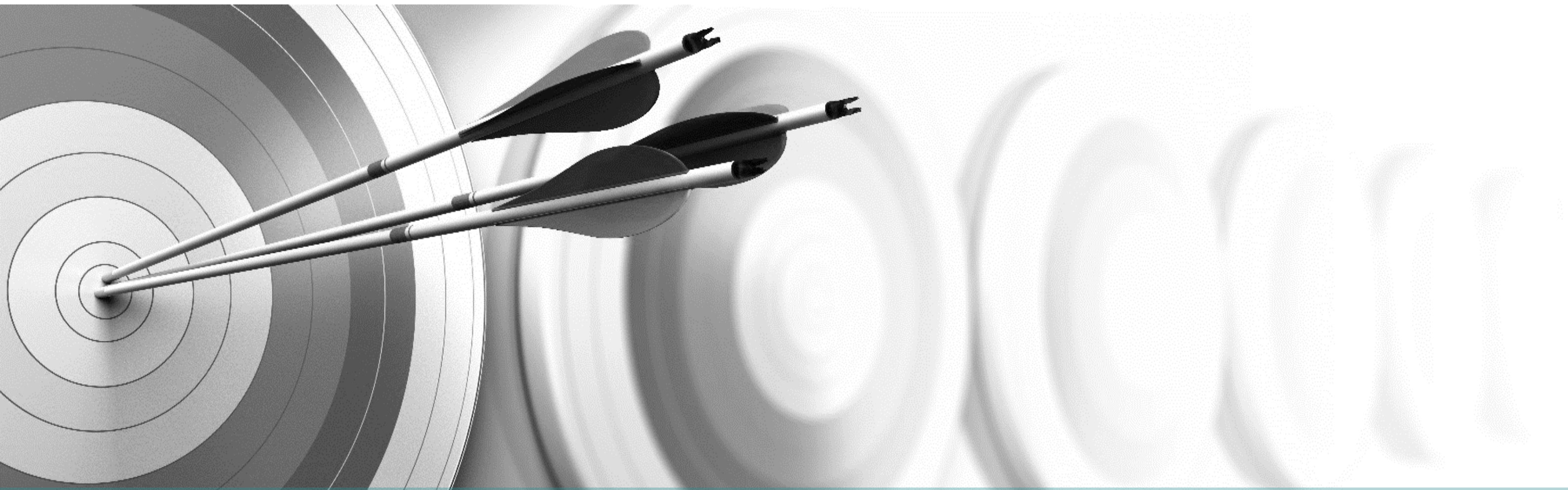

Executive Summary |April 2020

ASSET ALLOCATION IN EUROPE

Reality vs. Expectations

CHAIRMAN Jean-Pierre Pinatton RAPPORTEUR Cosmina Amariei

Disclaimer

This Task Force was organised by CEPS and ECMI as part of an independent research agenda.

A set of sound and clear principles has guided the entire proceedings in order to preserve an impartial approach to divergent opinions. The Chairman steered the dialogue among the various stakeholders in a constructive manner and provided valuable guidance throughout the entire drafting process. The Members were given ample opportunity to provide input at various stages and make sure their views are accurately reflected in the report. However, the content of this report should be attributed solely to the Rapporteur and not to ECMI, CEPS as institutions or any individual member/expert, observer or guest-speaker.

The report relies extensively on the discussions from dedicated meetings and workshop, bilateral consultations/review, secondary/desk research and empirical findings from recent external studies at ECMI. In addition, a series of debates on sustainable finance was organised separately from the main Task Force. The policy recommendations follow closely relevant market practices and regulatory developments.

It is beyond the scope of this report to suggest any specific savings or investment strategy to address the impact of the health crisis on the real economy and the financial sector at large.

A detailed overview of the overall proceedings is available on this dedicated webpage.

The full report is available for download here.

Note. The experts featured in the annex participated in their personal capacity and may not necessarily endorse the report in its entirety or subscribe to the full list of recommendations and/or overall conclusions.

Amariei, C. (2020). Asset Allocation in Europe: Reality vs Expectations, CEPS-ECMI Task Force Report, Brussels, April 24.

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FOREWORD

Our economic, social, financial and political environment is in a constant state of flux.

Changes are taking place at an ever-faster pace and sometimes in a brutal fashion. This results in substantial volatility in financial markets and the investment vehicles available to investors seeking to manage their savings efficiently. It also explains why asset allocation has become a key factor for anyone trying to generate a satisfactory return for a given level of risk. Changes in asset allocation have become as important as arbitrage between individual securities.

What does Asset Allocation mean and for whom?

