

European Investment Consulting

**2022 OECD/IOPS/NBS Global Forum on Private Pensions:
Current challenges faced by private pensions**

Session I

Impact of inflation on pension portfolios and ways to protect against inflation

Bratislava, 3-4 November 2022

OECD/IOPS GLOBAL FORUM ON PRIVATE PENSIONS

“Current challenges faced by private pensions”



Who we are

- European Investment Consulting (EIC) was founded in 2004 by Julian Alworth and is based in Milan. Its mission is to offer investment advisory services to a wide range of institutional investors (pension funds, foundations, insurance companies, financial intermediaries as well as real estate funds).
- The company which is based in Milan has grown over the years and now employees 12 professionals and more than € 50 bn of assets under advisory.
- EIC is independent and has no relationship, whether in terms of shareholding or exclusivity arrangements, with any financial institution.
- Since its inception the company has provided a wide range of consulting services to its clients. These include but are not limited to support of:
 - Strategic Asset Allocation and ALM;
 - Manager Selection;
 - Performance measurement;
 - Risk management;
 - Internal Audit.

> The EIC Expected returns survey – Key facts

- The EIC survey has its roots in the regulation of occupational pension funds. In 2012 COVIP, the Italian supervisory authority of Italian pension funds, issued a resolution containing guidelines for the adoption by pension funds of an Investment Policy Statement (“Documento sulla politica di investimento” (DPI))
- Art. 3 paragraph 4 of the resolution states that the DPI must declare, for each sub fund (“Comparto”) the expected yearly average return and volatility over the investment horizon. The expected return must be net of the expected inflation. In addition, the DPI must specify the value of the shortfall risk with regard to certain target returns
- Given the limited reliability of past risk premia at that time (very low equity returns, very high bond returns) EIC decided to integrate the traditional methods for estimating expected returns with a survey among asset managers, leveraging on the relations with those active in the Italian institutional investors market



