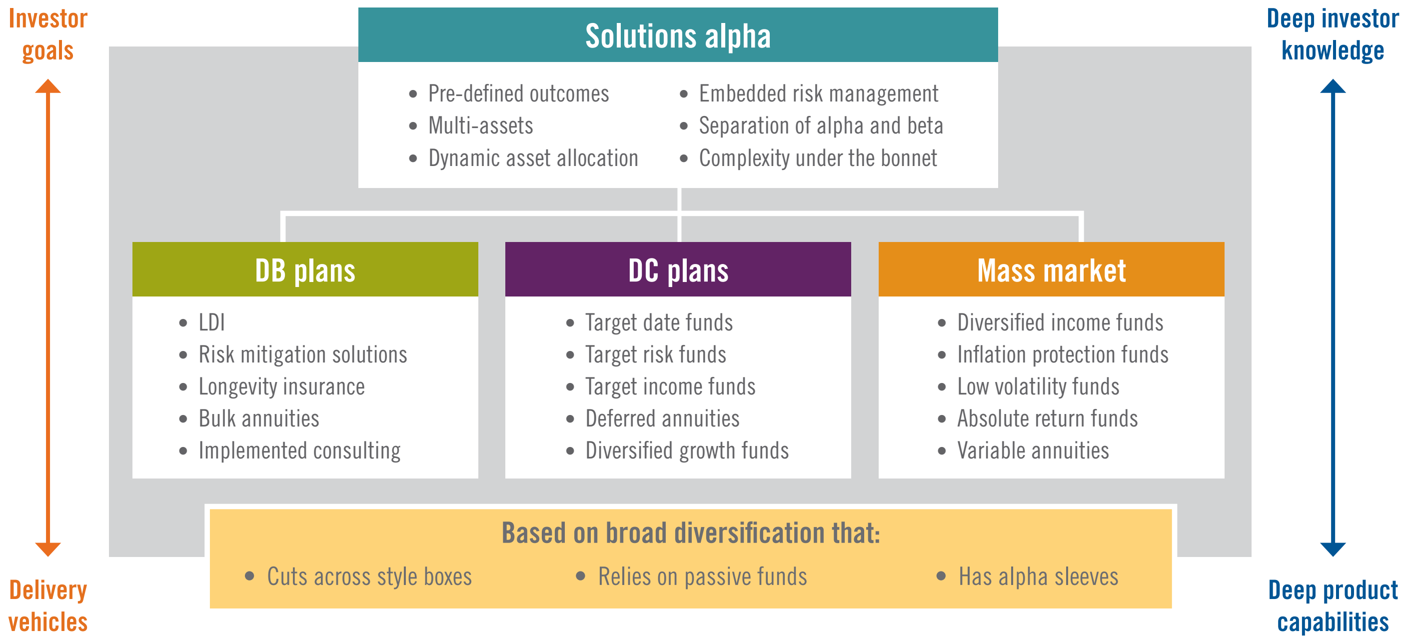
INTERVIEW QUOTES:

"Inflation is a phantom tax on retirees, when their nest eggs roll over into bonds."

"10,000 Americans and 14,000 Europeans are retiring every day."

"There's no place for beta jockeys dressed up as alpha managers. Investors have wised up."

FIGURE 2.5 What is solutions alpha and what form does it take with three core investor groups?



Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 5:

The next wave of innovation in the DC market will be the most ambitious yet

Today, global pension assets amount to circa US$30 trillion, of which the DC plans hold 43%. By the end of this decade, with the accelerated closures of DB plans, this share will exceed 60%.

There is a widely-held view that, instead of throwing the baby out with the bath water, there's a lot in the DB plans which can be incorporated into the next wave of DC products.

When asked to indicate the extent to which this has already happened (Figure 2.6), asset managers and pension plans responded as follows:

- 71% of asset managers and 58% of pension plans answered 'some extent'
- 40% of pension plans also answered 'not at all'

The desirable features include:

- Clarity about financial needs in retirement
- Higher and realistic contribution rates
- Seamless rollover of assets from the accumulation to the decumulation phase
- An LDI-lite facility which targets a retirement income benchmark from the outset
- Broad diversification which exploits risk premia from a variety of sources
- Dynamic asset allocation which exploits periodic pricing inefficiencies

Recent innovations have focused on life-cycle investing, which is gaining momentum in every DC market. They emulate some of the above features while closing the gap between the '*to*' retirement and '*through*' retirement phases.

Some plans are adopting the so-called '90-10-90' strategy: a minimum plan participation of 90% via auto-enrollment, a minimum 10% deferral rate via auto-escalation and minimum 90% of members invested in advice-embedded products, such as *target date funds*, with a pre-set glide path for asset allocation.

Some are changing the target date structure to provide guaranteed monthly income during retirement by replacing the traditional fixed income assets with a pool of unallocated deferred annuities.

Some plans are adopting the more ambitious concept of a *target income fund*. It shifts the emphasis from asset maximisation to liability matching based on five needs:

- Income
- Capital conservation
- Bequests
- Inflation protection
- Health care

It shifts attention from short-term returns to life-style planning. Not achieving the retirement goals will be their key measure of risk.

As in the DB market, so in the DC market, the early adopters of solutions driven investing are already there. Even in trustee-run markets, like Australia and the Netherlands, DC assets will be migrating as late adopters arrive on the scene. Early expression of interest is evident in Brazil, Hong Kong, Singapore and South Africa.

INTERVIEW QUOTES:

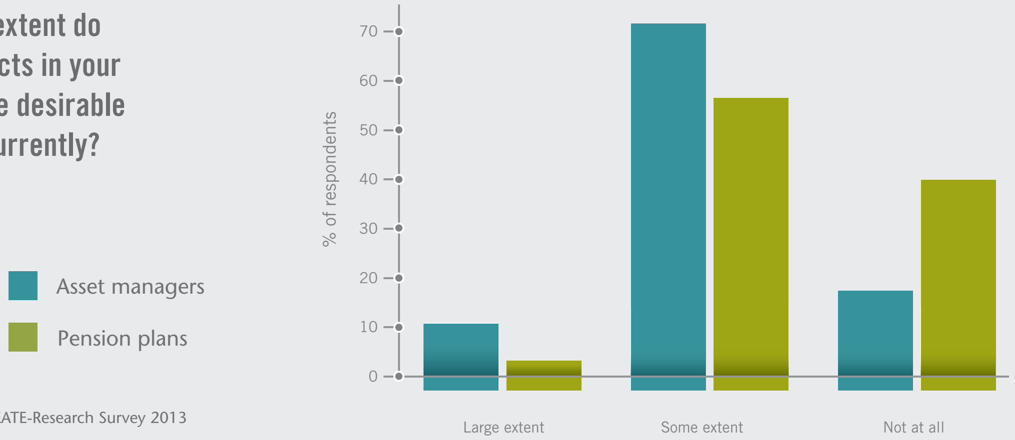
"Life-cycle funds will morph into a holistic product coalescing the 'to' retirement and 'through' retirement phases."

"Target income funds hold great promise for Australian investors."

"Without advice-embedded products DC plans will go the same way as DB plans."

FIGURE 2.6

On the whole, to what extent do the available DC products in your jurisdiction embody the desirable features of DB plans currently?



Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 6:

Equities, credit and real estate will remain attractive

Progress on political and economic fronts in the US is seen as vital for a sustained market recovery globally.

Solutions alpha will drive the undercurrents of investing by DB and DC investors. In the process, investors will draw a distinction between short-term opportunism and medium-term asset allocation (Figure 2.7).

Between 33% and 49% of our respondents expect DB investors to engage in opportunism via five asset classes: distressed debt, ETFs, high yield bonds, commodity funds and small cap equities (North-West box).

Between 44% and 56% also expect DB investors to engage in asset allocation via six asset classes: global equities, real estate, traditional indexed funds, emerging market equities, emerging market bonds and alternative credit (North-East box).

Clarity on policy issues will see expansion in earnings multiples for equities. More immediately, two asset classes are likely to attract big inflows as the search for yield intensifies: real estate and alternative credit (e.g. senior loans, commercial mortgages, and '*secondaries*' in private equities). These are viewed as '*cross over*' assets with bond-like features and equity-type returns.

Turning to DC investors, between 15% and 42% of respondents expect them to engage in opportunism via ETFs, actively managed funds, diversified growth funds, indexed funds and customised plans (South-West box).

For medium-term asset allocation, between 47% and 63% of respondents expect DC investors to engage in asset allocation via balanced funds, traditional indexed funds, target date retirement funds, actively managed funds and target income funds (South-East box). The weight of new money will go into three elements of life-cycle investing: target date funds, target income funds and target risk funds.

Both DB and DC investors see beta and cost as the main drivers of returns. ETFs are seen as low-cost liquid options, with the potential to deliver excess returns via smart beta.

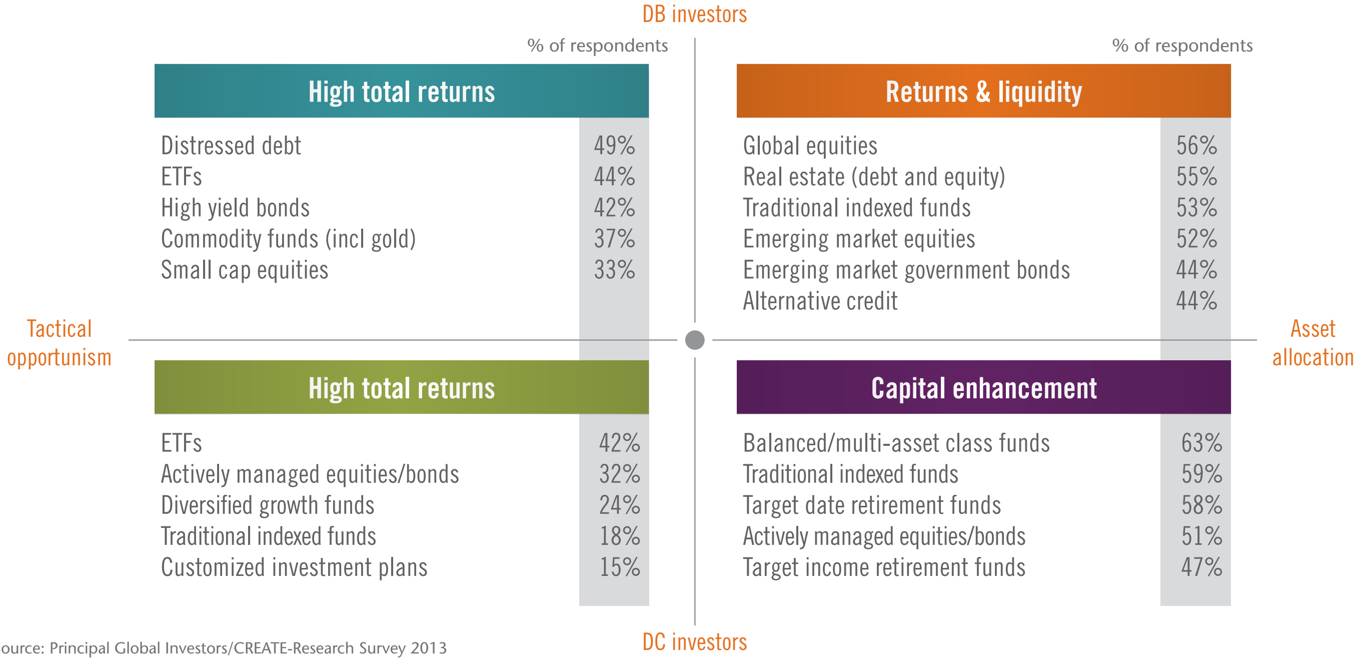
INTERVIEW QUOTES:

"Equities will be the prime beneficiaries of the central banks' most unusual financial experiment in history."

"Being claims on company profits, equities cannot diverge too much from the fortunes of the real economy."

"Interest in real assets and credit will grow at the expense of bonds."

FIGURE 2.7 **Which asset classes are pension investors likely to choose for short-term opportunism and for medium-term asset allocation?**



High total returns	% of respondents
Distressed debt	49%
ETFs	44%
High yield bonds	42%
Commodity funds (incl gold)	37%
Small cap equities	33%

Returns & liquidity	% of respondents
Global equities	56%
Real estate (debt and equity)	55%
Traditional indexed funds	53%
Emerging market equities	52%
Emerging market government bonds	44%
Alternative credit	44%

High total returns	
ETFs	42%
Actively managed equities/bonds	32%
Diversified growth funds	24%
Traditional indexed funds	18%
Customized investment plans	15%

Capital enhancement	
Balanced/multi-asset class funds	63%
Traditional indexed funds	59%
Target date retirement funds	58%
Actively managed equities/bonds	51%
Target income retirement funds	47%

Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 7:

Loss aversion in the West and search for high yield in the East will characterise mass market investing

In the West, over the next five years, up to 75% of retail assets will be held by baby boomers born during the period 1945-1965. The convergence between the mass market and the retirement market will accelerate. Retirees and near retirees are still nursing big losses from the last decade. On the bond side, too, the arithmetic of today's low yield sits uncomfortably alongside rising longevity. Low rates are driving up duration by stealth and hastening the move towards solutions alpha.

Between 36% and 48% of our respondents expect retail investors to become opportunistic via ETFs, theme funds and actively managed funds (North-West box in Figure 2.8).

Opportunism will be rife in emerging markets, as exemplified by the wealth management products in China. The search for high yield will be driving investors into such opaque products from the shadow banking system. They resemble the bonds that sliced and diced the sub-prime mortgages in the US pre-2007.

On the asset allocation side, between 50% and 65% of respondents expect retail investors to pursue funds with an income focus, active funds, indexed funds and capital protection funds (North-East box). Caution will remain the watchword for retail investors in the West.

Turning to high net worth individuals (HNWI), those in the East will chase absolute returns via opportunistic investing (South-West box), while their peers in the West will pursue a multiplicity of goals through a variety of asset classes (South-East box). The goals will include capital protection, capital growth, regular income, inflation protection and catastrophe avoidance.

For retail as well as HNWI, the migration towards solutions-driven investing will entail a growing use of passives, involving traditional indexed funds and ETFs.

There are, however, some concerns that the growing use of ETFs in particular will distort the price discovery mechanism, increase asset class correlations and conceal the divergence in their time-weighted returns and dollar-weighted returns.

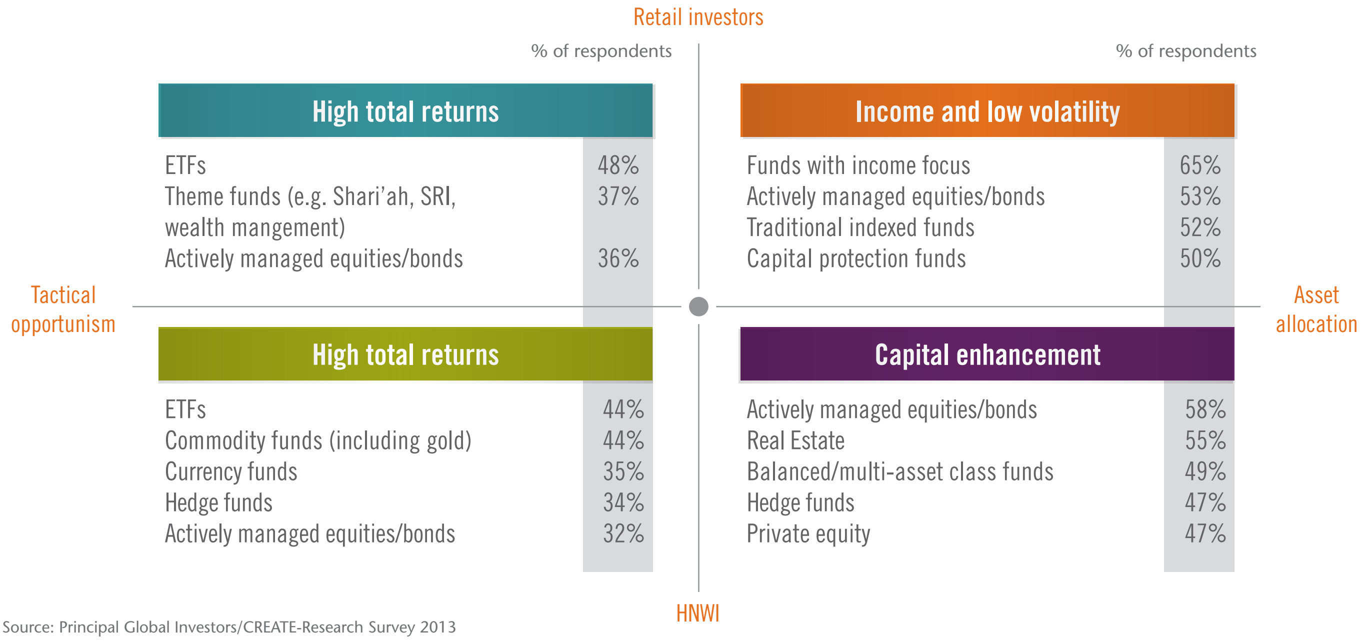
INTERVIEW QUOTES:

"If you can't stomach 30% volatility, don't invest in Chinese stocks."

"In Asia, there is a desperate hunt for yield akin to the one for sub-prime mortgage bonds before the 2008 crash."

"Most retail investors can't afford another 'lost decade.' They are not in DB schemes and risk outliving their savings."

FIGURE 2.8 Which asset classes are mass market investors likely to choose for short-term opportunism and for medium-term asset allocation?



High total returns	
ETFs	48%
Theme funds (e.g. Shari'ah, SRI, wealth mangement)	37%
Actively managed equities/bonds	36%

Income and low volatility	
Funds with income focus	65%
Actively managed equities/bonds	53%
Traditional indexed funds	52%
Capital protection funds	50%

High total returns	
ETFs	44%
Commodity funds (including gold)	44%
Currency funds	35%
Hedge funds	34%
Actively managed equities/bonds	32%

Capital enhancement	
Actively managed equities/bonds	58%
Real Estate	55%
Balanced/multi-asset class funds	49%
Hedge funds	47%
Private equity	47%

Source: Principal Global Investors/CREATE-Research Survey 2013

THEME 8:

Asset managers have to decouple marketing from thought leadership if they are to go from distant vendors to trusted advisors

Markets remain disconnected from their fundamental value drivers. Many see investing as a '*loser's game*': where the winner is not the one with the best strategy, but one who makes the fewest mistakes.