Retail investors must first choose where their savings are going to be placed: in a securities account with a bank or a broker? In a life insurance contract? Via contributions to a pension fund public or private system? They will then have to decide to invest directly in securities or through mutual funds and ETFs.

Numerous criteria are used in the decision-making process: safety, liquidity, FX risk, taxation, estate, trust in their advisor. Retail investors must also decide whether they have the time and expertise to manage their investment or if they prefer instead to give a discretionary mandate to a professional. But even in this case, they will have to guide the manager by expressing their criteria in terms of risk and investment horizon.

For professional fund managers, asset allocation criteria are a direct consequence of the investment strategy disclosed in the documentation of the vehicle that they manage. The manager of a UCITS fund that signalled the intention to try and beat the market by investing in large-cap stocks will have to suffer market downturns; his/her options are limited to the choice of stocks and the possibility of acquiring an edge if this has been authorised in the documentation. The manager must also consider the constraints resulting from the liquidity offered to the units' holders.

In contrast, a portfolio manager in a pension fund can take advantage of the considerable stability offered by the long-time horizon adopted by its subscribers.

The manager of discretionary accounts or of a diversified investment fund will have to achieve the level of volatility expected by the client by mixing equities, fixed income securities, cash, alternatives as well as the choice of the individual security in each category.

Asset allocation for insurance companies is impacted by prudential and accounting rules, which in turn may limit their ability to invest in equity instruments.

Faced with this immense diversity of situations, the present report does not aim to provide guidance for asset allocation but rather to describe the various aspects that affect asset allocation in Europe.

With an unwavering focus on the protection of retail investors, European regulation tries to provide for the harmonisation and quality of products across the European Union. It is, however, confronted with the diversity of local situations: tax treatment, pension systems, distribution networks, securities market development, levels of financial knowledge, etc. It is therefore difficult, at the European level, to guide savings in any one specific direction, for example, towards the financing of SMEs.

Asset allocation is, furthermore, increasingly set to include ESG factors, which are often requested by investors. A global approach is therefore necessary to remove barriers and encourage efficient asset allocation that will protect investors and finance the development of all types of companies.

This will be the challenge of the new Capital Markets Union.

Finally, I wish to express my gratitude to the several experts and numerous members of the Task Force, as well as observers and guests, who have actively contributed throughout the proceedings. A special thanks goes to Cosmina Amariei who, as Rapporteur, coordinated all the contributions and wrote the final report.

Jean-Pierre Pinatton
Member of the Supervisory Board, ODDO BHF

INTRODUCTION

In Europe, capital markets are expected to play a more prominent role in corporate financing, retail/institutional saving/investment and private risk-sharing altogether.

In the current institutional cycle, CMU remains as relevant as ever. However, it needs rethinking at EU level and real commitment from member states. The capacity of capital markets to enhance the resilience of our societies as a whole, especially when confronted with unprecedented shocks, should certainly be given more thorough consideration.

In order to contribute to the public debate, CEPS and ECMI invited relevant stakeholders– policymakers, supervisors, consumer associations, industry representatives, and academics – to take part in a dedicated Task Force on "Asset Allocation in Europe: What challenges and opportunities lie ahead?".

The main objective of our initiative was to explore meaningful ways of activating long-term savings and investment channels across the EU, with a focus on households, asset/fund managers, insurers and pension funds, under the overarching theme of sustainability in the real economy. The recent developments related to COVID-19 were also taken into account.

To this end, we invite you to read the analytical sections in the final report as well as the accompanying list of policy and market recommendations.

Cosmina Amariei
Researcher, European Capital Markets Institute

RECOMMENDATIONS

RETAIL INVESTORS

- There is significant potential for activating retail savings in capital markets across Europe. Less advantaged households should be prevented from making allocation mistakes and protected against the mis-selling of products. Public and private efforts on the financial education front should be complemented by progress on delivering affordable/unbiased investment advice and more open distribution channels.

- The extent to which retail investors can easily gain access to equity (public or private markets) should be carefully analysed, i.e. identifying market and regulatory hurdles and promoting investment solutions at national and EU levels. Retail investment could also be channelled into assets that establish stronger links with the needs in the real economy, such as the growing funding gap for SMEs.

- As regards specific financial instruments, policymakers and consumer associations have drawn attention to the limited participation in the ETF market. In Europe, these could provide individuals with low-cost vehicles to pursue opportunities generally confined to institutional investors. However, ETFs cannot 'miraculously' solve the problem of household portfolios being under-diversified.