➤ The EIC Expected returns survey – Key facts

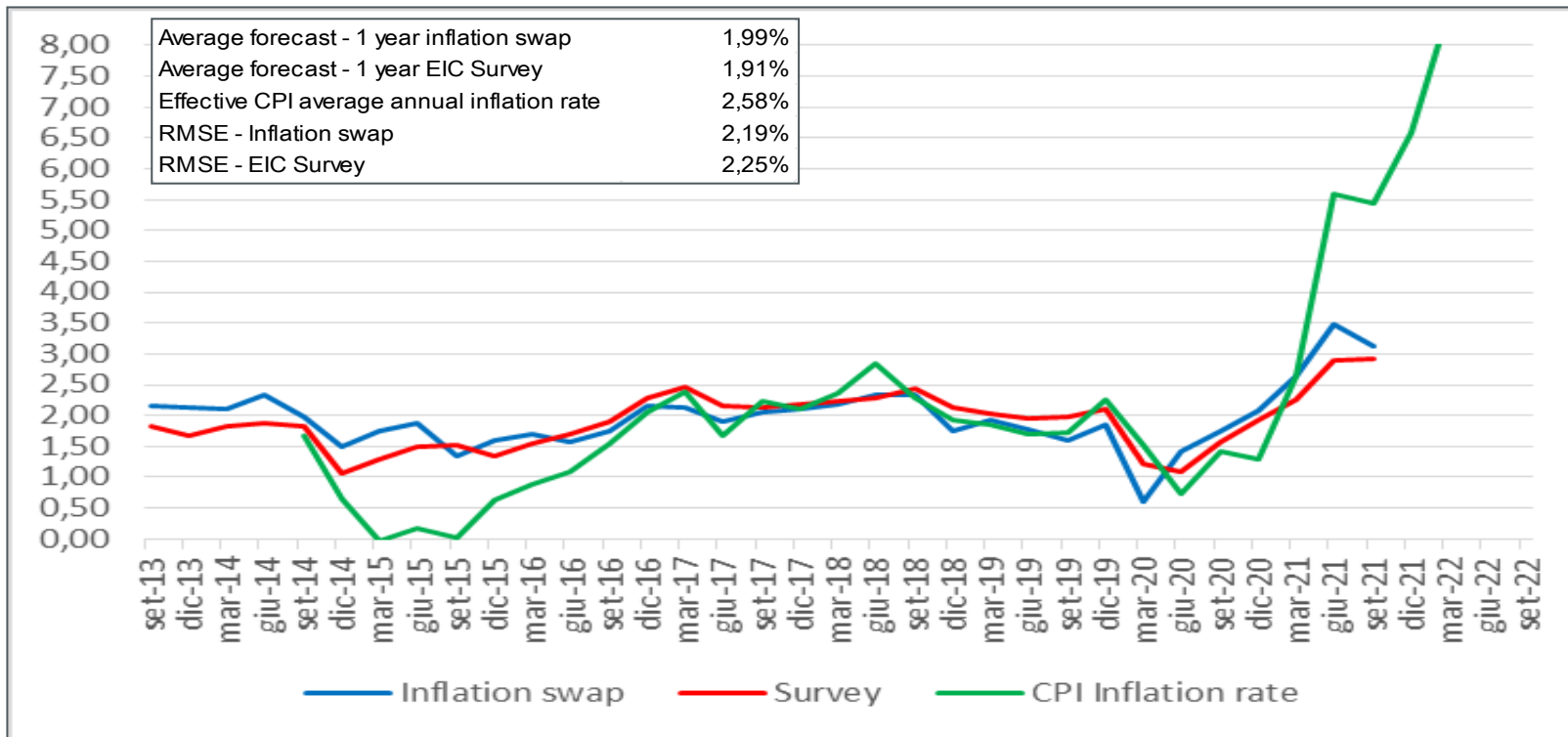
The EIC survey

- The questionnaire has evolved across time and now contains a total of 48 point forecasts over 4 time horizons, in total 192 possible answers.
- The number of participating companies and of total forecasts has increased over time from an initial group of 22 companies posting 851 forecasts, to a maximum of 63 companies on December 2019 with 3.203 forecasts. The last survey of June 30th 2022, received a total of 2.725 forecasts from 52 asset managers.
- The asset managers taking part in the survey are both global and Italian players. A constant feature of the panel has been that the majority of the respondents are based (or at least have their main local market) outside Italy and the Eurozone, allowing us to reduce the risk of “home bias” in forecasts.
- In the 38 surveys made so far (June 2022) a total of 85.779 forecasts have been collected. The answers are concentrated of the most important equity and fixed income indices. Answers are anonymous.
- The benefit of anonymity is a very wide range of expected returns, with a frequency of negative expected returns unusual among companies that are supposed to sell expectation of gains from the investment of a financial portfolio.



