Global news

Australia

In 2017, the themes that have preoccupied strategists and policymakers in Australia reflect those affecting the investment industry globally. The following have been a particular focus in Australia:

- **The impact of technology:** Most of the focus is on robo-advisers and other advances that will allow the industry to cater financial services to individuals as opposed to demographic averages. The prospect of tailoring post-retirement options for individuals remains the "holy grail" for a number superannuation funds.
- **Governance:** The focus on governance that we observed in 2016 has continued and is now deepening into a focus on two particular areas for larger clients: a total portfolio approach and developing a high-performance culture. There is an increasing awareness that an investment in both total portfolio management and an improved culture, although difficult, can be increasingly important sources of competitive advantage as we progress through the great acceleration.
- **Tail risk:** Portfolio construction discussions continue around the potential ways to diversify assets as investors get ready for the end of this very long economic cycle and the risk of a material fall in equity prices and/or rise in bond yields. Clients are investigating a number of potentially diversifying strategies and, at the same time, are finessing their fixed-income portfolios to reduce the potential for defensive portfolios to deliver sustained negative returns; this finessing has generally involved reducing duration exposure and increasing credit, liquidity and/or complexity exposure (in various guises).

The Australian regulators have had an active year, with most notably:

- A Royal Commission into banking and financial services misconduct: There was some surprise that this yet-to-be-completed review will include conduct within superannuation funds.
- A consultation package from APRA aimed at bolstering governance of superannuation funds: Trustees that are identified under the proposed prudential framework as being unable to consistently deliver sustainable member outcomes will be encouraged to lift their game or "to gracefully exit the industry." Other potential responses by funds would include merging with other funds, or seeking to outsource certain functions such as administration and/or investment management.

Canada

The subdued economic activity levels observed in 2017 in Canada combined with higher than expected inflation rates pose challenges to the outlook for 2018. In such an environment it is likely that the Bank of Canada will further increase interest rates throughout the year. Moreover, the potential review of NAFTA by the Trump Administration and its potential disastrous implications for Canada adds to these uncertainties.

Regulatory changes announced in 2017 in the Province of Ontario are likely to provide funding relief to some defined benefit pension plans, as funding will move for most plans from a solvency to a going concern basis. This change allows pension plans to focus on the long-term plan management strategy, as it will likely reduce contribution volatility and therefore remove short-term pressures from the system.

Given the high levels of uncertainty and change, the interest in outsourced CIO (OCIO) solutions in the Canadian market as well as the search for additional sources of portfolio diversification will likely remain strong and gain additional momentum in 2018, as plan administrators look for cost-effective ways to improve governance and risk management.

China

With large-cap companies outperforming small-caps by a distance, it would be fair to describe 2017 as divergent for Mainland China's stock market. The 19th National Congress that took place in October, with President Xi's position reinforced and top leadership reshuffled, ushers China into a new era. Under the President Xi's new vision and direction of developing a modernized economy, accelerating innovation and market-oriented reforms will steadily expand the opening of China's capital markets in coming years, allowing all types of investors access via various channels.

For example, the continuous rise in trading volume through the Shanghai-Hong Kong and Shenzhen-Hong Kong stock connect is believed to be indicative of a further and wider rollout. According to Carlson Tong, the chairman of Securities and Futures Commissions, the next step is for both stock connects to incorporate exchange-traded funds (ETFs) by the end of 2018. At the initial stage, only plain vanilla style ETF products will be included.

We believe China's pension industry has had its ongoing problem of uneven distribution in the long term; this is primarily due to inconsistent pension contributions across the country. Contribution rates can vary as much as 10% in different provinces, thus even with a balance of 4 trillion yuan, some provinces still struggle to achieve equilibrium. National coordination is ready to be carried out in 2018 as an attempt to resolve this issue. Their strategy is to transfer state-owned assets into pension funds in order to help tackle the pension gap nationwide, central and local state-owned enterprises as well as government-supervised financial institutions.