The scope for errors is large, especially when there is no consensus on the possible impact of the QE programmes. 35% of the participants in our post-survey interviews see them as delivering inflation. A further 30% see them as delivering deflation, as low yield promotes imprudence in public finance and undermines the viability of the finance sector. The remaining 35% see them as a motor for reviving growth and facilitating reforms.

Investors want asset managers to embrace solutions alpha and add value in three areas (Figure 2.9).

The first one centres on *investment capabilities*. Asset managers need to develop a deeper understanding of the debt dynamic, its hidden traps and its hidden opportunities. They also need to create opportunity sets in the credit space as banks withdraw from it under Basel III. Finally, they need to offer an integrated solution.

The second area centres on *client engagement*. Asset managers need to understand their clients' needs and risk tolerances. They need to avoid unrealistic claims about returns and manage client expectations of what can and can't be delivered in today's unusual environment. They should also solicit client feedback regularly and act on it.

The third area centres on *alignment of interest*. Asset managers need to promote co-investing, adopt meritocratic fees, avoid me-too products and offer proactive investment ideas. Above all, they need to upgrade their risk models.

Many of the current generation of risk models do not cope with extreme events, or with path dependency that allows returns in one period to influence those in the next, or with the effects of investors' own actions, or with risk factors that provide protection during market dislocation.

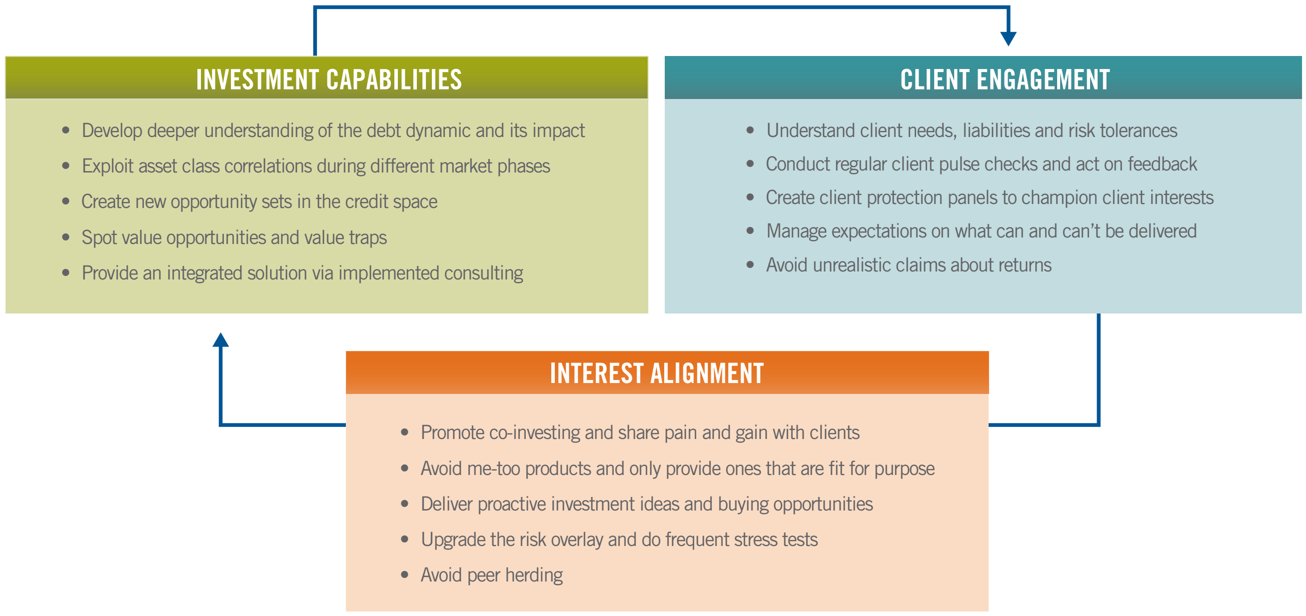
INTERVIEW QUOTES:

"Fundamental correlations will resume only when markets are driven by fundamentals."

"Asset managers' risk models need a big make over, as investors move towards risk-based diversification."

"Technology has improved our measurement of risk but not our understanding of it."

FIGURE 2.9 What do asset managers need to do to deliver solutions to their clients?



INVESTMENT CAPABILITIES

- Develop deeper understanding of the debt dynamic and its impact
- Exploit asset class correlations during different market phases
- Create new opportunity sets in the credit space
- Spot value opportunities and value traps
- Provide an integrated solution via implemented consulting

CLIENT ENGAGEMENT

- Understand client needs, liabilities and risk tolerances
- Conduct regular client pulse checks and act on feedback
- Create client protection panels to champion client interests
- Manage expectations on what can and can't be delivered
- Avoid unrealistic claims about returns

INTEREST ALIGNMENT

- Promote co-investing and share pain and gain with clients
- Avoid me-too products and only provide ones that are fit for purpose
- Deliver proactive investment ideas and buying opportunities
- Upgrade the risk overlay and do frequent stress tests
- Avoid peer herding

Source: Principal Global Investors/CREATE-Research Survey 2013

3 | PERSONALISATION OF RISK

> "People have to work longer, save more and spend less. The pension world will never be the same again."
>
> – AN INTERVIEW QUOTE

WHAT DO ASSET MANAGERS NEED TO DO TO FACILITATE THE SWITCH FROM DB TO DC?

OVERVIEW

In order to reduce their mounting debts, governments on both sides of the Atlantic are implementing a raft of policy measures, with QE as the centrepiece. They aim to stimulate growth on the one hand and promote deleveraging on the other. Either way, there are unintended side effects for DB as well as DC pension plans worldwide.

Against this background, this section pursues the following questions:

- What factors will drive capital markets over the next three years?
- How will the unfolding market dynamics affect DB plans?
- What actions are asset managers taking or will they take to ease the pressure on these plans?
- How are some of the positive features of DB plans being incorporated into DC plans?
- How is the asset industry being reshaped due to the personalisation of risk?

Research findings around each of these questions are presented in the following key findings under the appropriate headings.

Key Findings

MARKET DRIVERS

Market drivers can be categorized into two key clusters.

The first centres on the *policy action* designed to reboot growth in Europe and the US. It is expected to drive up the price of risky assets. Yet, stock markets will remain jittery because of fears that politicians on both sides of the Atlantic will yet again miss the window of opportunity created by the QE programmes to adopt the necessary reforms.

The second cluster centres on *ageing populations* and the *parallel shift* from DB to DC plans in the key pension markets. Their overall impact will be positive for fixed income and real assets.

Overall, investors can see positives on the horizon. But they fear renewed volatility on account of political inaction. They also fear inflation on account of excessive monetary creation by central banks. Worst of all, they fear financial repression. The QE programmes require exceptional foresight and luck. On their part, investors are being forced to lower their returns expectations and switch from products to solutions, from wants to needs.

IMPACT ON DB PLANS

The closure of DB plans will accelerate in virtually all the pension markets.

Their persistent deficits require average annual returns in excess of 6.5% — a benchmark that has proved elusive in the past ten years. Few hold out hopes of hitting it in the foreseeable future, without excessive leverage or risks. DB plans will continue to scale back member benefits and increase the retirement age.

Additionally, in the private sector, DB plans will continue to use unorthodox avenues to raise the funding levels as a prelude to a buyout (or transfer of the scheme's liabilities into the insurance market). In the public sector, some will be dialling up risk, while others will rely on taxpayer backstops.

ACTIONS BY ASSET MANAGERS

Asset managers can ease the pressure on DB plans by developing a deeper understanding of the debt dynamic, its hidden risk and its hidden opportunities. That means re-vamping their risk models in a number of crucial ways.

Furthermore, they can provide an integrated solution to asset allocation and manager selection, since many DB plans have neither the expertise nor the governance to cope with today's uncertainty.

Finally, asset managers can make step improvements in their client engagement models, so as to convey thought leadership ideas as well as manage expectations on what can and can't be delivered in the uncertain world of deleveraging.

UPGRADING DC PRODUCTS

DC products have come a long way since the Pension Protection Act 2006 in the US, which designated target date funds as a legitimate default option. Since then, the accelerated closures of DB plans have provided further impetus.

Some of the best features of DB plans are now being deployed into target date funds to ease the transition between the accumulation and the decumulation phases. These features also seek to improve retirement planning by enabling members to develop a better idea about their retirement needs and the contribution rates required over the lifetime of their plans. The result is the emergence of a single lifetime product that counters investors' behavioural biases and makes little demands on their financial literacy.

The DC landscape is set to change beyond recognition by the end of this decade.

PERSONALISATION OF RISK

Occurring against the backdrop of ageing populations, the switch from DB to DC plans has irrevocably put the onus of retirement planning on the individual. It has also sparked two waves of innovation that have unleashed enduring trends, like the course of a super tanker.

One relates to LDI and one to life-cycle products. Both will experience powerful tailwinds over the next three years.

> “Real interest rates will remain low for a long time. We are in a new era in which our expectations about growth, inflation and returns are being radically reassessed.”
>
> – AN INTERVIEW QUOTE

A diverse set of market drivers will pull investors in different directions

The global economy is back on track. Equities have rallied. But the crisis is not in the rear-view mirror — yet. Henceforth, a diverse range of factors will drive markets, creating both headwinds and tailwinds. They fall into three clusters (Figure 3.1).

Sovereign Debt

The first cluster centres on *sovereign debt* in Europe and the US. First, 65% of the survey respondents expect markets to remain jittery pending substantive progress on the debt front. Second, 65% expect the monetary stimulus from the QE programmes on both sides of the Atlantic to keep boosting the markets in risky assets. By driving interest rates down to super-low levels, the programmes are also seen as triggering a virtuous cycle that boosts investment in houses and jobs, while making it easier for households and governments to raise funding and pay off their debts. In the US, for example, the Federal Reserve has also been compensating for a tight fiscal policy by purchasing some 60% of 10-year Treasury notes since the 2008 crisis. Finally, 57% of respondents expect asset bubbles in the emerging markets, as the wall of money moves from West to East in search of higher returns. The overall impact of this cluster will be positive for risky assets — albeit with twists and turns from periodic political paralysis, as in the case of Cyprus in March 2013.

Demographics

The second cluster centres on *demographics*. First, 54% of respondents anticipate a continuing shift from DB plans to DC plans. The switch will also accelerate the adoption of LDI which seeks to immunise all unrewarded as well as rewarded risks. Second, 53% expect funding deficits to persist in the majority of DB plans worldwide. Those with a strong sponsor covenant will ramp up risk; those with a weak one will dial it down. Finally, 43% expect an ageing population dominated by the post-War baby boomers to affect the markets. For example, 10,000 Americans and 14,000 Europeans are now retiring every day, thereby reducing demand for risky investible assets in preference to the ones that deliver regular income, low volatility and inflation protection. This cluster is likely to have a positive impact on fixed income and real assets.

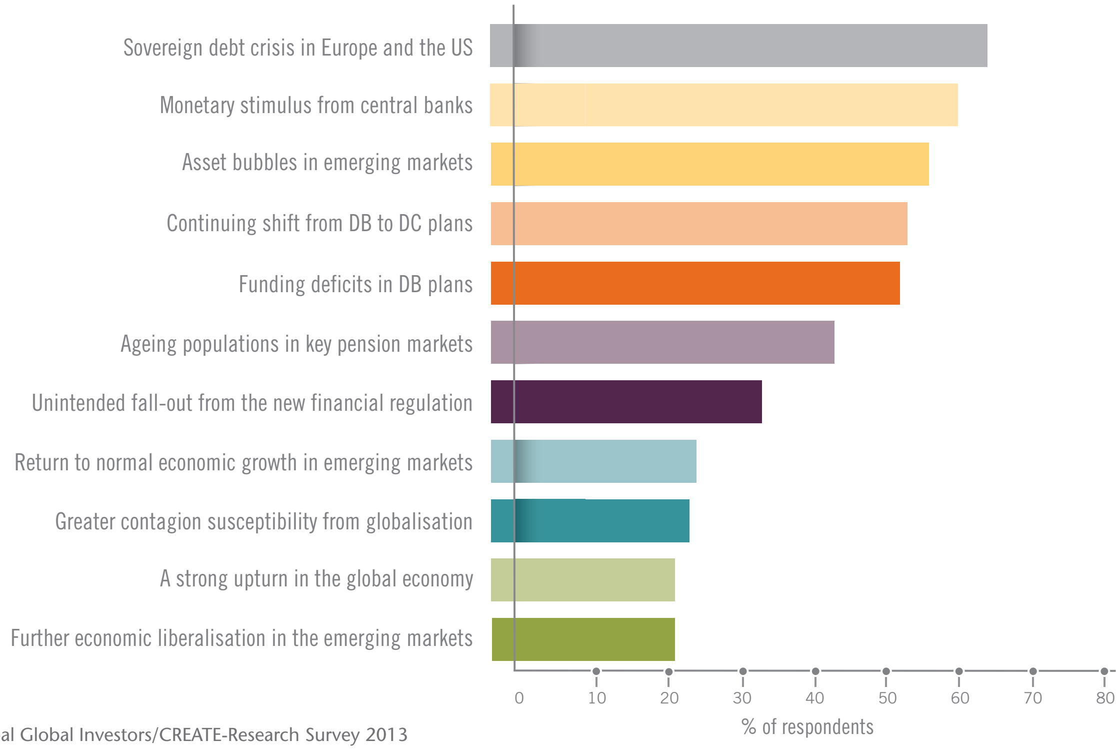
INTERVIEW QUOTES:

"There's a lot to worry about: everything from the US deficit to the future of the euro to China's economic growth."

"Corporate America has huge pent-up spending power and wealth creation potential."

"In the age of financial repression, there are no easy answers to the problem of capital protection, only difficult choices."

FIGURE 3.1 What factors would drive volatility in capital markets over the next 3 years?



Source: Principal Global Investors/CREATE-Research Survey 2013

65% expect the markets to remain jittery due to the debt crisis in Europe and the US

62% expect the actions by central banks to drive the markets

54% expect the shift from DB to DC to drive the markets

Regulation and Growth

The third cluster centres on three unrelated drivers, each capable of destabilising the markets from time to time. First, 34% of respondents expect unintended fall-out from the new financial regulations. Basel III will force the Western banks to hold higher sovereign debt in their core capital. Solvency II will go a step further and force insurance companies to hold capital buffers when investing in risky assets. The 'Volcker Rule' will harm liquidity and raise costs in the less traded bonds. Second, only 25% of respondents see the emerging economies resuming their normal growth path after the big 2011 hiccup. Finally, only 22% expect a strong global economy — traditionally a key source of tailwinds for risky assets.

Two recurring themes emerged in the post-survey interviews.

First, the QE programmes risk exposing investors to a prolonged era of financial repression, defined as a combination of low real yields which erode the purchasing power of their capital slowly but steadily while helping to vaporise public and private debt. In the past, such repressions have lasted anywhere from 10 to 35 years.

Second, there is plenty on the horizon that can send investors back into hiding: Europe's fragile banking system, the so-called sequester of spending cuts in the US, and the explosive growth of a shadow banking system in China, to name but a few. The tail-risks will be wagging the markets. The fear of another 2008-style collapse has subsided. Yet, the odds of another 2009-style bounce remain long, for now.

The feel-good factor is returning. But investors are not throwing caution to the wind. Fear continues to lurk in the background pending clarity on fiscal reforms in the West. Accordingly, different investor segments will display diverse behaviours in response to the identified market drivers.

INTERVIEW QUOTES:

"The US deficit in 2013 will be 5.3% of GDP, half the level in 2009. Prices are rising in almost half the housing markets."

"Inflation rarely fools investors unless it is unexpected. It is always discounted in interest rates."

"Expansion in P/E multiples will occur when we see concrete improvements in the real economy and fiscal reforms."

A VIEW FROM THE TOP...

All the dire predictions after the Lehman shock have not happened: the Eurozone has not broken up, America has not fallen over the fiscal cliff, China's economy has not crash landed and the world has not suffered an oil price spike. Markets have rallied due to disappearing worries as much as to positive news.

Decisive actions by the Fed in the US and the ECB in Europe have prevented a bad situation from getting worse. Indeed, we may well be turning a corner now.

In the US, the housing market, the job market and shale gas production are bright spots. Economic growth is below the long-run average of 3%. But fears of a double-dip recession have receded. No wonder the Dow and S&P 500 have hit pre-crisis highs — levels that can only be sustained if growth accelerates or Washington delivers the much-needed debt accord. For example, the health care system continues to account for 18% of GDP, eight percentage points higher than the OECD average. The US economy can surprise on the upside.

After a market slowdown in 2011, emerging economies, too, are back on track. Their current rate of 5.5% is below the past average. But countries like China, Indonesia, Singapore and Taiwan are moving into 7% territory. While their markets remain volatile, their fundamentals remain structurally sound, as shown by their increased currency reserves and low labour costs.

Europe, on the other hand, continues to muddle through with too many air pockets. While Germany, the Netherlands and Sweden have managed to avoid them, elsewhere the austerity programme is proving self-defeating. Spending cuts are inflicting a heavy drag on growth, jobs and tax revenues. Europe's will be a jagged recovery. The potential for policy errors is big. Negatives will keep cropping up — like the Cyprus banking crisis.

The global economy, thus, will experience a two-speed recovery, with the US and emerging markets in the fast lane and Europe in the slow lane. But three questions will continue to dog the markets: How long can central banks on both sides of the Atlantic keep rates so low as to help their governments to finance their debts? Will these central banks be able to unwind their massive balance sheets without fuelling big rises in inflation and interest rates? Will politicians stop kicking the can down the road and adopt coherent deficit reduction plans?

While there is reluctant acceptance that the Fed's QE is the least worst of all lousy options to reboot the global economy and financial markets, its end-game remains highly unpredictable. It can help investors. But it can hurt them, too.

– A GLOBAL ASSET MANAGER

The closure of DB plans worldwide will accelerate in the face of unsustainable deficits

The combination of two bear markets and marked-to-market accounting rules in the last decade has progressively made DB plans ruinously expensive for their sponsors.