Consensus forecasts, market forecasts and realized inflation - USA

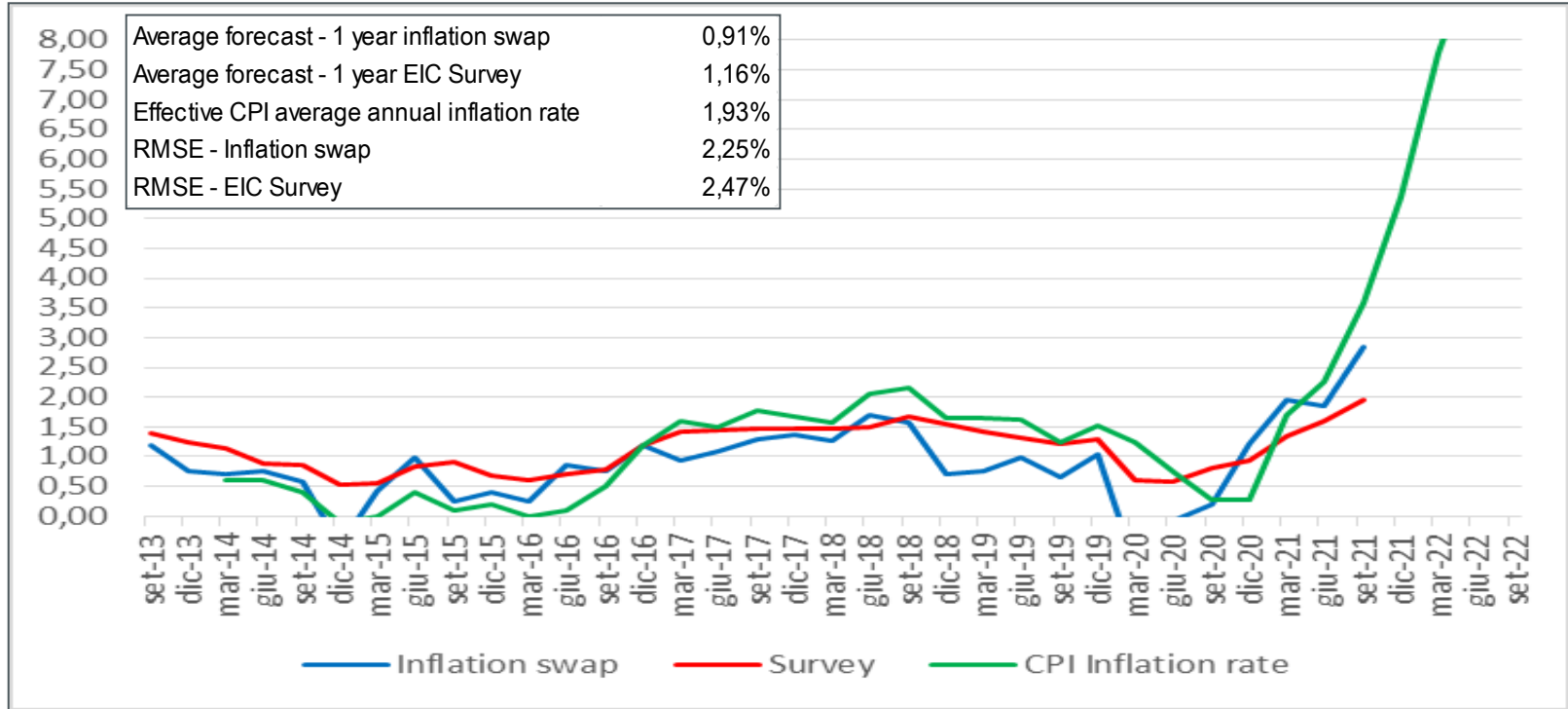
Inflation expectations





Consensus forecasts, market forecasts and realized inflation - Eurozone

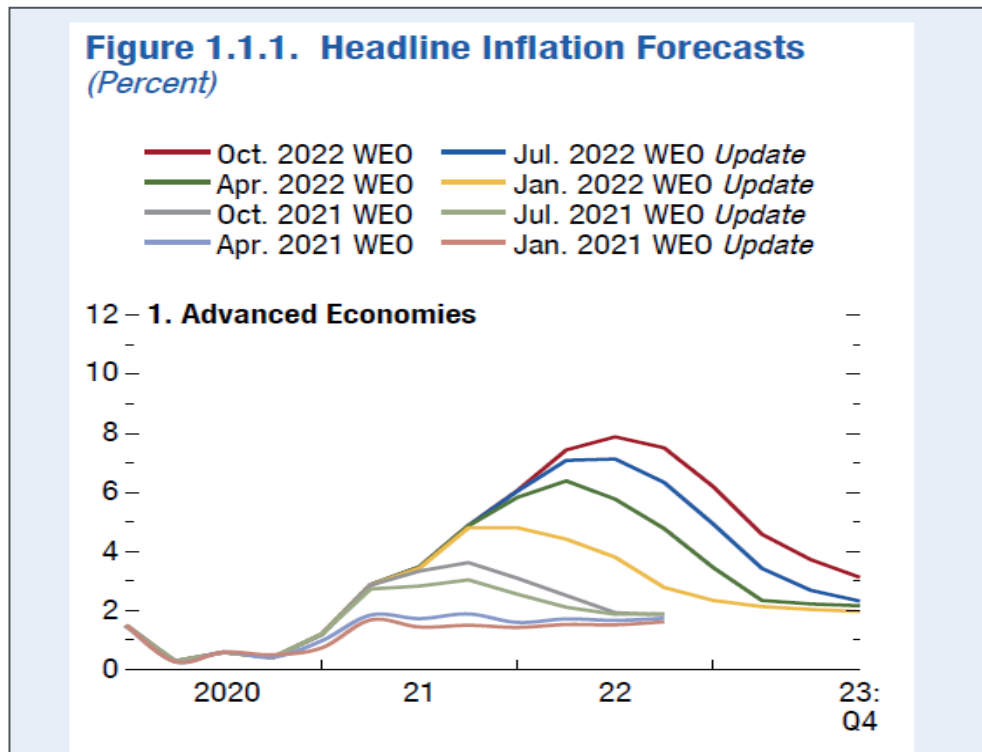
