

17<sup>th</sup> May 2013



# **Agenda**

- Global economic and market background
- Asset allocation trends
- Challenges facing pension funds
- Risk and uncertainty
- Thematic investing

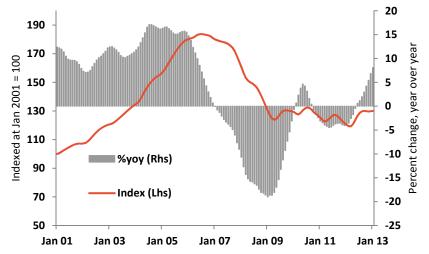


#### **United States**

#### Strong evidence that US housing market bottomed in Q1 2012

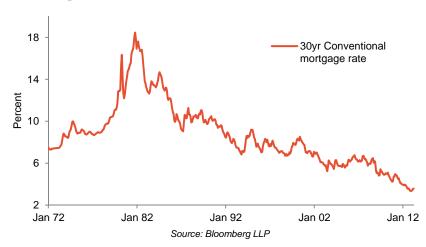
- House prices are following a sustainable upward trend.
- Near-record low mortgage rates have helped to sustain gross borrowing.
- Wider economic recovery is expected to reaffirm its improving trend over the coming quarters.

#### **US house prices – Case-Shiller index**

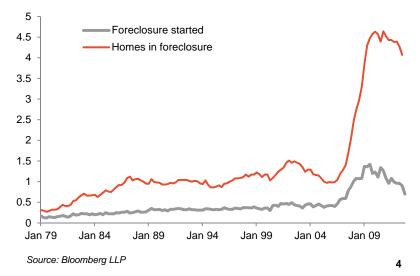


Source: Bloomberg LLP, Towers Watson

### Near-record low mortgage rates have helped to sustain gross borrowings.



#### US foreclosures have declined since peaking in 2009



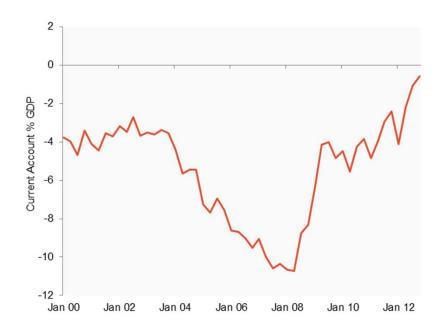
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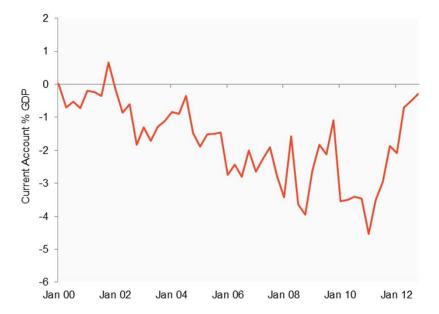
# Euro area: On a more sustainable debt path

#### Funding gaps in the periphery have closed in the last six months

Spain's current account deficit has been cut to zero, primarily through a significant reduction in demand and imports

Italy's external position has experienced similar improvement

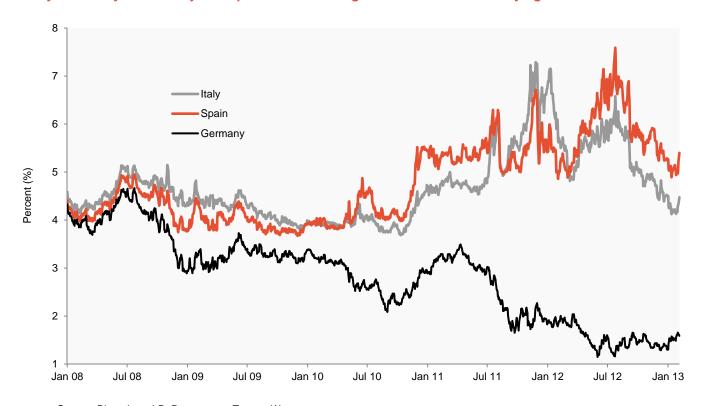




### Euro area

# Spanish and Italian debt dynamics are manageable – economic conditions will remain depressed

#### 10-year bond yields in Italy and Spain remain too high relative to weak underlying economic conditions



Source: Bloomberg LP, Datastream, Towers Watson

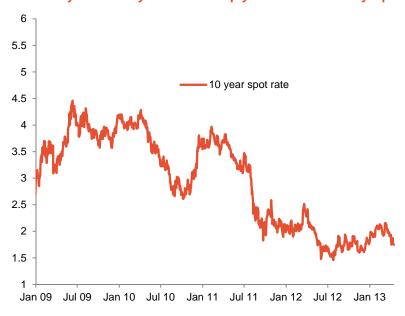
#### **Government Bonds**

#### Bond yields fall back below start-of year levels

#### An unchanged outlook

- Official rates are expected to be close to zero until 2015. Central bank purchases of long bonds have also depressed yields of longer maturity bonds.
- The unwinding of such policy could result in significant bond losses over a 3-4 year horizon.