As we saw in Figure 2.3 in the *Executive Summary*, only 33% of DB plans currently have a funding level in excess of 100%. In 11 major pension markets (including Canada, Ireland, Japan, the Netherlands, Scandinavia, the UK and the US), the deficit was 25% in 2012 compared with 4% 10 years earlier.

For example, companies in the S&P 500 Stock Index posted a deficit of circa US$610 billion at the end of 2012, sharply up from US$484 billion in the previous year. Despite rising markets since the crisis lows in 2008, many plans have gone nowhere due to the falling discount rates caused by QE in Europe and the US. Hence, plans are now obliged to adopt unrealistically high return targets.

As stated in the *Executive Summary*, just over 50% of plans target over 6.5% net of fees and charges. Not only is this well above what was achieved in the last decade, it is also optimistic when set alongside the projected return of between 4% and 6% for an average portfolio over the medium-term.

As a result, plan closures will accelerate in this decade (Figure 3.2). 63% of asset managers in the survey expect the pace to accelerate and 23% expect it to moderate. The corresponding figures for pension plans in the survey are 56% and 30%, respectively.

Of all the OECD countries, the UK has had the fastest rate of closures. Only 13% of plans are now open to new entrants and 20% are 'frozen' for current members. Even in Japan, with a culture of jobs-for-life, the pace of closures has accelerated. More notably, there and elsewhere, as the plans have closed, they have also moved into low-risk assets. The closure has been confined largely to private sector plans.

In marked contrast, in the face of rising deficits, public sector plans elsewhere in the West will continue to remain at the top end of the risk curve, as we shall see in Section 4 of this report. Apart from closures, a number of other one-off measures will continue to be taken over the next three years on two fronts: non-investment and investment.

Taking them in turn, retirement age and member contribution rates will continue to be raised by ever more plans. Benefits based on final year salary will be replaced by career average salary. Indexation will become discretionary. Hardwired as they are into job contracts, however, old entitlements will prove difficult to change.

INTERVIEW QUOTES:

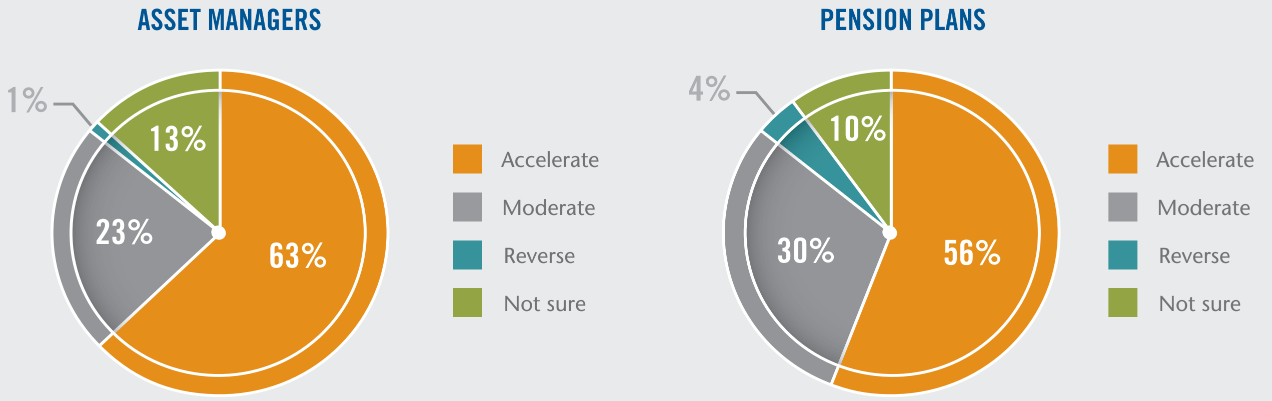
> *"Although markets have recovered from crisis lows, pension deficits have not improved due to low discount rates."*

> *"The EU's proposed Solvency II may well raise the deficits in DB plans in Europe by nearly US$550 billion."*

> *"The speed at which investment opportunities open and close is accelerating."*

FIGURE 3.2

What will happen to the pace of the switch from DB to DC plans in your jurisdiction in this decade?



Source: Principal Global Investors/CREATE-Research Survey 2013

63% of asset managers expect the closure of DB plans to accelerate

56% of pension plans expect the closure of DB plans to accelerate

30% of pension plans expect the pace of closure to moderate

On the investment front, new measures are being taken to change the interest rate assumptions that corporate plans use for calculating their liabilities. For example, in the US, instead of using recent rates, sponsors will be able to use a 25-year average of rates. Under federal law, this will shrink deficits for immediate funding purposes, without reducing long-term pension obligations.

Furthermore, in the US and Europe, corporates will continue issuing bonds at today's very low rates to bridge deficits and, in some cases, become fully-funded before buying bulk annuities for their members. For corporate DB plans, the end-game is in sight. Alongside LDI, plans are resorting to risk mitigation devices like longevity insurance, bulk annuities and implemented consulting.

Pressure is building up on public sector plans, too, notably in the US. Under the new rules from the Governmental Accounting Standard Board (GASB) in 2012, plans have to be more open about how they calculate their future obligations and also adopt much lower discount rates than the average of 7.5% used in the past 10 years. In the absence of cash injections from sponsors, this will drive them up the risk frontier.

Hence within the DB space, the responses to financial repression will vary by sector.

INTERVIEW QUOTES:

"Ever more plans are reviewing member benefits and retirement age."

"The median state pension plan in the US is 72% funded, down from 83% in 2007."

"Our foundation has floated a bond so as to buy Korean won to hedge against the Japanese yen to bridge its deficit."

A VIEW FROM THE TOP...

An ageing population and marked-to-market rules are together hastening the demise of private sector DB plans in Japan. Large companies are closing these plans to new members and shifting them to DC plans as has happened in other OECD countries over the past 10 years. With funding levels persisting at around 70%, some are even offloading the so-called substitution portion of their assets and liabilities to the giant public sector plan — Government Pension Investment Fund (GPIF), as permitted by the Daiko-Henjo ruling of the early 2000s.

Total pension assets in Japan amount to roughly US$3.5 trillion, with 97% in DB plans and the rest in DC plans. DB plans are dominated by the public sector, which accounts for nearly 70% of total assets after absorbing the liabilities of many private sector plans. It is in net draw-down phase now.

Japan has the fastest ageing population in the world. Around 25% are over 60. Yet, there is a dearth of retirement income products. The ones that are available cost too much: typically an upfront fee of 2% and a recurring fee of 1.25%. The returns are meagre. The money is invested in sovereign bonds in general and Japanese government bonds (JGBs) in particular. Their foreign investments were hit by currency fluctuations while the yen was riding high until recently. Notably, these income funds are allowed to eat into capital in periods when the returns are meagre. The new reality is that no nest egg is sacrosanct while yields remain so low. It has been forced on Japan because of our semi-permanent deflation due to bad business decisions and an ageing population.

Japan's companies have yet to deliver products that could unleash pent-up demand among the country's rank of wealthy retirees and pay higher wages to its shrinking and relatively poor youth. Some US$18 trillion — roughly three times the national income — of private savings are sitting in bank accounts earning 0.02% instead of being channelled into health care, nursing, tourism and leisure. A vicious cycle of contracting population and economic sclerosis has retarded innovation and productivity.

Without a growing economy, the pension promise is easy to make but hard to keep. The promise has to be rewritten. Societal expectations need to come down. At the same time, the asset industry needs to recalibrate its value proposition for retirees. With the closure of DB plans, retirees will emerge as the biggest investor group. They have the added worry that their hard earned savings will be eroded as the Bank of Japan doubles the amount of money in circulation over the next two years.

– A JAPANESE ASSET MANAGER

Asset managers who can find opportunities in the dynamics of deleveraging will be the biggest winners in this decade

The deleveraging now in progress in Europe and America is part of a bigger narrative that extends beyond cutting the debt. When banking losses were socialised after the Lehman crisis, what started as a financial problem turned into a structural one. If growth in Europe and the US had been maintained at its average level between 1990 and 2007, GDP would have been some 15% higher by 2013, with a bigger rise in tax revenues.

Hence, as we saw in the *Executive Summary* (Figure 2.1), governments are relying on a combination of five factors to drive the deleveraging process:

- Economic growth that increases revenues
- Rising inflation that increases the real value of debt
- Low interest rates that reduce the cost of servicing debt
- Austerity that reduces government borrowing
- Reform of public finances that enables nations to live within their means

The intent behind the QE programmes in Europe and the US is to accelerate the pace of the first three drivers (economic growth, rising inflation and low interest rates), so as to buy time for the last two (austerity and reform of public finances). However, all the political sound and fury around the ‘fiscal cliff’ and the Euro break-up, sparked by this dynamic since its inception, has side-lined the conventional investment wisdom on risk premia, diversification and risk-return trade-off. Investors feel stranded on shaky ground in uncharted territory. Their views on QE are divided.

According to the post-survey interviews, some 35% of the respondents see QE as delivering inflation and not much else. A further 25% see it as deflationary, as the associated low yield encourages imprudence on the part of governments and undermines the viability of the finance sector. The remaining 40% see it as a motor that can revive Western economies and improve the climate for sorely needed reforms in public finances.

Accordingly, when asked what asset managers can do to help their clients in these unusually unsettled times, the respondents’ views fell into two neat clusters (Figure 3.3).

Investment Capabilities

The first cluster centres on *investment capabilities*. First, 67% of the respondents want asset managers to develop a deeper understanding of the debt dynamic, its hidden risk and its hidden opportunities. Second, 49% want them to provide an integrated (implemented consulting) solution to asset allocation and manager

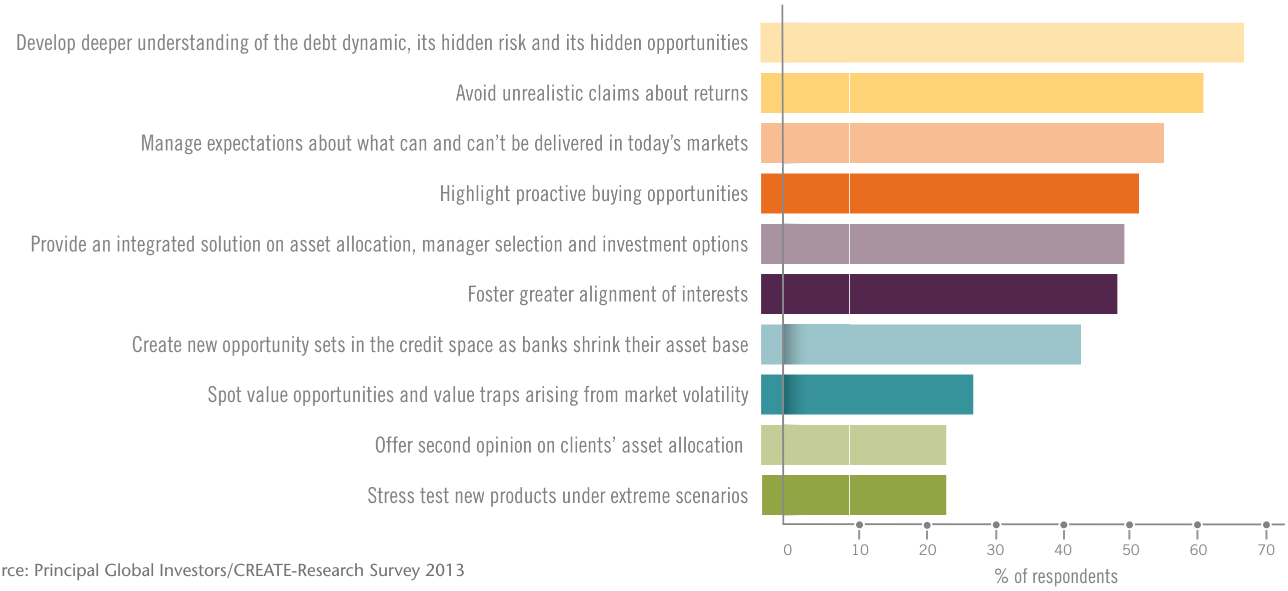
INTERVIEW QUOTES:

“It is impossible to deliver superior performance, unless you do something different from the rest.”

“Maximum benchmark relative returns or the top ranking in last quarter’s league tables should not be the goal.”

“Risk budgeting is an idea whose time has come. It requires a different mindset.”

FIGURE 3.3 How can asset managers help their DB clients to cope with the consequences of complex deleveraging and low interest rates?



Source: Principal Global Investors/CREATE-Research Survey 2013

67% cite a deeper understanding of the debt dynamic as important

61% cite avoidance of unrealistic claims about returns as important

55% cite managing client expectations as important

selection, since few pension plans have the skill sets and governance structures to cope in a prolonged era of volatility. This form of consulting — also known as fiduciary management — is taking off in Europe. Finally, 43% want them to create new opportunity sets in the credit space, as banks shrink their balance sheets when Basel III comes on stream.

Managing Client Expectations

The second cluster centres on client engagement. First, 61% want asset managers to avoid unrealistic claims about returns.

Second, 55% want them to manage their clients' expectations on what can and can't be delivered, while conventional investment assumptions have been over-powered by unpredictable macro events. Third, 51% want them to highlight proactive buying opportunities. Finally, 48% want them to foster greater alignment of interests via meritocratic fees and the avoidance of peer herding.

These clusters speak to two imperatives. First, asset managers need to place more emphasis on dynamic correlations between asset classes that are highly influenced by the state of market liquidity as much as their own perceptions of it. Fundamental correlation will resume only when markets are largely driven by fundamentals.

Second, to avoid the prospect of another 'lost decade', asset managers need to turn from distant vendors into trusted advisors of their clients. In the volatile markets since 2008, many good investment products have not survived the regular panic selling and buying. '*Wrong time*' risk has emerged like a bolt from the blue, only to be superseded by '*regret*' risk when markets recovered. Investors' herd instinct has cost them dearly.

INTERVIEW QUOTES:

"Asset managers have to decouple marketing from thought leadership. Clients value impartial assessment and advice."

"When asset class correlations are dictated by macro factors, risk-return numbers are observable, not exploitable."

"The fiduciary management market will grow at CAGR 20% as pension plans look for rounded expertise."

A VIEW FROM THE TOP...

Markets are now influenced more by 'noise' than 'signal' due to the debt crisis. The pool of AAA-rated government paper has contracted by 65% since 2007. There are now over 3,300 ETFs worth $1.5 trillion of assets, not only providing huge daily liquidity but also raising asset class correlations as trades move in tandem. Risk models based on the notions of risk-free assets and static correlations need a big makeover.

The 2008 global financial crisis showed all too clearly that these models are over-simplified and over-trusted. They've relied heavily on technology only to discover that it improved the measurement of risk but not our understanding of it. The models put more emphasis on returns than risk, on short-term than long-term, on normal distribution of returns than fat tails of returns and on marked-to-market measures than fundamental valuations. In all, they fail to capture two important factors that have had a disproportionate influence on returns in the recent past.

The first is path dependency. By not looking at risk in a multi-period context, the models ignored the fact that returns in any one period can be heavily influenced by returns in previous periods, when momentum is working.

The second factor is the Heisenberg Uncertainty Principle. In investment speak, it says that an investor's own actions and reactions themselves introduce new risks, as do the reactions of other investors as they weigh up each new situation. Investors have to lower their expectations of predictability and learn to cope with more randomness and more extreme events. It means plan less and prepare more.

Institutional investors are taking these messages on board. After the 2008 crash, there was a lot of willingness to buy tail-risk hedges with asymmetric pay-offs: for example, options, swaps and credit default swaps. This applied to those pension plans with derisking glide paths that exposed their funds to market risks for an extended period. Now, they are doubtful about the pay-off. Hedges impose a significant drag on performance.

The new pre-occupation is to secure the same protection with a risk-based diversification, in which assets are allocated on the basis of various risk factors (e.g. credit, liquidity, duration, inflation, equities). This is in contrast to the current practice in which assets are allocated mostly on the basis of their historical performance, irrespective of inherent risks. The new approach is being adopted in all the pension markets by around 40% of pension plans. They are creating pressures on asset managers to refine their own risk models and move towards a regime of risk-adjusted returns that factors in risks from a multiplicity of sources.

– A GLOBAL PENSION CONSULTANCY

Innovations are taking the best features of DB plans into DC plans

Currently, total pension assets worldwide amount to around US$30 trillion. Of this, 43% is held by DC pension plans compared with 35% in 2000. With the accelerated closures of the DB plans, this proportion is expected to exceed 60% by the end of this decade. That number has been already surpassed by Australia (82%), Hong Kong (78%), South Africa (73%), Brazil (66%), Switzerland (61%) and the US (61%).

A lethal mix of market losses, ultra-low interest rates, accounting changes and longer life spans has hastened the demise of DB plans. Yet, attempts are being made to salvage their best features and incorporate them into DC plans (Figure 3.4).

In this context, the survey respondents have identified six features: clarity on financial needs in retirement (cited by 56%), higher and realistic contribution rates (51%), a seamless rollover of assets from accumulation to decumulation phase (48%), a liability driven approach that targets a retirement income benchmark (47%), a broad diversification that exploits risk premia (44%) and dynamic asset allocation that exploits pricing inefficiencies (37%).

The 2012 CREATE-Research report, '*Market Volatility: Friend or Foe*', highlighted two related trends.

- First, in the face of low returns, investment approaches are becoming more diverse in the markets where DC plans are run by trustees (e.g. Australia, Brazil, Germany, Hong Kong and the Netherlands). This is driving the popularity of life-cycle investing.
- Second, the main thrust of this rise is driven by target date funds. Originating in the US, they are gaining traction in all the pension markets, at varying speeds and in different forms. Recent plan innovations deploy the best features of DB plans to close the gap between the '*to*' and '*through*' retirement phases.