Inflation expectations





Adaptive expectations? World inflation forecasts by the IMF

Inflation expectations



Source: IMF World Economic Outlook, October 2022, pag. 26

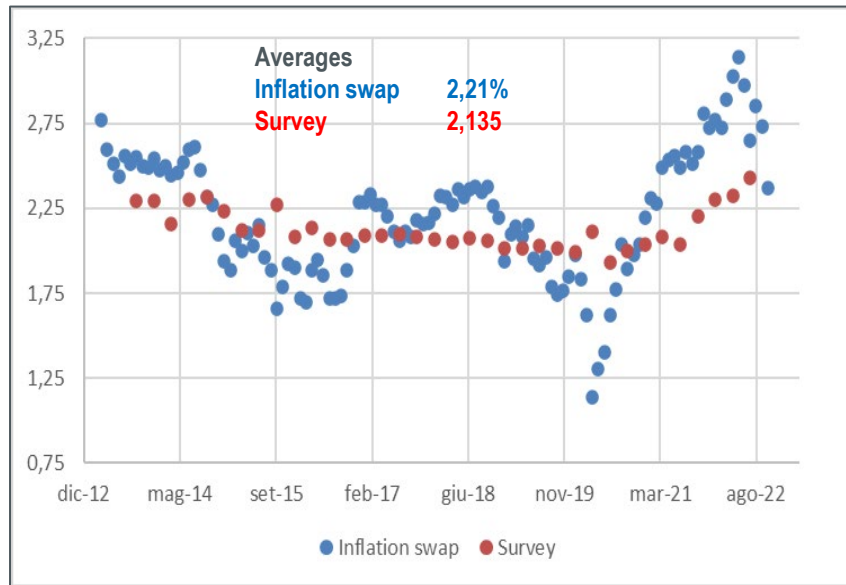
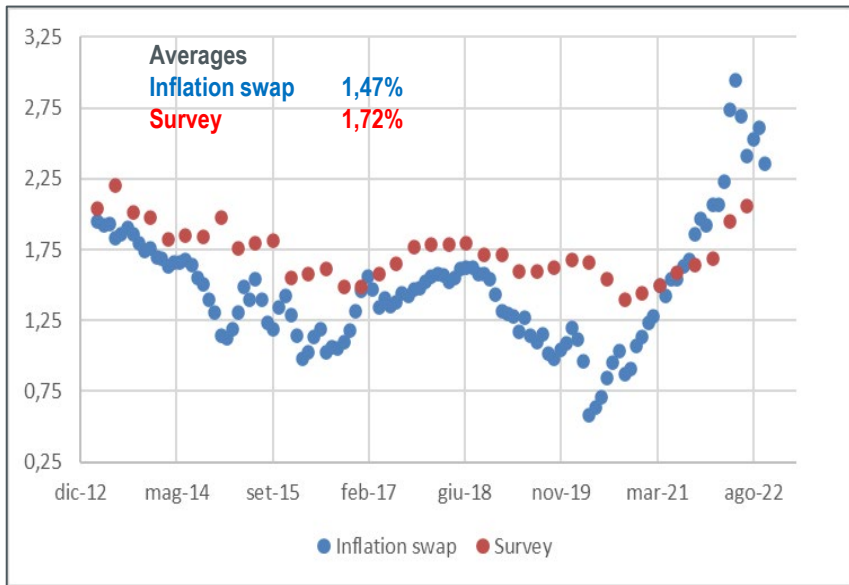