#### US 10yr nominal yields fell sharply in late March/early April.



Source: Federal Reserve

## **Equities**

#### We remain positive

Developed market performance strong year-to-date, emerging markets lag

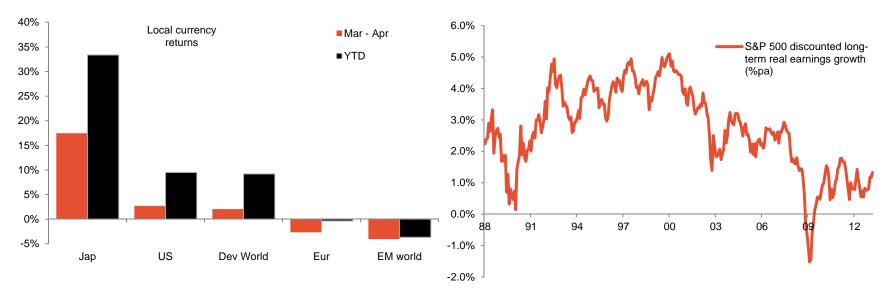
• Accommodative monetary policy in conjunction with improving economic data has continued to support equity prices year-to-date.

Markets remain moderately attractive

 Markets continue to price-in mediocre expectations for earnings we think equities are reasonably attractively valued over the medium term.

#### Strong developed market performance YTD, emerging markets less so

#### Discounted long-term real earnings growth in the US



Source: Thomson, Towers Watson

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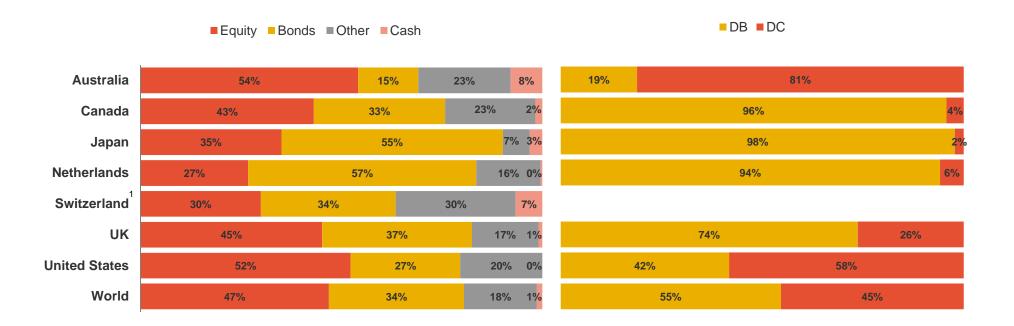


## **Global Pension Assets Study 2013**

Key findings

Asset allocation 2012

DB/DC Split 2012

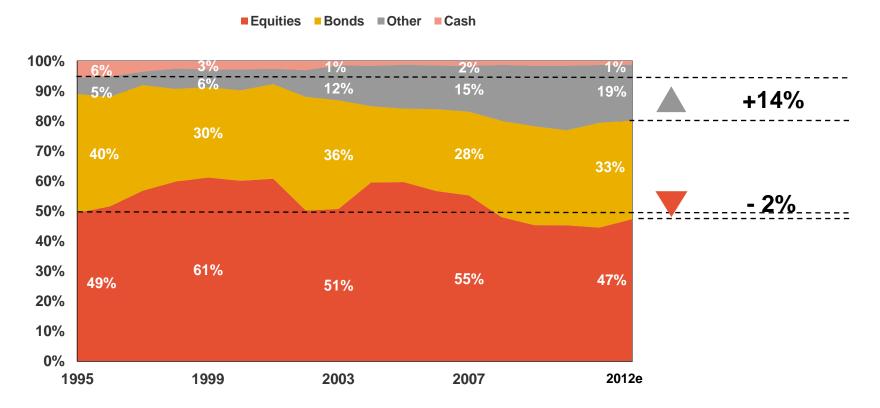


Source: Towers Watson and secondary sources

<sup>&</sup>lt;sup>1</sup> DC assets in Switzerland are cash balance plans and are excluded from this analysis.