Some DC plan sponsors are adopting the so-called '90-10-90' strategy: a minimum plan participation of 90% via

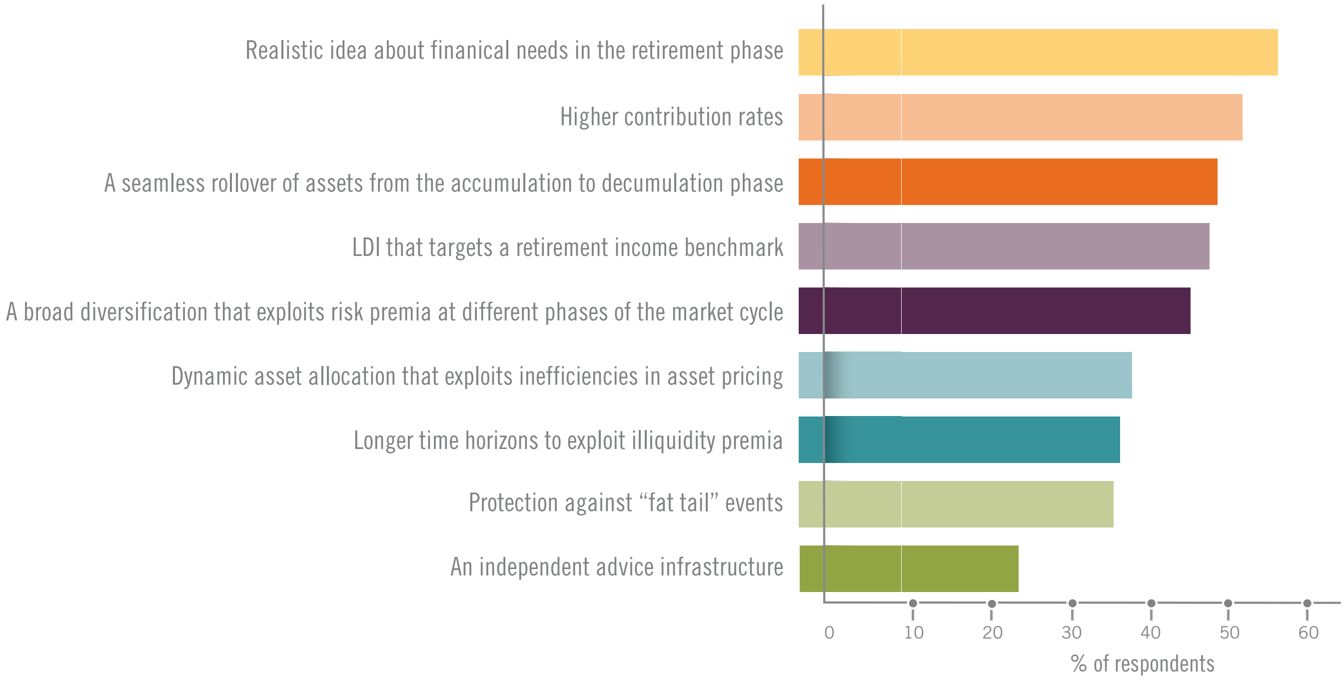
INTERVIEW QUOTES:

"Instead of throwing the baby out with the bath water, there's a lot in DB plans that can be retained."

"In the last decade, target date funds have taken off in America, holding over US$400 billion of assets currently."

"The switch from asset accumulation to income generation will characterise the pension markets in this decade."

FIGURE 3.4 Which of the positive features of DB plans can be emulated by DC plans as their share of global pension assets continues to rise in this decade?



Source: Principal Global Investors/CREATE-Research Survey 2013

56% cite realistic idea about retirement needs

51% cite higher contribution rates

48% cite a seamless rollover between accumulation and decumulation phases

auto-enrollment, a minimum 10% contribution rate via auto-escalation, and a minimum 90% of members invested in advice embedded products like target date funds with a pre-set glide path for asset allocation. This approach seeks to enhance the asset pot and offer various options on retirement.

Some asset managers are making a simple change in the target date structure to provide guaranteed monthly income throughout retirement by replacing the traditional fixed income asset class with a pool of unallocated deferred annuities. Starting at 3% at the outset, the annuity income allocation grows to around 55% nearer the target date.

Some managers are extending this approach around the more ambitious concept of target income fund, with a number of distinctive features. First, it shifts the focus from asset maximisation to liability matching, with a clear income benchmark (see the box). Second, it eschews peer-hugging and focuses on the retirement outcomes expressed in terms of income, inflation protection, health care and bequests. Third, it shifts the attention from short-term returns to overall lifestyle planning with mass-personalisation of advice. In Australia, for example, the superannuation funds measure risk as either performance versus peer funds or short-term variations in annual returns, with little downside protection in volatile markets.

Under the new approach, some 'supers' are developing pathways to annuity-type solutions with greater certainty. Not achieving the retirement income goal is the key measure of risk. This approach aims to be effective for members who are completely engaged as well as those who are not at all engaged on retirement matters.

INTERVIEW QUOTES:

"Plain vanilla DC funds short-change clients; as do the trustee-run plans based on a one-size-fits-all approach."

"Every challenge in retirement space brings an equal measure of opportunity. Innovation is the key. Outcomes are the new alpha."

"Today, DC plans are where DB plans were 10 years ago: focused on growing assets rather than matching liabilities."

A VIEW FROM THE TOP...

For DC investors, there is an implicit disconnect in the brand of target date funds. They are perceived as providing a path 'to' retirement as well as 'through' retirement. In reality, most investors cash out within three years after retiring, as these funds target an asset pot instead of a retirement income. It is like an aeroplane that takes off, crosses the ocean and finds that it has no landing gear as it get close to its destination. This is not to detract from their worth as an accumulation device. But we've discovered that they also lend themselves to innovation that enables them to incorporate a number of desirable features of a DB plan.

Our target income fund does just that. It has a liability benchmark expressed in terms of two outcomes that are meant to last over the retirement phase: sufficient income to maintain our clients' standard of living and inflation protection. Typically linked to the replacement ratio based on final year salary, the benchmark is also capable of accommodating health care needs and bequest aspirations.

It eschews a one-size-fits-all approach via a customised plan that integrates other known sources of retirement income like government benefits, DB plan entitlements, current plan balance and future contributions.

The underlying investment strategy has two goals: desired income and the minimisation of risk in achieving it. The latter is achieved by allocating a sufficient portion of a client's assets (plus future contributions) to an index-linked fixed income portfolio that is duration-matched as much as possible. The rest of the assets are managed to improve the estimated probability of achieving the desired income goals — with a dedicated sleeve for alpha. Once the estimated probability exceeds a predetermined level, assets are gradually shifted from equities to fixed income.

This LDI-lite approach is one way in which the target income approach seeks to mimic the best features of today's DB plans. There are others, too. It aims to provide inflation protection. It manages the estimated risk of failure to achieve the targeted goals and takes pre-emptive actions. It does not require members to make investment choices, nor does it expect them to be engaged or possess a high degree of financial literacy. Above all, as with a car, it leaves complexity under the bonnet.

Our target income fund has one over-riding merit. It aims to manage savings explicitly over a life-cycle rather than a defined period. All too often, the asset industry gets fixated on short-term or peer-based measures of performance without due regard to how today's assets can be converted into tomorrow's consumption.

– A US ASSET MANAGER

Personalisation of risk faces an Everest of a task without solutions-driven investing

In the OECD countries, governments are looking to reduce the cost of long-term retirement benefits. Employers, too, are de-risking their balance sheets by shedding volatile liabilities related to final-salary pensions. Insurance companies are pulling out of the annuity markets as low rates have hit their balance sheets. Risk is being personalised. Individuals are obliged to bear the brunt of four key risks in retirement planning: investment, inflation, interest rate and longevity. Countries such as Canada, Japan and the Netherlands remain rock solid DB markets. But even there, the winds of change are evident. Japan has started to roll back. The Netherlands, too, is restructuring (Section 4).

Everywhere, risk is being transferred from those who were unable to manage it to those who are ill-equipped to manage it. So, re-engineering the DC products is a welcome step in the right direction.

When asked what factors are likely to constrain the adoption of positive features of DB plans into DC plans, two constraints stood out (Figure 3.5): low financial education on the part of DC plan members (71%); and the restrictive governance structures and investment approaches under which they operate (48%).

Managing the key risks across one's working life brings with it a series of decisions with no cut and dried answers. So, financial education can help. But there is a big difference between financial education and investment education: one is about the basics of good financial housekeeping, the other about a deep expertise, acquired through training and years of practical experience.

Unsurprisingly, when asked to single out the actions that will minimise the identified constraints, three stood out (Figure 3.5): deliver outcomes that matter to investors (57%), implement solutions-driven investing (54%) and promote financial education (52%).They are inter-related. Just as a car requires its driver to acquire good basic motoring skills without understanding what's under the bonnet, the same

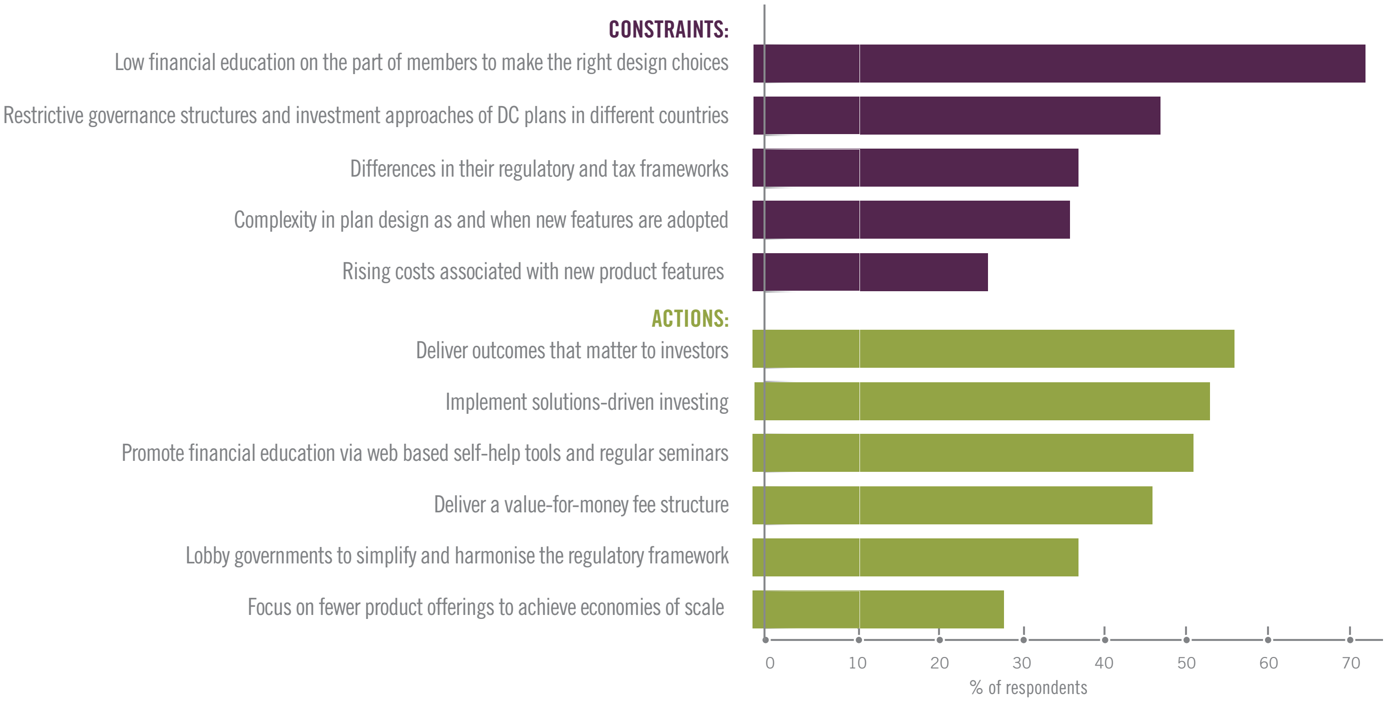
INTERVIEW QUOTES:

"Outliving their nest eggs is the number one concern of retirees."

"41% of retirees would like to leave an inheritance of some sort."

"Nearly 80% of investors are disengaged when it comes to retirement matters."

FIGURE 3.5 What factors are likely to constrain the adoption of the positive features of DB plans into DC plans worldwide and what actions can asset managers take to minimise them?



Source: Principal Global Investors/CREATE-Research Survey 2013

71% see low financial education as a constraint

57% see delivering relevant outcomes as a solution

54% see solutions-driven investing as an answer

with retirement planning. It requires a basic understanding of investing plus the ability to ask the right questions and seek the appropriate advice.

In fact, the emerging demographic paradigm already relies on a powerful mix of two ingredients: embedded solution and 'nudge' economics. The former customises the targeted long-term goals into an integral product feature. The latter uses behavioural tools to affect positive outcomes: as exemplified by auto-enrollment and auto-escalation that override investor inertia.

On the product side, the paradigm seeks to pinpoint the two sources of retirement income: via a new product at the point of retirement (as in target date funds) or via an investment option built into the retirement plan at the outset (as in target income funds). In the first case, retirement income is acquired by either stand-alone products like guaranteed annuities or by non-guaranteed managed pay-outs. Similarly, in the second case, retirement income is targeted either via integrated features like guaranteed deferred annuity or via non-guaranteed systematic withdrawal facilities.

Either way, the retirement market is stirring. Currently, the usage of guaranteed annuities is limited due to their high cost in a low-interest setting. Besides, few insurance companies anywhere have the balance sheets to support them in a volatile market of the recent past. However, interest is growing in variants of the old annuities — notably in Australia. To render them more attractive, some promise a capital refund after a set term and some offer inflation protection.

INTERVIEW QUOTES:

"Without solutions-driven investing, DC plans are on the road to nowhere."

"Life-cycle funds will go from peripheral to mainstream in all DC markets by 2015."

"The secret is to make a virtue of investors' behavioural biases and build practical design features into DC plans."

A VIEW FROM THE TOP...

The bulging baby boomer generation is on the cusp of retirement. Yet the majority of them only start to plan for it when they get close to the retirement date. Not only do they leave it late, the majority also aspire to retire when they are either 60 or 65, despite rising life expectancy. Evidence shows that only 14% of Australians are financially 'prepared' for retirement and 51% are 'somewhat prepared.' The remaining 35% of them are 'unprepared.' Only 30% seek financial advice. Welcome to Australia, the shining beacon in the DC world! The story is no different in other big DC markets. It's one of high expectations and low preparations.

Of course, better financial education can help. But there is a world of difference between financial education and investment education. The first is about basics like household budgets, compound interest, savings, investment and risk. The second is about market dynamics, liability matching, asset allocation, portfolio construction and manager selection.

In all Western societies, a lot is being done to improve financial education. Whereas it is necessary for investors to have it, it is not sufficient to enable them to make informed choices and deliver credible outcomes. Investing is complex and requires a degree of proficiency far in excess of what individual DC plan members can ever hope to possess. Their herd instinct is another major obstacle. History shows that they regularly turn the conventional investment wisdom, buy low-sell high, on its head.

The more practical alternative is to focus on making the investors' world easier: build default options into plan design so that the do-nothing option is itself financially literate. The personalisation of risk is creating a general sense of insecurity that has not been felt by previous generations of retirees. No wonder nearly 85% of our members remain in default options.

Of course, this does not denigrate the notion of investor empowerment. For example, the choice of opting out of the formal funds run by supers and setting up personalised savings vehicles has taken off in Australia. These self-managed super funds have grown by 94% in the last six years versus 45% growth in the retirement savings sector as a whole. Self-managed super funds now accounts for well over 30% of the assets of the superannuation system and meets the needs of 20% of members. The rest hope to muddle through.

Raising their level of financial education per se is unlikely to improve retirement planning, in the absence of products that embody solutions. Products with embedded advice are the way forward. We're at the dawn of a nascent revolution as our ageing populations hit the peak over the next 10 years when huge chunks of assets migrate into the draw-down phase.

– AN AUSTRALIAN SUPERANNUATION FUND

4 PENSION MARKET INVESTORS

> “QE is a high wire act. If it is rolled back abruptly, all asset classes, not just bonds, will suffer. If it continues for long, inflationary expectations will build up.”
>
> - AN INTERVIEW QUOTE

WHAT GOALS, STRATEGIES AND ASSET CLASSES WILL THEY PURSUE?

OVERVIEW

Section II outlined the forces that will be driving the switch from DB to DC plans in this decade. This section highlights the investment approaches that both DB plans and DC plans worldwide are likely to pursue in the transition. It addresses two specific questions:

- What goals, strategies and asset classes are *DB plans* likely to adopt over the next three years?
- What goals, strategies and asset classes are *DC plans* likely to adopt over the next three years?

Key Findings

DB PLANS

More than one in three DB plans will pursue one or more of four goals. In order of importance, they are: inflation protection, low volatility returns, capital protection and uncorrelated absolute returns.

In the process, they will pursue one or more of four strategies: asset-liability optimisation, LDI, smart beta using non-cap weighted indices and dynamic asset allocation.

The factors driving these goals and strategies include: record low interest rates, worries about the side effects of the QE programmes, market volatility, creeping inflation in some markets and weak sponsor covenants.

The investment choices in response to these factors will vary between private and public sector plans.

In the private sector, choices will be conditioned by the interaction of two factors: the funding levels and the strength of sponsor covenants, such that:

- Plans with good funding levels will adopt LDI glide paths with progressive derisking
- Plans with a strong sponsor covenant will re-risk and receive cash injections to get them on to an LDI glide path
- Plans with a weak covenant will adopt cautious choices and extend the duration of their recovery plans

In contrast, plans in the public sector are likely to dial up risk (English speaking countries) or go cautious (the Continent and Japan).

LDI will be the end-game in the private sector and asset maximisation in the public sector. Legacy assets will continue to migrate under the umbrella of LDI in the first case and risky assets in the second. As a result, a diversity of asset classes will be pursued — some via short-term opportunism to take advantage of periodic market dislocations and some via buy-and-hold investing to extract intrinsic value.

Demand for risky assets will co-exist alongside less risky assets.

There is recognition that risky assets are currently expensive. They have benefited from valuation differences between equities and bonds more than by the underlying earnings fundamentals. There is expectation that the latter may well improve, if the QE boosts the Western economies in general and the US in particular.

Finally, as part of a broad diversification, real assets and credit will attract bigger allocations, as will traditional indexed funds, ETFs and smart beta.

DC PLANS

At least one in four DC plans is likely to pursue one or more of four goals. In order of importance, they are: capital growth, inflation protection, capital protection and consistent low volatility returns.