10 years expected inflation – Inflation swaps and EIC survey

Eurozone

USA

Inflation expectations

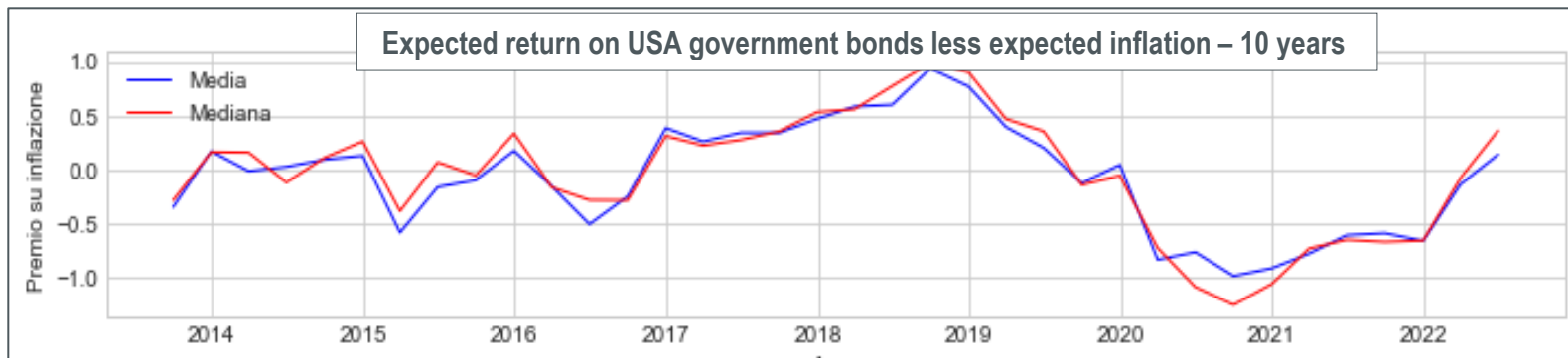
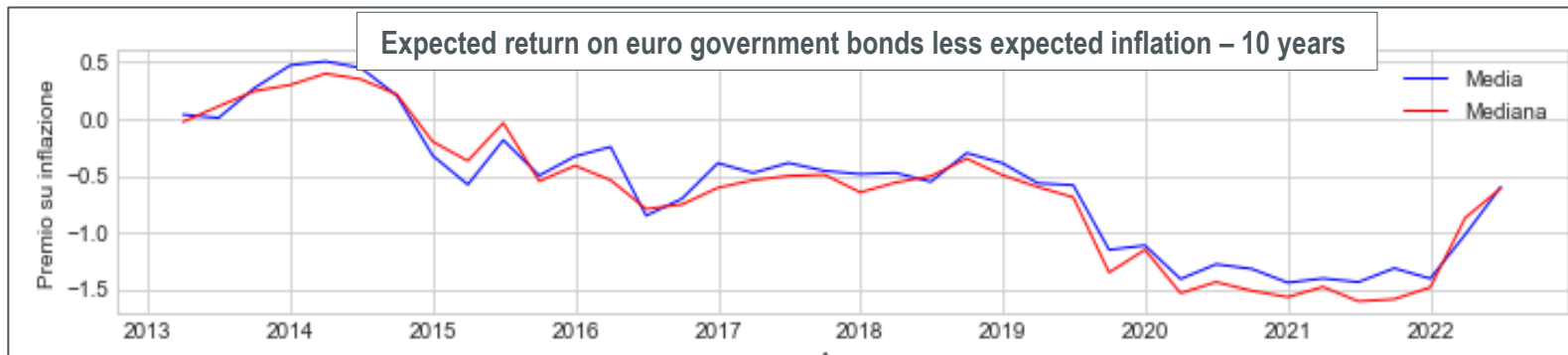