Global news

Germany

The German economy displayed strong momentum in 2017, and GDP growth for the year is likely to reach 2.5%. Broadly synchronized global growth has been supportive, while Germany's Euro-area partners are also experiencing a solid recovery. Unemployment in the Euro-area fell from 6.8% to 6.3%; in Germany it reached a new low of 5.5% in December, down from 6% in January. German inflation stabilized at around 1.7%, after moving along the zero-line for most of 2014 to 2016. The Bund curve has steepened somewhat over the course of the year, although 10-year yields fell back to below 0.5% in the last quarter. Yields on government bonds with maturities of up to four years are negative and have even been dragged lower over the year as a result of the ECB's bond-buying activities. The European central banks have to observe the (roughly GDP-weighted) "country key" when buying sovereign bonds, which has made shorter-term Bundesanleihen scarce and extremely expensive. Concerns that extremely low rates will create distortions in the financial sector have given rise to demands that the ECB phase out its bond-buying program. It looks likely that this will now happen in the second half of 2018, with an end to negative money-market rates possibly in the following year.

The German stock market outperformed most European peers a second year in a row, gaining 12.5%, ahead of the Euro Stoxx, which rose 8.2% year-on-year in 2017. Already low Euro corporate credit spreads compressed somewhat further, meaning total return exceeded current yields, achieving 2.4% over the year (Barclays Index). The effect was amplified in the lower-rated Euro high-yield sector, where the total return reached 6.7%. Euro-denominated corporate bonds benefitted from the economic recovery of the Euro area, which triggered a spread rally among Southern European issuers.

The new Investment Tax Law passed in 2016 came into effect beginning of 2018, giving investors a choice between transparent and in-transparent fund vehicles. The application of a one-off tax rate for in-transparent vehicles rather than a penalty taxation is a significant simplification and should broaden the range of investment choices being offered to German institutional investors.

Hong Kong

A 10 billion Hong Kong dollar or $1.28 billion public annuity scheme to be provided by the government-owned Hong Kong Mortgage Corporation (HKMC) will be launched in mid-2018. The scheme could be expanded if popular. Under the new scheme, citizens aged 65 and above will receive monthly payouts for the rest of their lives immediately after making a lump-sum premium payment.

Tentatively, a cap and a floor on the premium amount are set at $1 million and $50,000, respectively. Based on an internal return rate of 4% per annum, the expected monthly payout for males at the entry age of 65 would be around 580 Hong Kong dollars per 100,000 Hong Kong dollars premium paid, while for females, the monthly payout would be around 530 Hong Kong dollars due to longer life expectancy.

This new annuity scheme would complement the existing Mandatory Provident Fund (MPF), Hong Kong's compulsory DC scheme that requires monthly contributions to fund for one's retirement. Under the MPF scheme, retirees can withdraw their accrued benefits in one lump sum or in installments once they reach age 65. Retirees might consider investing all or a certain portion of their MPF-accrued benefits into this lifetime-guaranteed annuity scheme in order to receive a stable stream of monthly income.

Global news

Japan

Japan continues to concentrate its efforts on corporate governance reform, and enhancing stewardship attitudes in the investment chain remains a key focus of these efforts.

In 2017, the Financial Services Agency released the revised version of Japan's Stewardship Code since the original version was formulated in 2014. There are some amendments from the original version to polish the effectiveness of the code, including i) improvement of investment managers' governance structure to appropriately control conflict of interest, ii) increase in transparency of proxy voting disclosure by investment managers, iii) clarification of the concept of collective engagement and iv) enhancement of effective investment manager monitoring by asset owners.

Along with the revision of the Stewardship Code, there has been significant progress in the attitudes of investment managers over recent periods, such as the widely spread launch of independent committees to monitor proxy voting and to review disclosure policy on proxy voting to start publicly revealing individual votes by many investment managers, some of which further disclose rationales behind those individual votes. Another development that drew the industry's attention is the establishment of an organization for collective engagement by some of the largest domestic investment managers including the Pension Fund Association, an owner of assets valued at 12 trillion yen. From the asset owners' perspective, it is also recognized that public pension funds are starting to make an effort on strengthening their monitoring of stewardship activities by investment managers.