These will be pursued via one or more of three strategies: dynamic asset allocation, traditional beta and smart beta.

The strategic mix also reflects two other likely trends. One is the prospective change in the legal nature of DC plans as they evolve into '*defined ambition*' plans in some countries. The second is the steady rise of life-cycle investing.

> **“Greed won’t go away. But it is tinged with a dose of rationality forced by the reality of poor performance numbers.”**
>
> - AN INTERVIEW QUOTE

As a result, a diversity of asset classes will be pursued, once again blending short-term opportunism with buy-and-hold investing. Alongside the traditional actively managed equities and bonds, investor demand will also include newly emerging balanced funds and life-cycle funds.

This snapshot conceals an enduring dynamic now in progress, as most active funds have struggled to out-perform the markets. Under it, these legacy funds are migrating in two directions: one is diversified growth funds; the other is life-cycle investing. In both cases, the transition increasingly relies on traditional indexed funds, ETFs and smart beta. As in the DB space, so in the DC space, legacy funds will continue to transition towards solutions-driven investing with clear end-goals, pursued via a broad palette of funds, backed by periodic rebalancing and embedded risk management techniques. The early adopters are already on the scene. The late adopters are coming into view too.

Solutions-driven investing is coming of age.

Investment goals of DB investors will be influenced by their sponsor support and funding levels

When the respondents were asked to identify the *goals* that DB plans will pursue over the next three years, four stood out: inflation protection (52%), low volatility returns (42%), capital protection (41%) and uncorrelated absolute returns (34%) (Figure 4.1).

Similarly, when asked to identify the *strategies* that DB plans will adopt, four stood out: asset liability optimisation (66%), LDI (64%), 'smart beta' using non-cap weighted indices (32%) and dynamic asset allocation (31%).

Post-survey interviews with pension plans drilled deeper into these numbers. It was clear that many of them have yet to recover from four blows suffered since 2008: the emergence of record low interest rates, inflating the future value of their liabilities; exceptional volatility, injecting undue fluctuations in the balance sheets of plan sponsors and their share prices; creeping inflation in some markets, reducing the real value of assets; and rising sponsor covenant risk, undermining plan solvency.

Many plans fear that the next five years may be no different due to the uncertainty around the unintended impact of the QE programmes. In particular, real interest rates may have to remain low for a long time to enable governments to meet their debt obligations. Whereas plans in private and public sectors share these worries, their strategies will be different in the immediate future.

In the private sector, the interaction of two factors will have a major impact: the level of funding — current assets as a proportion

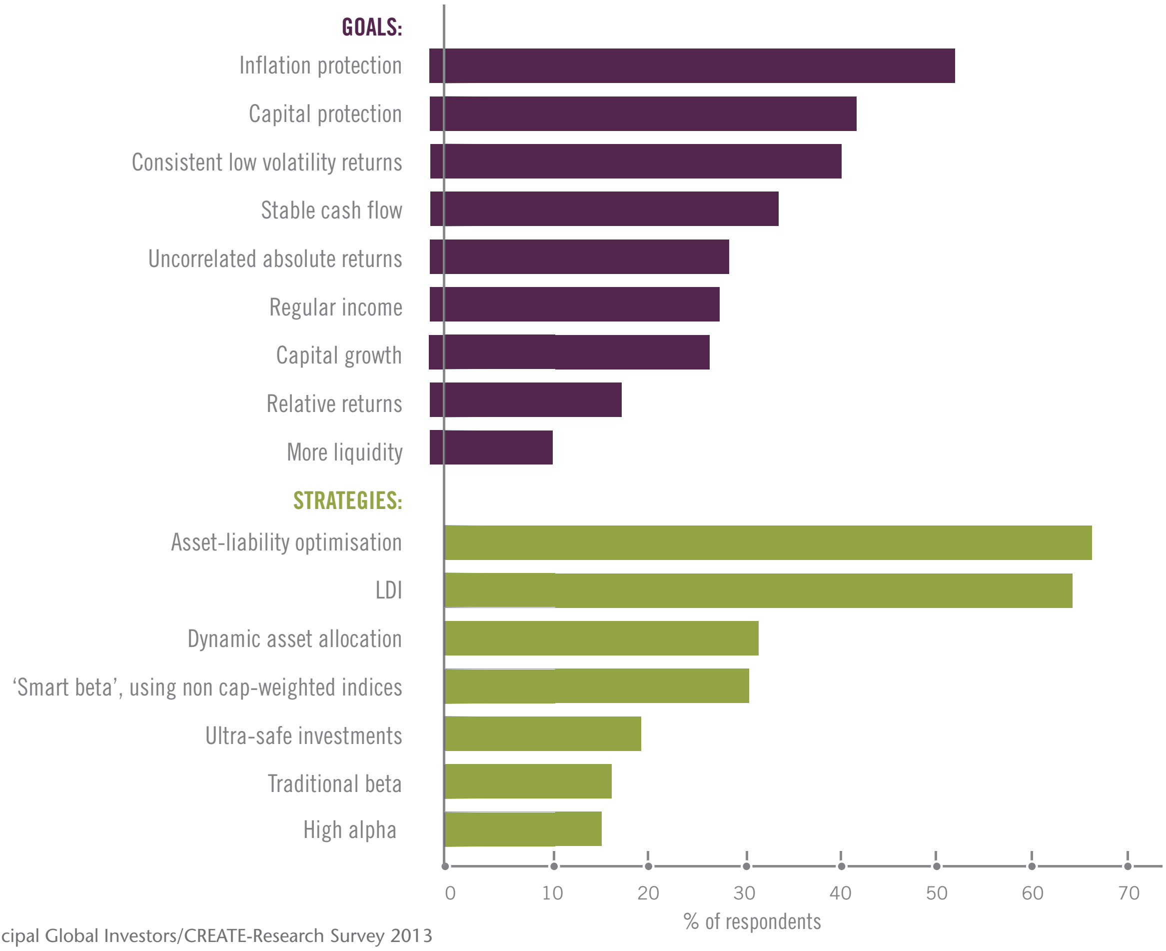
INTERVIEW QUOTES:

"In 13 markets, pension liabilities have grown by 113% since 1998, while assets have grown by 61%."

"Around 45% of private sector DB plans will be immunised by 2020, on the basis of the current profile of de-risking glide path."

"In 2012, inflation and interest rate hedges added US $7.5 billion to our results. Credit and equities added only US $2.2 billion."

FIGURE 4.1 What goals will DB investors pursue over the next 3 years and which strategies are they likely to adopt?



Source: Principal Global Investors/CREATE-Research Survey 2013

52% will pursue inflation protection

66% will adopt asset-liability optimisation

64% will implement LDI

of the present value of future liabilities — and the strength of sponsor covenant. For ease of analysis, plans are classified here into four funding groups.

Those plans with '*good*' funding levels (above 100%) have either adopted or will adopt LDI to fully immunise their portfolios. Their investment choices will be cautious.

Those plans with '*acceptable*' funding levels (between 91-100%) fall into two camps. Ones with a strong sponsor covenant will aim for partial and progressive immunisation, after one-off cash injections by sponsors. They will also dial up risk in their returns-enhancing portfolio. In contrast, those with a weak covenant will adopt cautious investment choices.

Similarly those plans with '*satisfactory*' funding levels (81-90%) will also be segmented along the same lines as the 'acceptable' group, with the strength of the covenant being the main differentiator.

Finally, in the fourth group, those plans with '*poor*' funding levels (below 80%) will adopt cautious investment choices and extend the duration of their liabilities.

Turning to the public sector plans, few outside the Netherlands and Scandinavia aim to adopt LDI. The plans in Canada, Ireland, the UK and the US will mostly dial up risk or extend their recovery periods; and plans in Japan will mimic the ones in the fourth group. With backstops from tax payers, they will continue to benchmark assets, not liabilities.

The upshot is clear: first, roughly 25% of all plans will be on an LDI trajectory by 2020; and second, for every one plan that dials up risk, there will be another that will dial it down.

INTERVIEW QUOTES:

"A quarter of Fortune 500 companies have frozen their plans. Their adoption of LDI has tripled to 60% since 2008."

"We will not do 100% LDI because we can earn money with money."

"Low yields can fuel equity markets. But they also appear to discount deflationary outcomes for Western economies."

A VIEW FROM THE TOP...

The current crisis has been the final straw for many plans in the private sector. Their deficits have been trending up since the beginning of the last decade. It is unlikely that a significant minority will be able to honour their pension promise. Amongst the rest, full immunisation is seen as the end-game and LDI the principal means.

A growing number are adopting a dynamic approach that sets a glide path that targets rising funding levels, with clear trigger points over time at which assets are progressively shifted from the growth portfolio to the hedging portfolio.

The hedging portfolio covers assets that correlate to liabilities, and provide duration, credit spread and liquidity. The growth portfolio, on the other hand, covers assets that offer liability 'plus' returns, low correlation and broad diversification. The latter is increasingly using smart beta strategies tilted towards minimum variance, value, momentum, quality and other factor risks.

As and when the funding levels improve due to good returns from the growth portfolio, an asset shift is triggered into the hedge portfolio, such that over time the latter reduces the duration curve and inflation risk, while ensuring that liquidity needs are met as the scheme matures. Some plans also use leverage in the hedging portfolio to spice up returns and achieve risk parity between the two portfolios. However, there remain three concerns about the LDI approach.

One is that estimating liabilities is an inexact science. Many plans have been obliged to raise the funding targets at every trigger point in their glide path, so as to protect against sovereign default or other counterparty risks in their hedging portfolio. Today, nobody knows what a fair price for the bonds of indebted nations is.

The other concern is about interest rates. At today's historically low rates, many see the next move as being upward. So the potential adopters of LDI are obliged to sit on the side-lines. However, just as many also fear that rates can go down and wreck their well-crafted glide paths.

The final concern is about the composition of the hedging portfolio. In the first generation of LDI programmes in the UK, it had mainly gilts or indexed-linked gilts. Over time, derivatives, swaps and then swaptions were added to the mix for reasons of costs and accuracy. But with falling yields and the Bank of England mopping up some 75% of the indexed-linked gilts in circulation under its QE programme, plans are obliged to move into other asset classes, like infrastructure, property and social housing. These may or may not deliver inflation protection or regular cash flow. Bonds with shorter maturity and higher credit quality are hard to find. We need other gilt-like instruments to help plans match their liabilities.

– A UK ASSET MANAGER

Equities will see expansion in price/earnings multiples once the debt-front gets the green light

Having identified the future goals of DB plans, the respondents went on to identify the asset classes likely to be chosen to meet them. In so doing, they drew a distinction between those that would be targeted for short-term opportunism and those for medium-term asset allocation (Figure 4.2).

For opportunism, six asset classes were singled out: distressed debt (49%), ETFs (44%), high yield bonds (42%), commodities including gold (37%), small-cap equities (33%) and currency funds (32%).

For asset allocation, a further six were identified: global equities (56%), real estate (55%), traditional indexed funds (53%), emerging market equities (52%), emerging market bonds (44%) and alternative credit (44%).

Post-survey interviews revealed the thinking behind these numbers.

First, the QE programmes have lifted all the risky asset classes recently in the belief that their multiplier effects will provide a second wind. This could result in an expansion in earnings multiples, if there is also debt accord in Europe and the US In any event, progress on the political and economic front in the US is seen as the vital for a sustained market recovery globally, given its economic weight. The cult of equities can return at an awesome speed. Pension plans that aim to re-risk believe that risky assets are already crowded trades at their current valuations. They are unlikely to be chased simply because they are the only game in town or because markets have now surpassed their 2007 peaks.

Second, those DB investors who are eyeing distressed debt, high yield bonds and emerging market bonds believe that these will

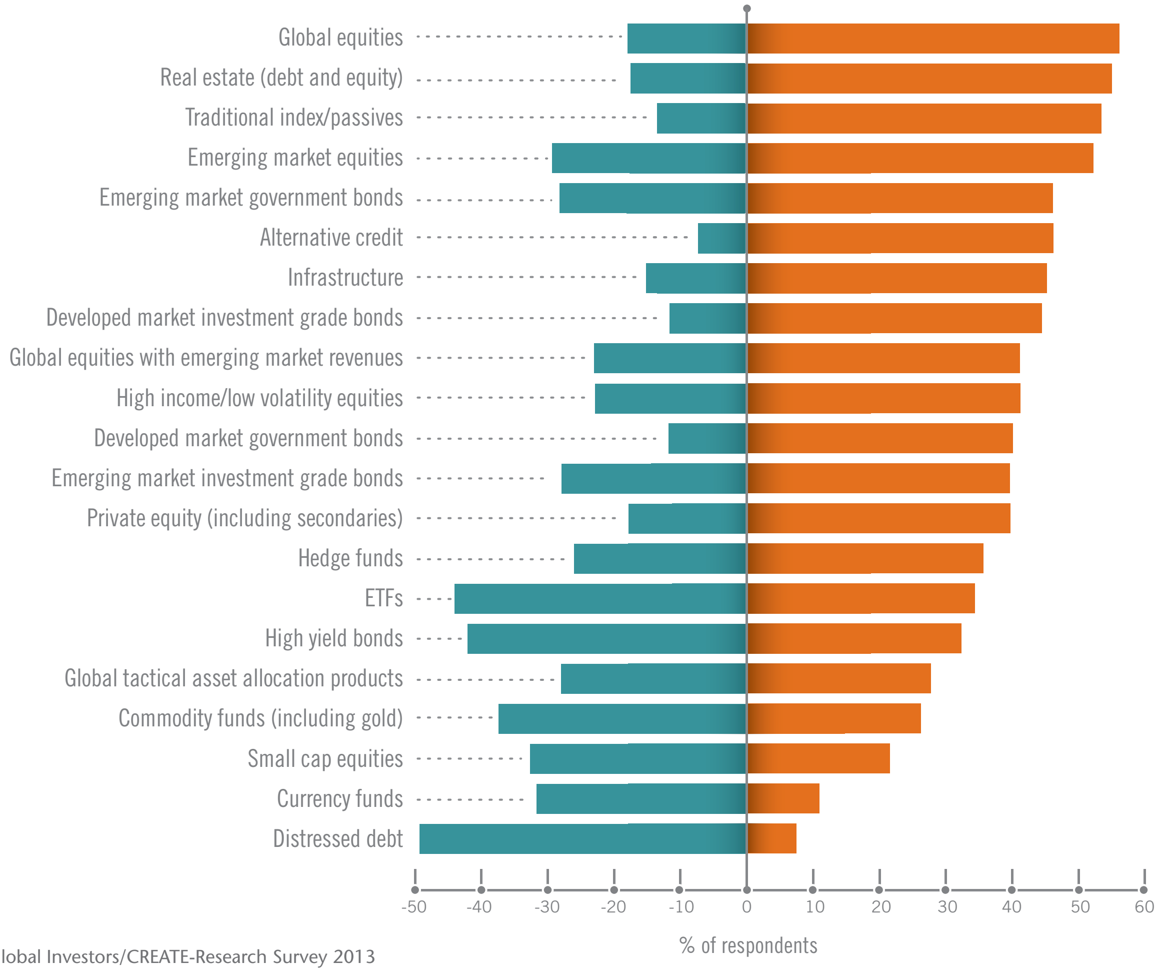
INTERVIEW QUOTES:

"The rich world's growth will be 1% in 2013, slightly up on 2012. America will pick up solidly. But Europe will remain flat."

"There's a better chance of being repaid by cash-rich companies than by national governments."

"Until we see an orderly unwinding of QE, gold remains attractive. The potential for nasty surprises is ever present."

FIGURE 4.2 Which asset classes and generic products are most likely to be chosen by DB investors for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation?



Source: Principal Global Investors/CREATE-Research Survey 2013

56% will invest in global equities

55% will invest in real estate

49% will invest in distressed debt

remain attractive as long as rates remain low and spreads do not narrow further. However, emerging market bonds will attract smaller flows due to recent over issuance and perceived low quality of covenants. This is in contrast to their status in the 2012 survey, which anticipated bigger in-flows.

Third, the demand for real assets — especially real estate, infrastructure, farm land — will continue to grow, as ever more pension plans overtly target inflation protection in their diversification. For example, some Canadian and Scandinavian plans have raised allocations to 25%. This rising interest in real assets is the single biggest change from last year's survey. As the price of inflation-linked bonds has sky-rocketed, pension plans are looking for substitute assets in their hedging portfolios yielding 4-6%.

Fourth, alternative credit will also attract rising interest as banks aim to beef up their tier-one capital with covered bonds and sovereign bonds ahead of Basel III. Instruments such as senior loans, collateralised loan obligations (CLO), subordinated corporate debt, commercial mortgages and '*secondaries*' in private equities will attract growing demand. Like real assets, alternative credit has one over-riding virtue: low correlation with traditional equities and bonds and high single digit yields. Indeed, real assets and alternative credit are now viewed as '*cross-over*' assets with bond-like features and equity-like returns.

Fifth, traditional indexed funds and ETFs will attract rising allocations, far higher than reported in our 2012 survey. Both are seen as avenues of low-cost market exposures. Both are also amenable to tilts towards specific risk factors within a smart beta framework (box below).

Finally, demand for developed market investment grade bonds and government bonds will persist, due to their diversification benefits or due to sponsors' preference for cautious choices.

INTERVIEW QUOTES:

"For every five active mandates that come up for renewal, three end up in passives or ETFs."

"Real assets provide all-weather protection. 43% of pension plans are now invested in them compared to 5% 10 years ago."

"As plans advance in their draw-down phase, they need to chase a number of outcomes other than good returns."

A VIEW FROM THE TOP...

Will the Fed derail the stock rally? Will it exit rapidly or gradually? Will it sell assets or hold them to maturity? Our main worry is that its path could easily turn what is now a stabilising factor into a destabilising factor. Hence, we pursue two competing goals: capital appreciation as well as capital preservation, via a broad diversification with periodic rebalancing and multiplicity of levers.

Our guiding beliefs strike a balance between alpha and beta. Increasingly we have resorted to beta investing by bringing it in-house. Around 80% of our investments in equities now rely on traditional index funds and smart beta. The cap-weighted indices are inefficient, owing to their embedded bias towards concentration and momentum. So, we tilt them towards factor premia like value, quality, low volatility and momentum. We also use the risk-parity approach, which has delivered a higher Sharpe-ratio at ultra-low cost.