Source: Bloomberg, USA inflation USSWIT10, Euroze inflation EUSWIT10



Negative real expected returns are not a novelty

Expectations and actions





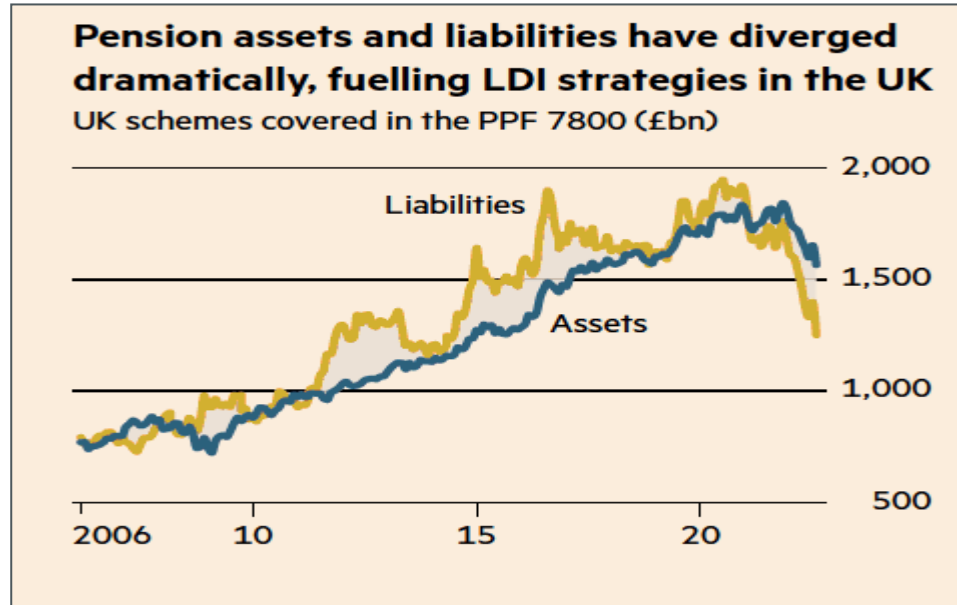
Protecting against inflation - What Italian occupation pension fund have done?

- Inflation can have several and disruptive impacts on financial markets and private pensions (see more later) but, as far as real bond yields rise to positive levels, it can result in a benefit for participants with a reasonable investment horizon
- For defined benefit pension funds the increase of yields reduces the present value of liabilities
- Italian occupational pension funds are defined contribution and can mitigate the impact of inflation with:
 - The end of «financial repression» and the rise of real bond yields to positive levels
 - The averaging role of new contributions on the value of retirement position (real wages growth is key)
 - The long average duration of investment in the funds by participants, given an average age of 47 years and an estimated retirement age ranging from 62 to 70 years
- Italian occupation pension funds had already adapted their asset allocation to the «low for long» environment with:
 - An Increase of the weight of equities;
 - The diversification of bond portfolios outside the Eurozone;
 - An increase of credit risk;
 - An increasing, even if still marginal, allocation to alternatives (mainly private debt);
 - An opportunistic allocation to inflation linked bonds



High rates are good for DB pension funds...