However, in contrast, among pension funds sponsored by the private sector, there is a persistent hesitance toward the burden of engaging with stewardship activities. In fact, there has virtually been no increase in the number of signatories of the code in corporate pension funds since a handful of them signed at the beginning. As a countermeasure, the Ministry of Health, Labour and Welfare recently revised its guidelines on fiduciary duty of pension funds as a way of officially encouraging corporate pension funds to consider evaluating stewardship activities of investment managers in their investment decisions. It is currently one of the most controversial topics in the industry and could be either a touchstone of success or failure of corporate governance reform in Japan; how can the wave of stewardship mentality be effectively extended to those conservative corporate pension funds?

Middle East

Over 2017, Middle Eastern economies have continued to be affected by the reduction of the oil price relative to pre-2014 levels, and this is likely to remain a concern in 2018. However, this is likely to be offset by the continuation of production cuts, resilient global growth and accommodative financial conditions. Several countries in the region have adopted 2018 budgets, which echo an expansionary theme made possible through a combination of increased debt issuance, reductions to subsidies and the imposition of taxes. Saudi Arabia has revealed the largest ever budget expenditure to date, while Dubai and Qatar also focus on higher expenditure ahead of the 2020 World Expo and the 2022 FIFA World Cup, respectively. As a result of this sizable planned government spend, commentators are expecting Middle Eastern countries to remain regular issuers in sovereign bond markets during 2018, and Saudi Arabia will also undertake a program of IPOs potentially including Saudi Aramco, the world's most valuable company.

Over 2017 and during 2018, we note that many institutional investors are working hard to respond positively to the new economic paradigm in the region. Assessing individual client context – particularly the objectives of an institution's mandate – has been vital and has led to polarizing outcomes. For example, a number of funds have brought assets back onshore to bolster State balance sheets, whereas other investors have taken the opportunity to diversify their investment portfolios internationally in line with more advanced portfolio management. These changes are being made possible through investors undertaking programs to increase their governance capabilities and by making changes to the "investment model" they employ. Coupled to this trend, we're working with investors to identify areas where they can work their assets harder in order to access higher returns through alternative credit, private markets and direct investment. However, in these changing times we caution investors to take the time to determine their competitive advantages and fully assess the range of implementation options from building internal capabilities to using outsourced solutions.

Global news

Netherlands

In 2018, we foresee a continuation of the trends that emerged over recent years. An important one is the ongoing investment in governance of the Dutch pension sector, driven by both the regulator and pension funds themselves. The number of pension funds is ever decreasing, and the funds that are here to stay have become bigger and invest heavily in their in-house investment capabilities. Starting with more than 1,000 pension funds 20 years ago, it is very likely that by the end of 2018 that number is less than 200. This consolidation is happening through mergers with larger pension funds, the introduction of the so-called "General Pension Fund," an active insurance market and the rise of DC solutions. At the same time, the larger pension funds are looking to unbundle their activities with specialized, internal or external, solutions to optimize their governance and investment portfolios.

Part of this optimization is an increased focus on diversification and effective management of their investment portfolios (i.e., more dynamism). Over recent years, very loose central bank policy and the subsequent search for yield has driven spreads down and practically all asset prices up. Despite continuing momentum across most markets, Dutch investors are increasingly risk aware. To mitigate downside risks, diversification across risk and return drivers is key. This will be illustrated in 2018 by ongoing research into the unlisted alternative credit space, growing attention for secure income assets and reconsideration of both interest rate and inflation hedging. Given market dynamics and increasing complexity, we believe pension funds agree on the importance of efficient implementation and managing the different return drivers underlying these assets more dynamically.

Finally, Dutch pension funds will continue to take pride in their efforts on sustainable investing. Progression on ESG in The Netherlands, by pension funds and Dutch asset managers, has been substantial over the recent years and inspired discussions globally. As more and more implementable solutions are being offered, Dutch pension funds are able to execute on their policies. Overall, 2018 will be a year of increased focus and professionalization to further optimize portfolios in this complex and dynamic environment.

U.K.