We seek to improve our smart beta approach indirectly via implemented consulting. Under it, we have formed alliances with prominent specialist asset managers with a depth of expertise. We give them go-anywhere type mandates and have monthly review meetings in which we obtain cutting-edge market intelligence that is fed into our smart beta offering.

In the process, we seek to strike a balance between buy-and-hold investing and opportunistic investing, in order to exploit illiquidity premia on the one hand and short-term bargains on the other. Within this separation, complex strategies (e.g. private equity, hedge funds and real estate) are managed externally, while others are managed internally via smart beta or simple passives.

Overall, our diversification seeks to achieve five distinct outcomes: capital growth, high income, inflation protection, regular cash flow and high liquidity. Via regular rebalancing, our returns have improved markedly since 2008. Both over 10- or 20-year periods, returns have averaged around 8% per year.

But the deficit has not gone away. It will probably get worse due to the new accounting rules for calculating liabilities in the public sector in the US.

That's why the end-game of QE can have an important impact on our liabilities. Another reason is that we are equity-overweight and equity markets can reverse quickly, if they lose confidence in the Fed's ability to achieve a safe landing. Investors are braced for market-moving events that may potentially result in big losses or big opportunities. A broad diversification is vital.

– A US PUBLIC SECTOR PLAN

The DC space will remain the focal point of innovation

Section 3 highlighted the changes now in progress towards implementing some of the best features of DB plans into DC plans. It also underlined the rising interest in advice-embedded products in key markets like Australia and the US. Against that background, the survey respondents have identified the goals and strategies that DC investors are likely to pursue over the next three years (Figure 4.3).

Starting with goals, 50% cite capital growth, 33% cite inflation protection, 31% cite capital protection and 26% cite consistent low volatility returns.

For DC investors in Australia, Hong Kong, Singapore, South Africa and large segments of the US market, capital growth had always featured high. Elsewhere, investors had opted for cautious low volatility options like cash and government bonds — only to discover their obvious downsides in today's very low yield environment. In countries like Denmark and Germany, with strong reliance on insurance contracts, returns have been low and costs high. There and elsewhere, the winds of change are blowing in the direction of life-cycle investing. Plan trustees have accepted that they cannot control performance but they can control risks and costs via advice-embedded products in the whole area of life-cycle investing that takes into account members' risk appetite and retirement aspirations. In the UK, for example, the new state-sponsored DC plans have adopted target date funds as a default option along similar lines to the Pension Protection Act 2006 in the US.

Elsewhere a broad diversification is also likely to be pursued so as to target inflation protection and capital protection. This is clear

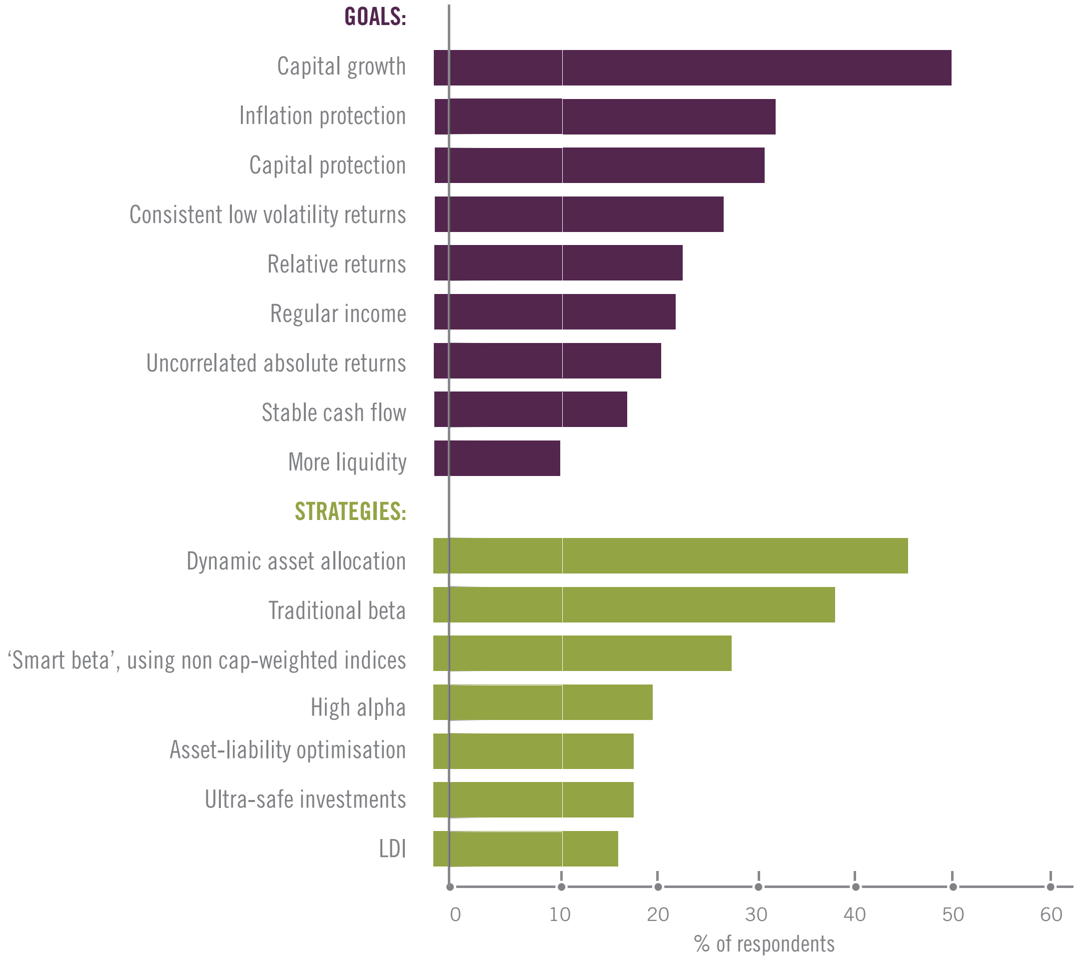
INTERVIEW QUOTES:

"DC plans have to diversify from the holy trinity of equities, bonds and cash, and go into alternatives."

"Our diversified income fund is nudged towards a guaranteed coupon rate."

"Trustee-based DC plans in Europe are too cautious. They protect the value of contributions without much upside."

FIGURE 4.3 What goals will DC investors pursue over the next 3 years and which strategies are they likely to adopt?



Source: Principal Global Investors/CREATE-Research Survey 2013

50% cite capital growth as a goal

30% cite inflation protection as a goal

45% cite dynamic asset allocation as a strategy

from the list of strategies that are likely to be pursued: dynamic asset allocation (45%), traditional beta (38%) and smart beta (26%). Dynamic allocation will be targeted via discretionary and non-discretionary rebalancing within vehicles such as multi-asset class funds, life-cycle funds or smart beta funds.

Post-survey interviews revealed two other points: one about the legal framework and one about investment approaches.

First, there is widespread acceptance that the current generation of DC plans in many countries are not fit for purpose. Yet, they are here to stay. Over time, they may well morph into the so-called '*defined ambition*' plans: an amalgam of DB and DC that delivers a more equitable sharing of risks between employers and employees (box below). The Dutch are leading the way and Canada and the UK may follow suit. This is also seen as a device to slow down the demise of DB plans. They amount to rewriting the pension promise by downsizing it.

Second there is ample recognition that DC investors need an intelligent approach to risk that can deliver better outcomes on the one hand and minimise investor foibles on the other. Advice-embedded products in general and life-cycle funds in particular are gaining momentum.

INTERVIEW QUOTES:

"We can't keep the pension promise. So, we have to rewrite it."

"The magical age of 65 has to go. But politicians have to tread a minefield to change public opinion."

"As markets evolve, the DC scheme will evolve into a different animal than it is today."

A VIEW FROM THE TOP...

The Dutch pension system is held up as the strongest in the world. Yet, this year, its pension plans are obliged to do something unprecedented: decrease pension benefits by 0.5% -7% for millions of retirees. The main reasons are very low discount rates due to the Euro crisis and the rising longevity of pensioners.

In 2007, our coverage ratio was over 140%, today it has sunk below 100%. Under the Pensions Act 2007, we have to discount our liabilities by a rate that reflects market rates, which are now at their lowest in centuries. Given the state of the economies on both sides of the Atlantic, we do not see the rates rising over the next three years. Our pension system, as a result, is in the midst of a big change in two respects.

The introduction of 'Defined Ambition' pensions is one of them. It is best described as a compromise pension that sits between a pure DB scheme and a pure DC scheme. Three versions of it are under discussion. The first version is a cash balance scheme under which the employer guarantees a fixed pension pot on retirement and the employee deals with the uncertainty of how much retirement income the pot will buy. The second version pays a guaranteed pension income, with the proviso that the retirement date can change, if life expectancy rises again. The third version gives younger employees an estimate of what their retirement income will be, with the range being progressively narrowed on approach to retirement. All three versions seek a compromise between DB and DC plans with risks shared equally between employers and employees.

The first version is the one most likely to be adopted, with soft rather than hard guarantees. The employer will 'promise' to target a specific pension income based on average career salary on the condition that the employer contribution will not have to be raised in order to achieve this. As an aside, Canada, too, is considering a similar option under the heading of 'target benefits' plan. More generally, the retirement age in the Netherlands is being raised in the state pension scheme in 2014 and will be linked to life expectancy thereafter. This measure will be adopted by other countries before long.

The second aspect of change in the Netherlands is the introduction of the Premium Pension Institution (PPI), a fully transparent low-cost pure DC vehicle that can be used on a cross-border basis under the European Institutions for Occupational Retirement Provision directive. As in the UK and US, it provides no guarantees. But the employer has to exercise a duty of care towards plan participants by providing life-cycle funds as the default option.

For an established DB plan like ours, these proposals are essential although there are bound to be various transitional problems. If the current low interest rates become a way of life, as seems likely, our move towards the defined ambition scheme will accelerate. This is especially so, since the adoption of Solvency II has reduced our ability to invest in risky assets without capital buffers. Over 75% of our assets are already in fixed income. We're not alone in this.

Our neighbours, Denmark and Germany, are also re-writing their pension promise. An important new element is the move towards life-cycle investing. Their old reliance on traditional insurance contracts only works when yields are a lot higher than now. Ten years ago, an average 30-year old with a 12% contribution a year would expect a retirement income of 67% of the final salary. Now, that has dropped to 39% of the final salary.

– A DUTCH PENSION PLAN

DC investors will increasingly adopt new approaches while legacy assets are gradually unwound

On the face of it, DC investors are likely to invest in a variety of asset classes, duly distinguishing between short-term opportunism and medium-term asset allocation.

The ones most likely to be used for opportunism include: ETFs (cited by 41% of respondents), actively managed funds (31%) and diversified growth funds (23%) (Figure 4.4). The latter deploy a broad palette of assets and frequent rebalancing during different volatility regimes.

The ones most likely to be used for asset allocation include: balanced funds with a strong buy-and-hold orientation (62%), traditional indexed funds (59%), target date funds (58%), actively managed equities and bonds (51%) target income retirement funds (47%), and diversified growth funds (46%).

In part, this seeming diversity can be explained by the usual inter-country differences in risk appetite. For example, at one extreme are Australia and Hong Kong with an overwhelming focus on active equities. At the other are Germany and Switzerland with a strong focus on insurance contracts.

But there is also a new dynamic at work here, according to the post-survey interviews.

There is a gradual migration of legacy assets, as they have failed to meet investors' return expectations. The migration is heading in two directions with a common overlay.

The first direction points towards balanced funds and diversified growth funds; the second one points towards life-cycle investing, covering target date funds, target income funds and target risk funds.

In both directions, the overlay is provided by traditional indexed funds and ETFs — the former in buy-and-hold strategies and the latter in opportunistic forays. The use of traditional cap-weighted indexed funds is growing and, as in DB plans, becoming an important vehicle for diversification. The use of ETFs and smart

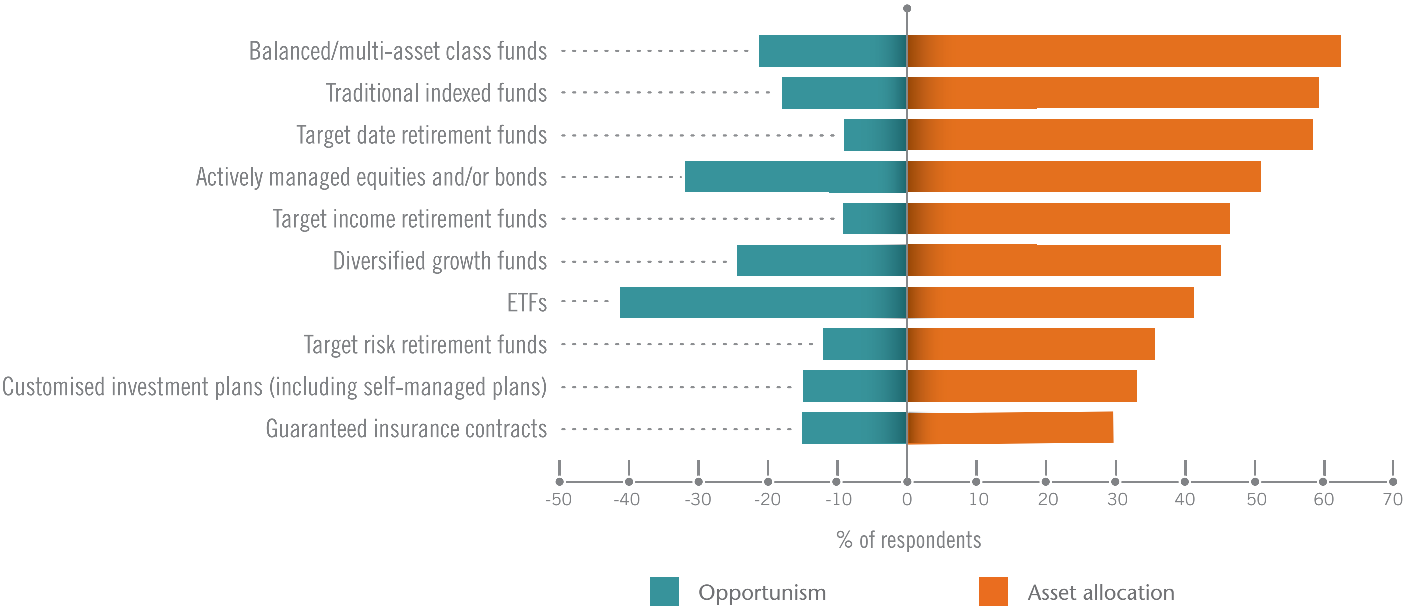
INTERVIEW QUOTES:

"There is a chunk of legacy assets that are being unwound. Life-cycle investing will be the main beneficiary."

"Multi-asset class funds and diversified growth funds have weathered the 2010-12 storm rather well."

"Actively managed equities and bonds are too limiting for an ageing population."

FIGURE 4.4 Which asset classes and generic products are most likely to be chosen by DC investors for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation over the next 3 years?



Source: Principal Global Investors/CREATE-Research Survey 2013

62% cite balanced funds for asset allocation

59% cite traditional indexed funds for asset allocation

41% cite ETFs for opportunistic investing

beta, on the other hand, is nascent. Only 2.5% of DC assets in the US, for example, are invested in them. More and more financial advisers worldwide are likely to channel assets into them such that, on various forecasts, the total ETF assets will top US$9.5 trillion by 2020, from the current level of US$1.7 trillion. A large part of this growth will be driven by the migration mentioned above.

As in DB plans, so in DC plans, beta and lower fees are now seen as the main source of returns. ETFs are, thus, seen as low-cost liquid options to source cheap beta. We shall return to their limitations in Section 5.

For now, it is worth pointing out that this dynamic will see significant adaptation of the traditional active equity and bond products. They will be increasingly deployed within multi-asset class products with in-built devices that permit retirement planning. The projected adaptation will mirror the switch from products to solutions.

Overall, the migration is indicative of an important development highlighted in Section 3: the Personalisation of Risk. It will drive the demand for advice-embedded products to the detriment of stand-alone funds. Now firmly established, this trend will change the DC landscape by importing institutional quality asset allocation tools that build on the best of the old to create the new. They aim to compensate for the limitations in investment expertise not only among end-investors but also their advisors.

INTERVIEW QUOTES:

"Traditional funds will evolve into solutions as baby boomers near the retirement age."

"Without innovation, the DC plans face large unfunded 'shadow liabilities' and face the same future as DB plans."

"With US$400 billion worth of assets, target date funds account for over 10% of DC assets in the US."

A VIEW FROM THE TOP...

The Australian superannuation funds are in the midst of a major change. Under new legislation, they have to submit their proposals on default offerings for regulatory approval. They also have to adopt prudential standards in areas like liquidity and stress testing to bring them in line with banks and insurance companies. They have to publish league tables of costs that take no account of value added. Consolidation will accelerate.

Long before these changes, however, the original 'super' model of asset allocation had come under strain. Its dominant orientation towards a 70:30 equity-bond mix worked while the Australian stock market had a prolonged bull run until the global financial crisis (GFC) in 2008. In the face of double digit annual returns, it didn't matter that this one-size-fits-all approach took no account of members' risk tolerances or income aspirations in retirement.

Since the GFC, however, returns failed to beat the cash benchmark until 2011. This underperformance has resulted in new approaches to asset allocation. Multi-asset class funds are in the ascendancy. Even more importantly, the spotlight has turned on life-cycle funds in general and its two early variants in particular.

Under the first variant, members choose one of three risk profiles at the outset and more or less stick to it over the lifetime of the plan: cautious and moderate and aggressive. Under the second variant, members invest in target date funds, with a fixed glide path for asset allocation: starting with aggressive equities in the early years of members' lives with a progressive switch to cautious bonds as they approach their chosen retirement date.

Thus asset allocation evolves with age. Life-cycle funds have been popular in the US where they account for nearly 30% of DC assets and are included in 77% of plans. They are a new phenomenon in Australia, where the corresponding figure is just under 5%. But make no mistake, Australia will catch up with the US — if not surpass it — by the end of this decade.