Expectations and actions



Source: Financial Times, October 24 2022



Finally, real expected returns are positive again - 1 - Eurozone

Expectations and actions





Finally, real expected returns are positive again - 2 - USA

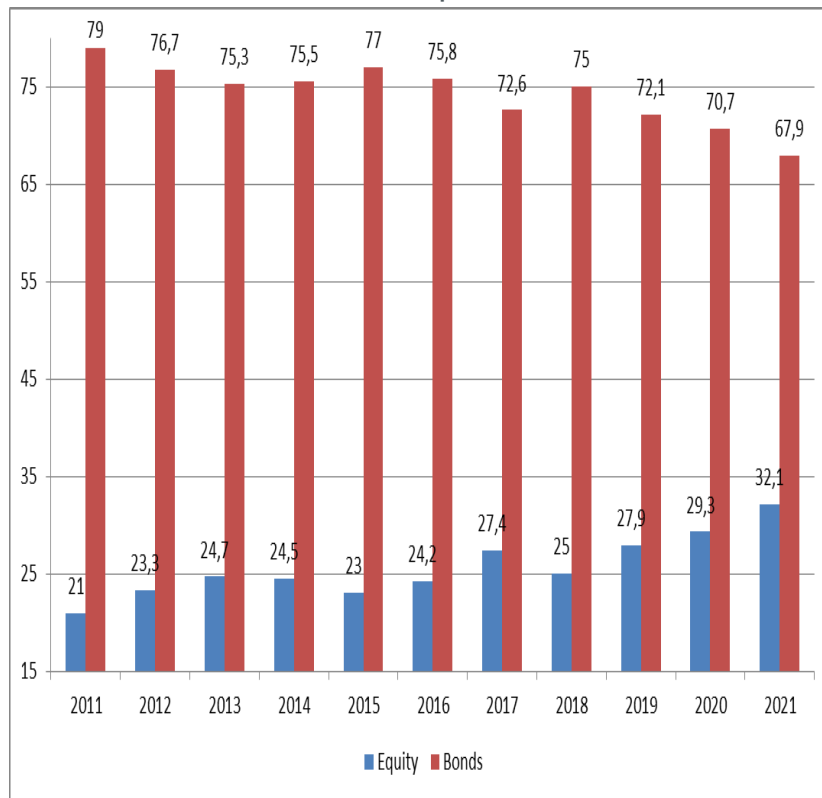
Expectations and actions



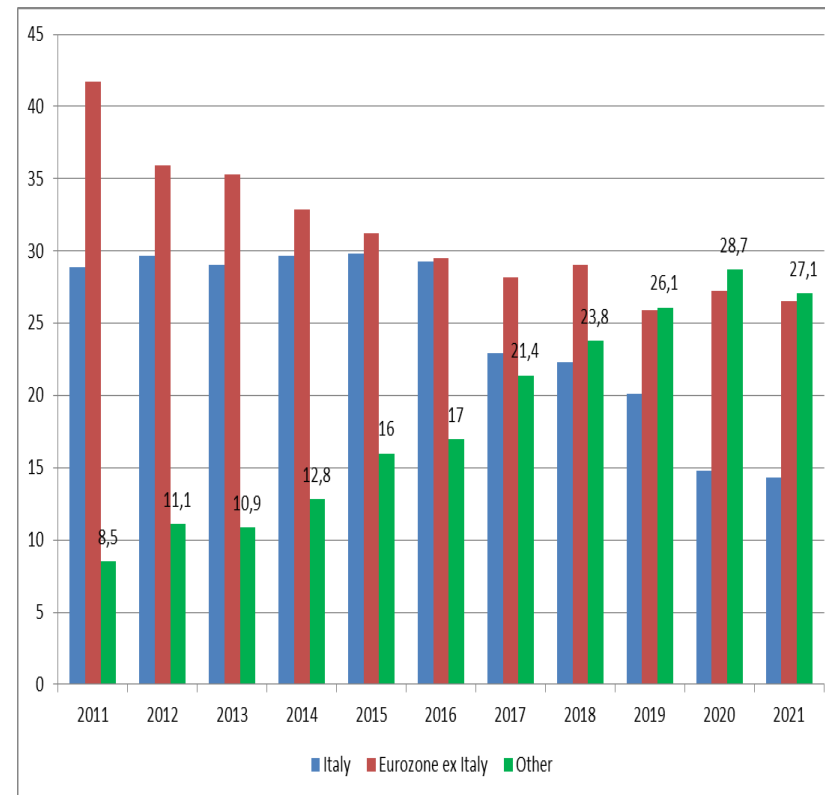
➤ What Italian occupational pension fund have done?

Expectations and actions

More equities



More bonds outside the euro area





In search of «real» assets



Source: bfinance



Inflation is often associated with other dislocations in markets (political uncertainties, changes in fiscal and monetary policy, commodity price spikes)

- Leads to changes in short/medium term revaluations
- Example: Expected returns on illiquid investments relative to liquid assets
- Example: Positive nominal returns on bank deposits are a competitive investment for DC plans

Defined contribution unlike defined benefit do not have implicit indexation of returns (e.g. a link to indexed wages)

- For investors in DC the substitution ratio may decline if nominal returns do not keep up with inflation (not easy to achieve if real returns are negative)

Supply side effects: issuance of long dated securities tends to dry up during inflation (experience of 70-80s)