For DB investors, 2017 was similar to 2016 in that investors continued to worry about economic uncertainty and the potential for equity market falls, or further reductions in gilt yields to blow them off course as they seek to achieve their long-term objectives. This means there is a continued desire for diversification within growth assets and, as schemes look to de-risk, for a range of low-risk assets that help manage the risks associated with DB liabilities.

With liabilities maturing, there is an increasing focus on nailing down the long-term goals for DB schemes and constructing strategies aligned with these goals. DB investors are choosing between two long-term paths depending on their funding position, the ongoing strength of their covenant and the maturity of their liabilities; the two paths are either buying out the liabilities with an insurance company or long-term "runoff" (effectively planning to continue to pay benefits as they fall due). This focus on the long-term path means DB pension trustees are starting to think more like an insurance company and structure strategies that aim to reduce the cash flow burden. There is increasing demand for assets that provide very long-term, inflation-linked cash flows that have very strong counterparties and/or are well-collateralized (and, preferably, over-collateralized); these types of assets include property-based strategies such as long lease and ground rent as well as social infrastructure and renewable energy. Additionally, buy-and-hold credit strategies are gaining popularity.

Pension scheme trustees are recognizing the need for good governance to ensure they are getting their fair share of the right assets, and that they are in a position to react quickly to market conditions and changing funding positions to capture opportunities. This is leading to trustees spending the bulk of their time determining the direction of travel but outsourcing a lot of the operational matters (such as manager selection and implementation). This trend is likely to continue into 2018 and beyond.

Outsourcing is becoming more prevalent for DC benefit provision, and there has been significant growth in assets moving to Master Trusts, which is expected to continue into 2018. For DC plans that are continuing to be run under the traditional Trust structure, there is more interest in Target Date Funds which, up until now, have been widely used in the U.S. but uncommon in the U.K.

Global news

U.S.

The past year surprised to the upside. Positive market sentiments following the election of President Trump received further support from continued GDP and corporate earnings growth. Inflation remained muted despite tightening labor markets and long bond yields ground lower despite the Federal Open Market Committee (FOMC) continuing its tightening cycle with three additional rate hikes. Monetary policy in Europe and Japan remained largely accommodative, and the populist specter looming over Europe appeared to recede with the election of establishment favorites in Germany and France.

However, it's worth pausing and considering where this leaves us. Equity valuations are at or nearing historic highs across a variety of metrics. Credit spreads are similarly nearing historic lows. Investors are receiving very little compensation for bearing risk as the U.S. moves into the latter stages of the economic cycle: inflation pressures build, China's credit expansion remains unresolved, and significant geopolitical risks loom over the Korean peninsula, Eastern Europe and the Middle East. Low risk premia and major central banks limited in their ability to provide any new large scale stimulus leave little buffer against future market shocks.

While accommodative monetary policy and other cyclical trends may result in continued positive market surprises in the near-term, looking forward, we continue to maintain our "new world" outlook of historically low growth with growing downside risks over time. In this environment, it's prudent for institutional investors to reflect on their current positioning and consider how much and what types of risk are worth bearing.

Market movements over the past year, which have allowed many institutional investors to make progress on their objectives and policy changes over the coming year, including the recently passed Tax Cuts and Jobs Act of 2017 and FASB accounting changes concerning the recording of pension expense, provide incentives to reduce risk and diversify.

The above, taken together, we feel points toward the continued need for U.S. institutional investors to:

- Assess critical resources and fiduciary risk. All investment committees must prioritize their activities. But not all investment committees are created the same; plans, staff, budgets and expertise vary drastically. Consider how your governance structure affects your ability to focus on high-impact decisions, and identify areas where you may require additional support.
- For DB plan sponsors, have a purposeful approach to liability hedging, subject to your context.
- Explore diversity and other risk management strategies (e.g., options, dynamic hedging) in portfolios seeking returns over bonds to potentially reduce the impact of the downside market event on portfolios.
- Use dynamic portfolio views where possible and appropriate, subject to your governance.
- Keep a sharp focus on external costs and value for money, with expected returns and yields likely to stay historically low for years, recent and expected FOMC rate hikes notwithstanding.