In the process, life-cycle funds will also morph into a holistic product: the two current separate phases, 'to' retirement and 'through' retirement, will coalesce. The outcome will be target income funds, similar to what is now appearing in the UK and US. The relative returns benchmark may well be replaced by an implicit liability benchmark for each member. We will see LDI-lite in the DC space before long. That means taking money off the table from time-to-time when the going gets rough.

The upshot is simple. Our pension landscape will evolve away from the mechanical equity-bond allocation. The risk profile of the ageing population is changing. There is less time to recover from big losses. The centre of gravity is already shifting from investment return to retirement outcomes. The entrenched 70:30 equity-bond mentality will be history.

– AN AUSTRALIAN PENSION CONSULTANCY

5 | MASS MARKET INVESTORS

> "We're at the dawn of a revolution in which investors are demanding outcomes that cut across conventional style boxes and asset classes."
>
> - AN INTERVIEW QUOTE

WHAT GOALS, STRATEGIES AND ASSET CLASSES WILL THEY PURSUE?

OVERVIEW

Section 4 highlighted the investment approaches of pension investors, in the light of six forces that will drive the capital markets over the next three years: the sovereign debt crisis, QE programmes, asset bubbles in emerging markets, closures of DB plans, ageing populations in the key pension markets and the rise of solutions-driven investing.

This section goes on to highlight the approaches that two segments of mass market investors are likely to pursue in response to these market drivers. It addresses two questions:

- What goals, strategies and asset classes are retail investors likely to adopt over the next three years?
- What goals, strategies and asset classes are HNWI likely to adopt over the next three years?

Key Findings

RETAIL INVESTORS

Over the next five years, nearly 75% of the retail assets will be held by baby boomers who are retirees or near retirees. The retail market and the retirement market will converge rapidly. Regular income, capital protection and low volatility options will be the key goals for retail investors. These will be pursued via traditional beta, ultra-safe investment options and dynamic asset allocation that can target the stated goals within a single diversified fund. The implied caution will be underpinned by ageing demographics and the '*sequence of returns*' risk.

Retail investors have also recognised that, when chasing individual active funds in the past, they always lagged behind the market, often buying high and selling low. Now, the dawning retirement needs are fast ushering in an era of solutions-driven investing, in much the same way as with DB plans and DC plans, as discussed in Section 4 of this report.

This has already shifted the emphasis from high returns to a high probability of certainty in investment outcomes: from risk at the *end* of their investment horizon to risks *within* the horizon.

Retail investors expect the current low yield environment to remain low for a long time. They also believe that the conventional monetary multipliers will take a lot longer to boost the Western economies in what is an unusual balance sheet recession.

Risk Will Divide Retail Investors Between West and East

In the West, demand for income-focused funds will grow. Significant innovations are in the works to deliver regular income, inflation protection and low volatility within a single fund. Yet opportunism will not go away altogether, especially when momentum is working. ETFs will remain its main vehicle.

In the East, in contrast, the hunt for yield will intensify and attract money into risky opaque vehicles, as exemplified by 'wealth management' products or 'trust' products now available in the shadow banking systems in China. Japan, however, will remain a stand out. With memories of horrendous losses in the equity market crash in 1989 still anchored in the investor psyche, retail investors will continue to invest in term deposits, typically offering 0.02% return.

HIGH NET WORTH INDIVIDUALS

Risk will be returning to the table, as will demands for better ways of managing it.

Uncorrelated absolute returns, capital protection, capital growth, inflation protection and regular capital will be the key goals for HNWI. The inclusion of goals other than absolute returns in the list reflects the belief that returns in the future will not be high enough to compensate for the exclusion of other goals.

Hence, investment strategies will blend caution with opportunism — and include high alpha, dynamic asset allocation, smart beta and ultra-safe options.

Globally, the HNWI industry is expected to grow at a compound annual growth rate (CAGR) of 9%, with the bulk of it coming from the new generation of entrepreneurs running the multinationals in emerging markets. They will invest in high-alpha strategies, with a strong opportunistic tilt towards commodities (especially gold), currencies, hedge funds and active funds. Exchange-traded funds will be used as a key vehicle in the process.

> “Retirement used to be easy – you worked until 65, enjoyed retirement for ten years and died. Now there's a 55% chance that one of the couple will live to 90 and outlive their savings.”
>
> - AN INTERVIEW QUOTE

Their counterparts in Europe and the U.S, in contrast, will migrate towards an LDI-lite approach whose benchmarks will include day-to-day necessities, lifestyle needs, philanthropic needs and estate planning.

As a result, they will increasingly adopt institutional-quality tools for asset allocation, diversification, risk management and smart beta. Their interest in equities will wax and wane. But interest in three other areas will intensify: real assets, alternative credit and passive funds in general and ETFs in particular.

Overall, this migration towards solutions-driven investing in the retail as well as the HNWI segments will rely on passives as a key delivery vehicle.

Growth in ETFs and smart beta will accelerate over the next three years to the extent that asset managers are already sounding alarm bells on their potential systemic risks.

The ageing population is driving convergence between the retail market and the retirement market

When asked to identify the goals that retail investors will pursue over the next three years, one in three respondents singled out five goals: regular income (53%), capital protection (46%), inflation protection (42%), consistent low volatility returns (39%) and capital growth (34%) (Figure 5.1).

When asked to identify the strategies that will be used to pursue these goals, one in three respondents singled out three strategies: traditional beta (48%), ultra-safe investments (48%), and dynamic asset allocation (39%).

Thus, retail investors are likely to adopt cautious options, since the bulk of retail assets are held by baby boomers who have already retired or are heading for it in this decade. In the process, there is a complex dynamic at work, similar to the one reported for DC investors in Section 4.

It is conditioned by their investment experiences in the last decade. Retail investors increasingly realised that they significantly lagged behind the market. It was not unusual for them to miss the first half or two-thirds of a strong rally in stocks. If anything, they spent too much time chasing hot stocks — buying high and selling low — while racking up the charges. This approach cost them dear.

On the bonds side, too, an ageing population has forced introspection. Investing in government bonds was fine when the rate was 7% and a 65-year-old could expect to live only 10 years. This approach is a far cry from today, with yields below 2% and life expectancy over 80. Apart from credit risk, duration (or interest rate risk) has become a major concern with bonds of longer maturity and low coupon. At any rate, low rates are driving up duration by stealth. The hunt for yield per se no longer seems appealing. Instead, retail investors are transitioning to solutions-driven investing (see box on the next page).

By blending multiple asset classes within a single offering, this approach enables investors to target regular income, low volatility

INTERVIEW QUOTES:

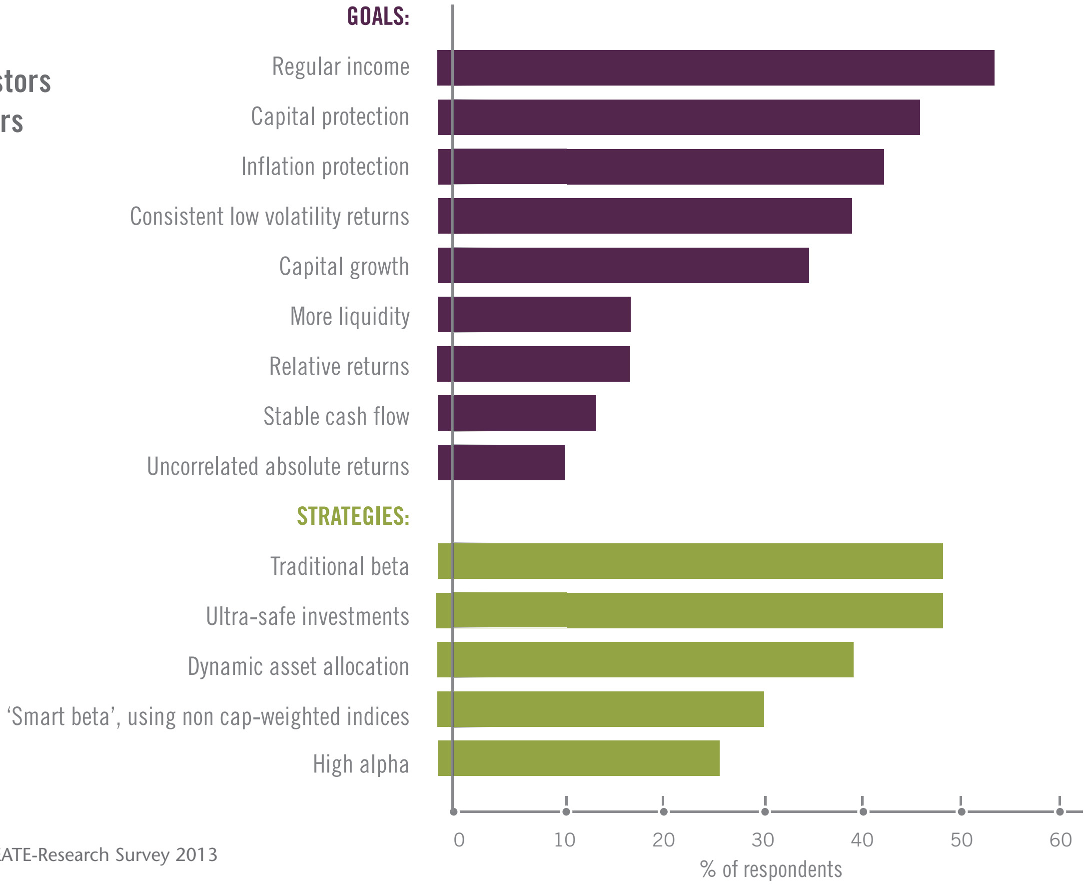
"Individuals and governments are deleveraging. The fear of deflation is real. Rates will stay low for a long time."

"Stocks in Europe are cheap. They are trading on fear rather than price-to-book or price-to-earnings."

"Since 1950, the average holding period of mutual funds has dropped from 6 years to one year."

FIGURE 5.1

What goals will retail investors pursue over the next 3 years and which strategies are they likely to adopt?



Source: Principal Global Investors/CREATE-Research Survey 2013

53% will target regular income

46% will target capital protection

48% will deploy traditional beta to meet their goals

and inflation protection on approach to retirement and thereafter. Their packaging approach targets specific objectives rather than a single investment strategy. It also targets a high probability of certainty rather than high returns.

Indeed, plans are afoot to create ETFs based on lifestyle risk — with distinct tilts towards healthcare, life sciences, fuel and care homes, backed by simple hedges. Baby boomers are retreating from their risk-taking mode.

Alpha is in the eye of the beholder.

As the 2012 survey report, *Market Volatility: Friend of Foe?* indicated, investors are increasingly distinguishing between product alpha that is about beating the markets and solutions alpha that is about meeting investors' identified needs. The balance is shifting towards the latter and will continue to do so, as baby boomers retreat from their risk-taking mode.

By the end of this decade, the weight of the retail money will be in the decumulation phase, as in Japan today. Thus far, the shift out of equities has marked in Europe and America. In the wake of the 2008 crash, fixed income was the main beneficiary. Now concerns about ultra-low yield are diverting money into a new breed of diversified funds that target distinct solutions.

INTERVIEW QUOTES:

"Our society is older now than 20 years ago. Investor interest in regular income is growing over capital gains."

"Our products make money by the power of compounding. It doesn't make investors rich overnight. But it keeps them satisfied."

"Investors want to be compensated for taking risk. They don't care about alpha and beta."

A VIEW FROM THE TOP...

The 2000s will long be remembered as a 'lost decade', when risk failed to generate return and conventional equity-bond investing came under intense scrutiny. That experience sparked a revolution that has gained ground since the great crash of 2008. Its main thrust is directed at solutions-driven investing, with a clear line of sight between investment innovations and the investor needs.

Its early adopters are already visible in all segments. In the DB space, they are switching to liability matching; in the DC space to life-cycle investing; and in the mass market space to solutions-driven investing. The fear of a prolonged financial repression may well create a tipping point at which these innovations will go mainstream.

In the retail space, solutions-driven investing is appearing in a variety of forms, each with a distinct theme. The most prominent one is new balanced funds that target equity-like returns, with a strong focus on yield and downside protection. Notably, their risk is measured by the probability of missing the targeted outcome, instead of the standard deviation of returns.

This switch from generic products to niche strategies is evident in the newly emerging array of diversified income funds. The early adopters are baby boomers already in the retirement phase as well as those nearing it. Such funds deploy a broad basket of assets, such as high-yield bonds, global value securities, global real estate securities, preferred securities, commercial mortgage-backed securities (CMBS), emerging market debt and infrastructure. They also use a call option programme to reduce the volatility of the underlying equity investments. In all, they target regular income and low volatility.

The over 60s are also emerging as early adopters of real assets within a diversified investment portfolio to offer inflation protection. These include Treasury Inflation-Protected Securities, commodities, real estate investment trusts (REITs), infrastructure and floating rate notes where rates are linked to prices. Higher inflation may well be a side effect of three challenges facing the US economy today: deficits, debt and demographics. Even at a modest annual inflation rate of 3%, prices double every 23 years. Over longer time periods, such hedges have proved especially effective.

A growing number of retail investors are also adopting alternative investments in their diversified portfolios to deal with the so-called 'sequence of returns' risk, arising from volatility. Average annual total returns of a portfolio are a good indicator of performance over time. But the sequence of returns is just as important in determining the dollar value of the portfolio. A variety of hedge fund strategies are also finding early adopters among those who want to hedge the tail risk.

In the West, over the next five years, nearly 75% of the retail assets will be held by baby boomers born in the period 1945-1965. On approach to retirement, they are switching from conventional investing to solutions-driven investing. This migration is real, it is happening and it is creating new opportunity sets for managers with business models to capitalise on the unfolding population dynamic in the developed as well as large parts of the emerging markets. We are seeing a Darwinian exercise in motion collapsed in time.

– A US ASSET MANAGER

Loss aversion in the West and the search for yield in the East will characterise retail investing

In the light of the identified goals, retail investors are likely to choose a variety of asset classes, distinguishing between short-term opportunism and medium-term asset allocation. The ones likely to be chosen for opportunism will include: ETFs (49%), actively managed equities or bonds (38%) and theme funds (38%) (Figure 5.2).

The ones likely to be chosen for asset allocation will include: funds with income focus (66%), actively managed equities or bonds (54%), traditional indexed funds (52%), capital protection funds (50%) and ETFs (45%).

Thus, caution will prevail alongside opportunism. There will be some marked regional differences between the West and the East, however, according to the post-survey interviews.

In the West, caution will remain the watchword. Ageing populations will be the key contributory factor. The demand for income-focused funds will grow. It has been challenging for asset managers to define what guaranteed income funds mean at today's level of yield. However, such funds are seeing considerable innovation.

A variety of asset classes are blended to deliver one or more of three key goals that retail investors are targeting within a single fund: regular income, low volatility and inflation protection. The resulting asset mix also deploys hedging tools to improve the probability of outcomes (see page 43).

Alongside this steady but pronounced trend, retail investors in the West will continue to engage in periodic opportunism when momentum is working. Exchange-traded funds will be the principle means. Financial advisers in the US and parts of Europe are already marketing ETFs as an allocation product that embraces different asset classes on the one hand and allows opportunism on the other. Investors will continue to warm to them in the belief that although the cult of equities is not dead, it is unlikely to deliver high returns without high risks. When momentum is working, investors would prefer to ride it out with ETFs, with daily liquidity and low costs.

In the East, on the other hand, the hunt for yield will intensify. Brazil, Russia, India, and China (BRIC) economies have witnessed large net outflows from equity funds recently, as the MSCI BRIC Index has languished 37% below its 2007 peak, at a time when the S&P 500 Index has reverted to its previous peak.

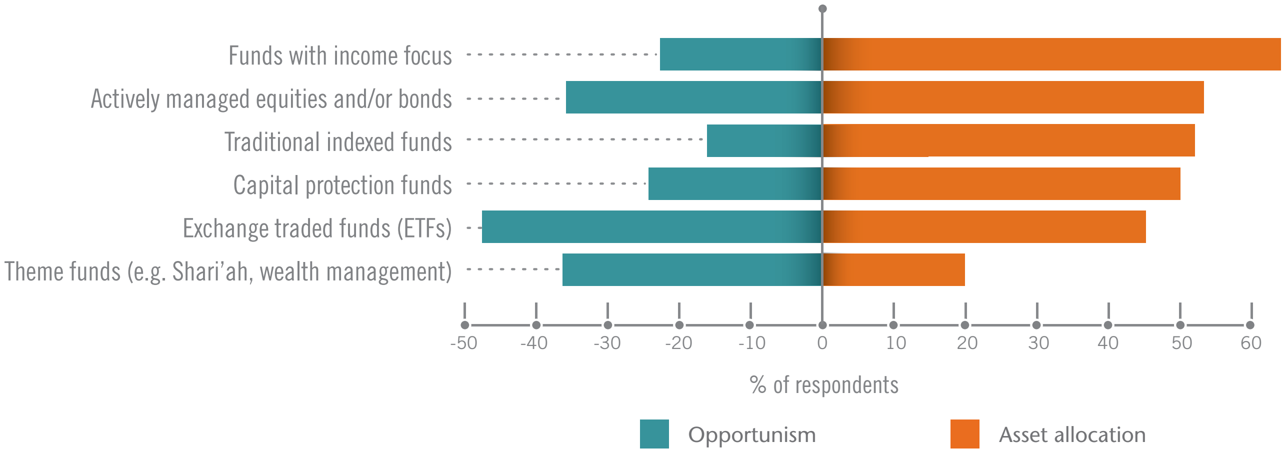
INTERVIEW QUOTES:

"In 2001, 53% of US households held stocks. Now it is 46%."

"Political paralysis in the West is driving away Asian investors. They are putting their money in emerging markets."

"Stocks in BRICS nations have been trailing global shares for four straight years now."

FIGURE 5.2 Which asset classes and generic products are most likely to be chosen by retail investors for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation over the next 3 years?