Contributors to the June 2022 survey

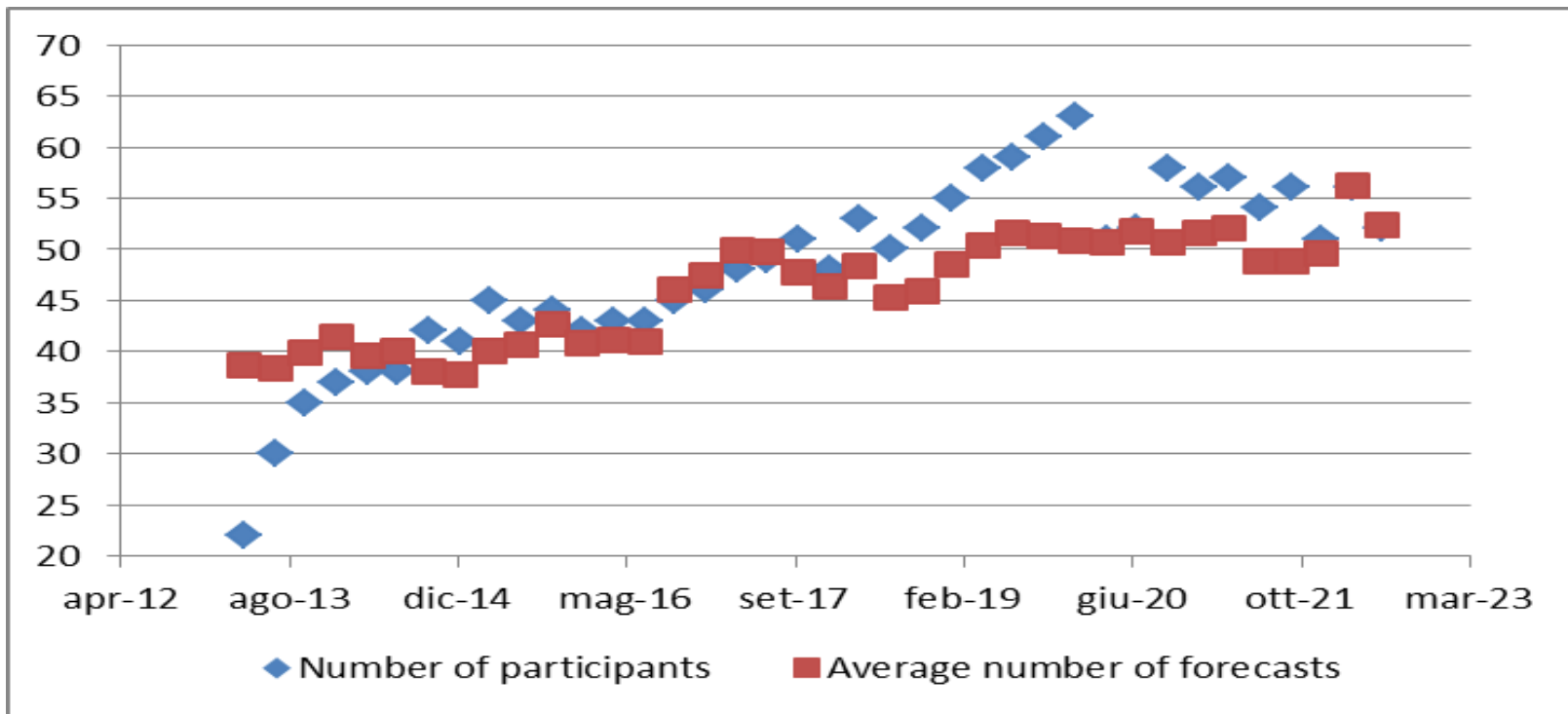
The EIC survey





Number of participants and average answers

The EIC survey





How good is the survey? – 1 – An horse race

The EIC survey

Number of surveys	34	Root mean squared error of forecasts		
Number of 1 year forecasts	Asset class	Median forecast	Last year return	MA 10 years annualized return
914	Equity - USA	13,23%	21,27%	13,45%
819	Equity - Japan	15,46%	28,32%	16,03%
798	Equity - Eurozone	15,10%	25,12%	15,54%
780	Equity - Europe	12,91%	22,04%	13,57%
761	Equity - Emerging Markets	15,41%	26,89%	15,59%
682	Equity - Global Developed	12,86%	20,76%	13,17%
714	FI euro - Gov all	5,24%	6,92%	5,72%
621	FI euro - Gov AAA 10 yrs	4,96%	6,85%	5,08%
610	FI euro - Gov Italy	5,62%	8,05%	6,78%
802	FI euro - Corp IG	3,92%	6,18%	4,34%
716	FI euro - Corp HY	6,18%	11,02%	7,23%
825	Cash euro	0,14%	0,20%	0,50%
698	Inflation - Eurozone CPI	2,06%	2,02%	2,30%
733	FI USA - Gov	4,63%	7,06%	5,11%
681	FI USA - Corp IG	5,13%	7,92%	5,42%
660	FI USA - Corp HY	7,18%	13,01%	8,17%
562	Cash US\$	0,20%	0,80%	1,26%
620	Inflation - USA CPI (*)	2,13%	1,97%	2,29%

(*) 32 observations



How good is the survey? – 2 – A test using the Black & Litterman model

The EIC survey