- It is paramount that ESAs and NCAs effectively oversee the interaction among the different sectoral EU rules affecting households (banking, asset management, insurance, pension funds) and assess their impact on how they allocate assets. This is also linked to a holistic assessment of the cumulative impact of product governance, prudential and tax rules and the need to ensure a level playing field among providers.

- A horizontal regime in manufacturing, distribution and advice should be benchmarked against the extent to which retail investors benefit from increased access, transparency and suitability. Comparison-tools for different savings/investment products, statistics on performance, costs and net returns and a public online database (in the long run) should be designed at EU and/or national level.

- PEPP could offer a tangible improvement for European citizens. If sufficiently attractive for both providers and savers, PEPP could become a 'quality label' for a vehicle for long-term investments delivering stable returns over time. Life-cycle strategies and financial guarantees for the default option, competition as well as partnerships among different providers, and preferential tax treatment are key elements.

ASSET MANAGERS

- Asset managers will have to re-examine their strategies for organic growth in retail and/or institutional assets given the prolonged low interest-rate dynamics, increasing costs (research, regulatory, data) and fee pressure, i.e. revisiting portfolio construction (traditional and alternatives) and the range of funds/solutions as well as fine-tuning the quality of trade execution and advisory services.

- Retail investors need a more balanced, diversified asset allocation. Fund managers are expected to bring institutional capabilities to private wealth management through bespoke/customised solutions but also to develop fully scalable, simple, high-quality and cost-efficient retail products. Sourcing assets on a cross-border basis and optimising distribution networks will play a key role in penetrating local/regional markets.

- Institutional investors are looking at their investment portfolios in a holistic manner and rethinking the mix of alpha-seeking, index-based, cash management as well factor-based strategies. For liability-driven mandates, asset managers will need to double the risk-adjusted returns analysis with capital consumption/absorption for each asset class, over multiple time frames and scenarios.

INSURANCE COMPANIES

- The Solvency 2 regime must remain risk-based, work for the insurance industry as a whole and ultimately achieve its key objective of policyholder protection. Any changes should be assessed against wider policy objectives, such as supporting long-term savings and investment in Europe, while monitoring their impact on asset allocation and the overall product mix.

- Encouraging buy-and-hold behaviour should not be seen as the unique approach to ALM; the capacity to actively rebalance portfolios over market/economic cycles is equally important. Recalibrating the risk weights for listed equity as well as exploring alternative accounting to fair value measurement should have a sound prudential basis, beyond the economic and political considerations of CMU.

- As part of search for yield, the shift in exposures should be grounded in the illiquidity profile of liabilities and complemented by enhanced risk management. Where asset management is outsourced, mandates will require returns in capital-adjusted and cost-effective terms. This will allow insurers to improve operational efficiency and have access to specialised research/investment portfolio capabilities.

PENSION FUNDS

- The product mix (and underlying asset allocation) will have to accommodate demographic trends, in particular the longevity risk. Exposing participants to maximum market risk in the early stages of their professional life and minimising the risks progressively towards mid-career and retirement (but ideally still invested into equity after the retirement age) through life-cycle strategies should be actively promoted.

- Pension plans should provide ‘good value for money’ by setting fair, affordable contribution levels and implementing adequate investment strategies. Policymakers should create and maintain benchmarks for DB and DC providers (peer groups, default funds) that include information on administration costs and service levels and investment cost, risk and return, depending on the specificities of their markets.

- The challenging market environment will continue to put funding positions of pension plans under pressure. Recovery mechanisms at national level are able to mitigate only the short-term effects on financial stability. In the longer run, the feasibility of measures at EU level should be analysed provided that the specificity of the pension sector and diversity of players within and across member states is taken into account.

SUSTAINABLE FINANCE

- Raising the bar for company disclosure and third-party assurance by establishing integrated and standardised frameworks at EU level is the way forward in order to achieve greater consistency, comparability and reliability. Large companies tend to report more comprehensive ESG metrics and dominate investors’ portfolios compared to SMEs, for which requirements should be adequately calibrated.

- On the duties to explicitly consider ESG factors, the roles of asset owners and asset managers should not be conflated. A priority should be given to avoiding an unwarranted market segmentation between individual and institutional investors by making product marketing and distribution as well as portfolio management more responsive to sustainability preferences, i.e. standardisation vs customisation.

- ESG risks are characterised by deep uncertainty, non-linearity and endogeneity. Pricing them in investors’ portfolio requires moving from the backward-looking nature of traditional financial risk assessment and conventional market benchmarks to a forward-looking approach through scenario-analysis. The ESAs should provide detailed guidance, in addition to adjusting sectoral stress tests and monitoring interconnected exposures.

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