Source: Principal Global Investors/CREATE-Research Survey 2013

66% cite funds with income focus for buy-and-hold investing

54% cite actively managed funds for buy-and-hold investing

49% cite ETFs for opportunism

The resulting chase for yield has diverted funds into opaque risky funds. The so-called wealth management products and trust products in China are the best examples (see box below). The demand for such funds will continue until the regions' equity markets become less volatile. The current round of financial reforms in China has the potential to transform its equity market (see box below).

For the near-term, however, regional differences will persist. In the East, retail investors are generally bullish about their own economies. In pursuit of yield, their demand for opaque assets will remain insatiable. In the West, retail investors are much less bullish about their own economies. In pursuit of safety, they will be prepared to sacrifice returns.

Within this broad assessment, Japan will remain a standout. Even after the Nikkei's strong rally since November 2012, there is a generation of retail investors who have grown up convinced that stocks only go down. The memory of losses worth $18 trillion after the Nikkei's prolonged downward trajectory since 1989 has created gambling undertones around equity investing.

In the absence of a strong and sustainable rally in the wake of the Bank of Japan's latest intention to double the money supply, Japan's retail investors will remain ultra-cautious.

INTERVIEW QUOTES:

"Wealth management products in China can be as toxic as subprime bonds. They are not what it says on the tin."

"Retail investors in Japan have not been stirred by the latest 35% leap in the Nikkei."

"Indian investors remain weary of equities. They're chasing yield and real assets instead."

A VIEW FROM THE TOP...

After the financial crisis in 2008, Asian investors started re-channelling their assets into emerging markets. Funds have flowed into vehicles with a distinct local flavour: e.g. Shari'ah funds in Malaysia and wealth management products (WMP) in China.

The latter have had explosive growth, with assets of US$2 trillion by the end of 2012, representing 15% of total banking deposits. China has surplus savings (almost half of GNP) but no suitable vehicles for thrift. Bank deposits offer meagre returns and stock markets remain volatile and momentum driven.

Forming a key plank of the country's shadow banking system, WMPs are short-term investments that banks sell as a high-yield alternative to low-interest term deposits. The amount of leverage now building up in them is not supported by sufficient capital. Regulators are duly tightening up the rules to curb their popularity.

There has been a parallel trebling in the number of mutual funds, yet their total AUM has hardly moved since 2008. Equities are out of favour. Over the same period, however, there has been sevenfold growth in assets in what are called trust products with the traditional investment trust wrapper.

They invest in equities, bonds, real estate, direct loans to local government and infrastructure projects. Unfortunately, investors do not understand the true nature of the underlying risk and continue to rely on implicit guarantees from questionable third parties. Accordingly, trust products, too, are now under regulatory scrutiny.

This increased regulatory oversight is part of a major drive to open up the capital markets and relax the currency and interest rate regimes. The aim is to progressively promote the renminbi as a reserve currency, as China goes from a net creditor to a net debtor nation over the next decade, as it rebalances its economy from foreign trade to domestic consumption.

In addition, the mainland Chinese stocks (A-shares) are to join global indices over the next three years. Once A-shares are added to the FTSE Emerging Market Index, China will account for 40% of it and all that means for portfolio rebalancing around the globe. The renminbi-denominated qualified foreign institutional investor (QFII) quotas are being raised sevenfold.

Finally, the Shanghai Stock Exchange got the ball rolling by directing listed companies to return 30% of profits to shareholders via dividends. The aim is to kick-start a buy-and-hold culture by changing corporate governance practices that have long conspired against shareholder interests.

In China, as elsewhere in Asia, funds are sold and not bought. Investors wait for a salesman to call them with an idea. Initiatives are now being implemented to raise the level of financial education so as to persuade the citizens to save for the long-term. Like other rich nations, China faces a rapidly ageing population in the 2020s due to the delayed effects of the one-child policy.

– A CHINESE ASSET MANAGER

Risk will be returning to the table in the HNWI segment

As the 2012 survey report showed, HNWI are turning into extra demanding investors, after suffering big losses in the last decade. For them, risk is returning to the table, as are demands for new approaches to managing it. When asked to identify the goals that HNWI investors are likely to adopt over the next three years, more than one in four respondents singled out five goals: uncorrelated absolute returns (49%), capital protection (46%), capital growth (42%), inflation protection (39%) and regular income (26%) (Figure 5.3).

Notably, this multiplicity of goals marks a major shift from the previous surveys, which singled out high returns as the overarching goal. This was done in the belief that high returns in themselves can accommodate other goals, in much the same way as pension plans had assumed until the equity bear market of 2000-2002. What pension plans did after that debacle, HNWI have started doing after the recent unprecedented bout of volatility — namely, liability matching. We shall soon return to this point.

The strategies likely to be used in the process include: high alpha (54%), dynamic asset allocation (46%), smart beta (32%) and ultra-safe investments (20%).

Over the next three years, global assets in the high net worth segment are expected to grow at CAGR of 9%. Europe and the US will remain the epicentre of the industry but its growth engines will be the Middle East, Asia, Africa and Latin America, in that order. The bulk of this new growth will come from the new generation of entrepreneurs running the emerging market multinationals, in marked contrast to the inherited wealth held in Europe and the US. Such entrepreneurs are more demanding, less trusting, keen to manage their own affairs and more interested in growing their wealth. Their main goals are in uncorrelated absolute returns and capital growth.

INTERVIEW QUOTES:

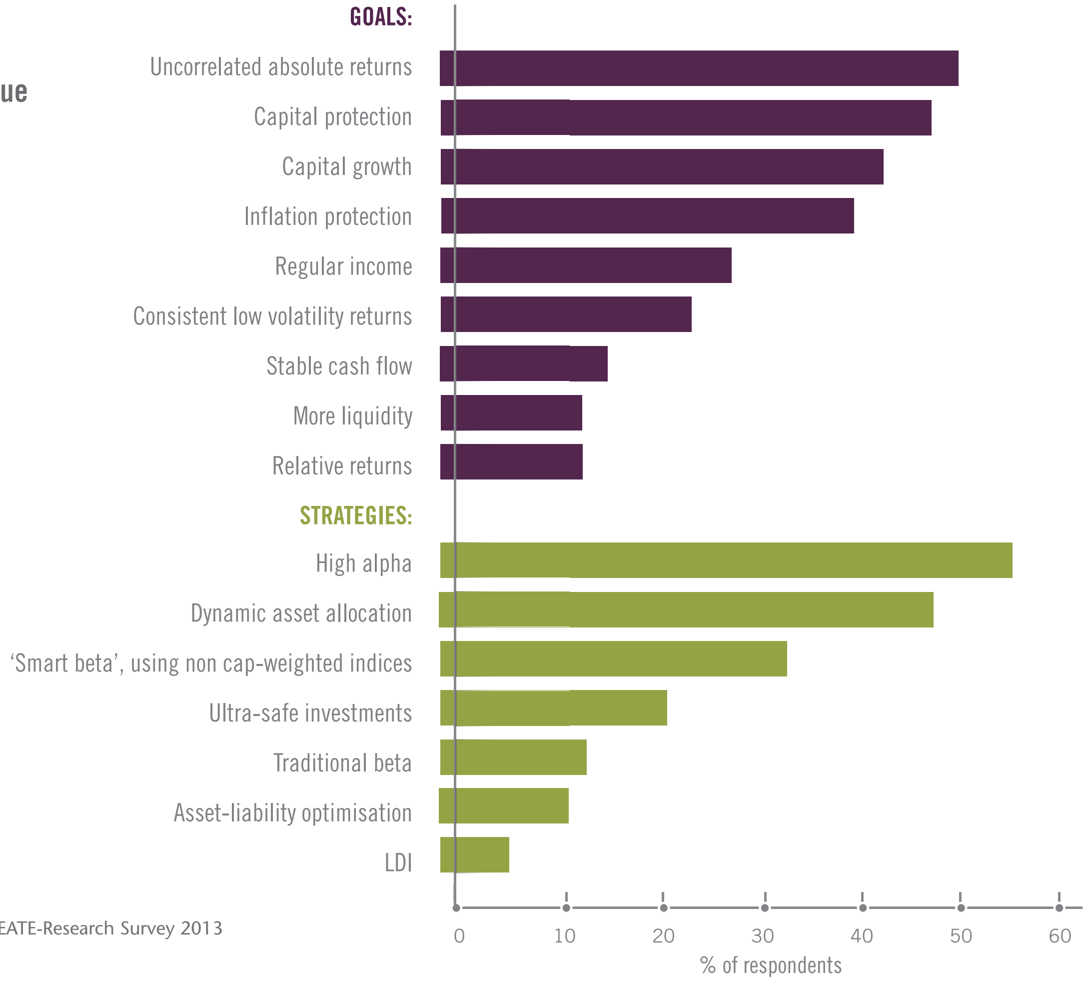
"Relative returns are dead and absolute returns have many mothers."

"Asian ultra-rich investors are very demanding, since they have the choice to invest in their own business."

"Black box investing will remain out of fashion in a trendless market."

FIGURE 5.3

What goals will HNWI pursue over the next 3 years and which strategies are they likely to adopt?



Source: Principal Global Investors/CREATE-Research Survey 2013

49% will target uncorrelated absolute returns

46% will target capital protection

54% will target high alpha

In contrast, their counterparts in Europe and the US have adopted a multiplicity of goals in the light of extreme market turbulence in 2010-2011. These focus on basic day-to-day necessities, lifestyle needs, philanthropic aspirations and estate planning. A blend of assets is used in the process, with a strong focus on real assets such as real estate and gold. They seek capital growth, regular income, high liquidity, inflation protection, low volatility and catastrophe avoidance.

One version of this approach centres on the traditional core-satellite model. Buy-and-hold investing is concentrated at the core; and opportunism at the satellites. Such pragmatism puts heavy emphasis on risk, liquidity and transparency — all backed by periodic forays into dislocated markets where the savagery of periodic downturns is creating value opportunities.

HNWI investors will be emulating their institutional peers in two other ways as well. First, their evolving diversification will seek absolute returns that focus on risk minimisation more than return maximisation.

Second, they will continue to distinguish between *re-risking* and *smart risking*: one involves dialling up risk; the other involves the investor's version of the Holy Grail — getting additional alpha without taking on further beta risks. For the latter, HNWI investors in the West will increasingly rely on smart beta to deliver cheap alpha. Smart risking will remain the new mantra.

INTERVIEW QUOTES:

"The risk-reward balance in real assets has improved a lot, as investors have intensified their search for alternative yield."

"Many of our rich clients are keen to extract nuggets from noise."

"Old style investing only works in a raging bull market. If you can't get stellar returns, you have to set other goals."

A VIEW FROM THE TOP...

The commercial real estate market has been polarising between the core and the periphery. The core is capacity constrained and expensive. The periphery is cyclical and speculative.

Dominated by niche players, the periphery covers assets that have been modernised recently with low occupancy, low rents or shorter leases. Much of the opportunistic investing is centred on the periphery, which has also been the focus of distressed selling after the credit crisis.

The yield differential between the core and the periphery has been widening; the core command 5%-9% yield and 1-5% capital appreciation. The corresponding figures for the periphery are 4-7% yield and 1-3% appreciation. In both camps, the yield came down sharply after the 2008 crisis.

Now, the core assets are seeing faster appreciation as pension plans and sovereign wealth funds have started making their biggest ever allocations in 2012. They target 5-7% returns net of fees depending on locations. The ones that are particularly favoured are key business centres in America, Europe, Australia, Japan, Hong Kong and Singapore. Fees vary widely between the core and the periphery.

Investments from HNWI are mainly channelled to the periphery where bank lending has been severely curtailed, opening up scope for mezzanine finance. Commercial real estate is also seen as a good hedge against inflation. The yield in the core market proxies bond yields. But the two do not go in tandem, depending on what drives the interest rate changes. If rates rise because the economy is recovering, then the overall return is much bigger due to capital appreciation. If the rates rise because of currency crisis, for example, then capital appreciation evaporates.

In our UK operations, we sell real estate as an LDI hedge asset by exploiting a new niche: student accommodation and social housing. These assets are acquired and then leased back over long periods — as long as 35 years, in some cases. These assets have regular tenants and regular cash flow. They are fully amortised, such that assets revert to the previous owners at the end of the lease to avoid the perception that owners are selling the family silver.

They are structured as open-ended funds, so they can be bought and sold in secondary markets. Currently they yield 200-600 basis points over gilts. The rent increases are automatic, linked to inflation and capped at 5%.

Big pension plans are earmarking their investments to specific portfolios of real estate. HNWI, on the other hand, are making allocations via dedicated feeder funds. Commercial real estate is regaining its halo. Our net inflows are up nearly 20% since 2010.

– A SWISS ASSET MANAGER

Opportunism will divide the HNWI segment in East and West

The regional differences in the risk appetite of wealthy investors are also manifested in their investment approaches, as defined by opportunism and medium-term asset allocation.

At a global level, when asked to identify the asset classes that are likely to be chosen for opportunism, four stood out: ETFs (44%), commodity funds including gold (44%), currency funds (35%) and actively managed funds (32%) (Figure 5.4).

In contrast, a wider array of long only and alternative funds will be targeted for asset allocation: actively managed equities or bonds (59%), real estate, covering debt and equity (55%), balanced funds (49%), hedge funds (47%), private equity (47%), and income funds (46%).

Fund markets in Asia, Europe and America will deploy these funds except for one notable difference: those in Asia (excluding Japan) will be driven more by opportunism and those in the West by buy-and-hold considerations.

Taking them in turn, as mentioned previously, Asian investors chase returns, not asset classes. They prefer to make a few big bets. The concept of diversification has yet to take root, as has the concept of macro risks that regularly buffet all emerging markets. Investors in Asia tend to polarise their investments between cash at one extreme and property, individual stocks and gold at the other.

Such biases reveal a more acute challenge: the lack of a buy-and-hold mentality. In countries as diverse as China, India, South Korea and Taiwan, the average holding period for mutual funds is less than a year. The widely predicted transition from opportunism to buy-and-hold investing will be anything but gradual. The extreme volatility of the local stock markets is one obstacle. The other is the loss of confidence in the markets in the West. The Madoff scandal,

INTERVIEW QUOTES:

"Bond returns are almost guaranteed to be miserable over the rest of this decade."

"Asian investors have higher return expectations and shorter time horizons."

"Alternatives are becoming less and less alternative with HNWI."

FIGURE 5.4 Which asset classes and generic products are most likely to be chosen by HNWI for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation over the next 3 years?

Source: Principal Global Investors/CREATE-Research Survey 2013

59% will target actively managed funds for buy-and-hold investing

55% will target real estate funds for buy-and-hold investing

44% will target ETFs for opportunism

the MF Global debacle, the flash crash, the software error at Knight Capital, and the bizarre spectacle of the Facebook IPO have undermined the confidence of wealthy investors in the East. They feel that the game is rigged against private investors.

In contrast, HNWI in the West are likely to spread their wings. They will target a broader diversification than the traditional 60:40 equity-bond mix. Their interest in equities will wax and wane, in view of previous losses. But interest in three other areas will intensify. To start with, real assets (commodities, especially gold and real estate) will feature high on the agenda. Allocations to these assets may well double from the average of 10% currently.

Similarly, allocations to credit products will double to take advantage of opportunities created by the withdrawal of banks from a distinct segment of the credit market on account of the new capital needs under Basel III. Like pension plans, HNWI will be allocating to the resulting 'cross-over' assets with bond-like features and equity-like returns (see page 35).

Finally, allocations to passives in general and ETFs in particular will increase. Under regulatory pressure, wealth managers are being obliged to migrate from sales commissions to advice-based fees. Migrating clients from one to the other is proving painfully slow, as few are willing to pay for advice. In the US, ETFs have gained momentum in the advice channel. The same is happening on the Continent. In both cases, smart beta is firmly on the radar screen and is expected to remain so in the absence of big blow-ups.

INTERVIEW QUOTES:

"HNWI are increasingly using institutional quality tools and approaches to diversification and dynamic investing."

"ETFs are actively traded by financial advisers and wealth managers. Smart beta is the flavour du jour."

"Derivatives-based ETFs worry the hell out of me. The low quality collaterals can be a major source of risk."

A VIEW FROM THE TOP...

The rise of ETFs has been an outstanding phenomenon of the last five years, with a CAGR of 30%. By slicing and dicing the investment universe, they give customised choices at low cost. They are an easy route into an asset class without having to pick individual managers or securities. They are also seen as cash equitisation vehicles that invest excess money that would otherwise languish in a low interest rate environment. ETFs are used to short the market or to hedge and trade in an opaque manner. Although they are 10% of the size of the mutual fund industry, ETFs punch way above their weight by accounting for a third of all equity trades in the US. Their popularity outside the US is growing too. As with all investment tools, they do have some potential downsides.

Some 96% of individual ETFs and 87% of ETF assets are highly concentrated. They cover narrow market segments such as commodities and emerging markets. Given the astonishing array of more than 3,400 ETF options available, selection is not easy. Many are investing in the same basket of securities. They attempt to minimise idiosyncratic risk while being unaware of the systemic risk being created. They also distort the price discovery mechanism while jacking up correlations between different indices.

Furthermore, many of the relatively solid offerings are falling short of expectations, once the difference between the time-weighted returns reported by the ETF providers and the dollar-weighted returns actually earned by investors is factored in. For example, in a sample of narrowly focused ETFs, over a five-year period, the reported returns were 21.3%; the earned ones were 0.8%. The corresponding numbers in a sample of broad-based ETFS were -4.8% and -10.8%. As ever, timing of investing makes the difference. As more data are available over time, we will have a better idea about the actual gap between these two measures.

Finally, synthetic ETFs — prominent in Europe — carry counter-party risks. They do not own assets like shares and bonds as collateral. Instead, they rely on derivatives from investment banks to deliver the benchmark return, such that the investor faces the risk that the bank may not be able to pay up. These concerns point to potential limitations. But they do not detract from the merits of ETFs. Indeed, we anticipate double digit growth with the emergence of active ETFs. Their ability to pursue specific themes make them an ideal retirement product that can target regular income, low volatility and inflation protection, as retail investors and DC investors increasingly migrate into the solutions-driven space.

The new wall of money flowing into traditional index funds as well as ETFs carries concentration and momentum risks. Ironically, it will also be creating pools of underpriced assets excluded from the indices for active managers to exploit.

– A FRENCH ASSET MANAGER

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