#### **Pension asset allocation**

Aggregate P7 asset allocation from 1995 to 2012



Source: Towers Watson and secondary sources



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## Issues facing pension funds

- Global assets now exceed \$30 trillion\*, up 80% in 10 years, but liabilities are about \$5 trillion more than this
- Pension fund strategy has moved more defensive and more diversified
  - '40/40/20 is the new 60/40'
- Strategy is now challenged by the credit risk of sovereign bonds
  - Doubts on the risk free safe place
  - A lack of appropriate hedging assets
  - LDI evolution hampered by low interest rate regime
- But most of all, funds need higher returns than seem likely under the new macro

\*Source: Towers Watson 2012 Global Pension Asset Study

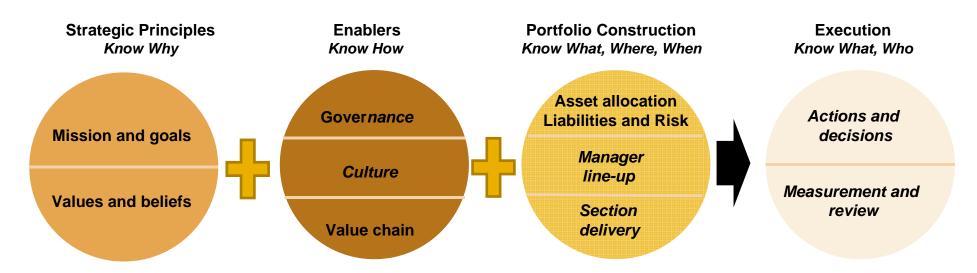
### 'Thrifty Fifty' - the 50 biggest and most influential longterm asset owners

- 'Thrifty' = 'wise economy in the management of money and other resources'
- 'Fifty' = 50 funds all above or around \$50 billion and 50 professionals
- 33 pension funds, 14 sovereign wealth funds, 3 endowment/ foundations, totalling \$10.3 trillion
- 2012 report card:
  - Mission: Fiduciary responsibility and playing their part in wealth creation/ well-being
  - Governance: organisational effectiveness and transformational change
  - Private market integration: private markets made up to public market standards
  - Long termism: optimising sustainably to the long term, satisficing the short term

Several reasons to study these funds' next moves

### **Investment governance**

- Organisational effectiveness concepts
- Effective Board and executive team roles
  - The product of Board and executive team should be more than the sum of parts
- Emphasis on strategic principles and enablers
- Value comes from optimising governance budget and risk budget



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### The big picture on 'risk'

- We tend to manage risk we can see and measure
  - a case of 'wrong type of snow'
- Risk is a considerable source of competitive edge for organisations
- While the tools and theory to manage risk are getting there, the problems are on the people and processes side
- Managing risk well involves combining a strong risk framework with strong risk governance, with the effective risk tools completing the list

#### Risk framework

Framing risk in its widest form, having regard to all its sources and facets and paying particular regard to time horizons

#### Risk governance

Approaching risk with the right resources, responsiveness, thinking and processes, with special regard to decision-making

#### Risk tools

Accessing security-level detail, integrated to fund context, consistent with risk framework, real-time in delivery

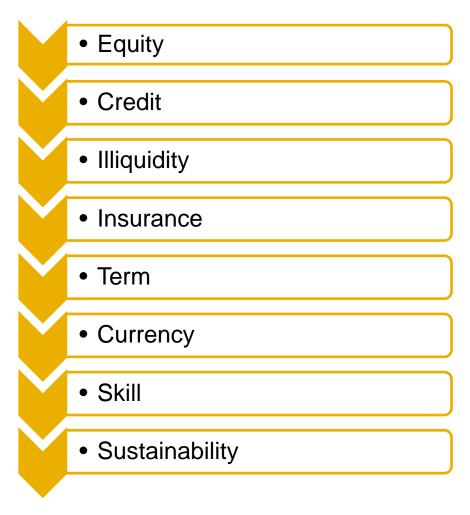
### Risk is multi-sourced



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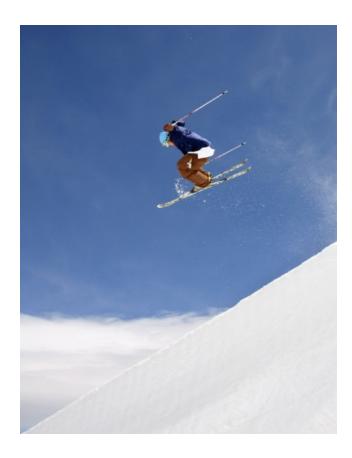
### Risk can be good as well as bad

- Funds with long-term missions need to take risk to create wealth and meet liabilities
  - Taking the right amount of the right types of risk
- Deliberate taking of risk is a major area of decision
  - Economically justifiable factors
  - Secular and temporal factors



# Ultimately, risk is about not surviving the journey

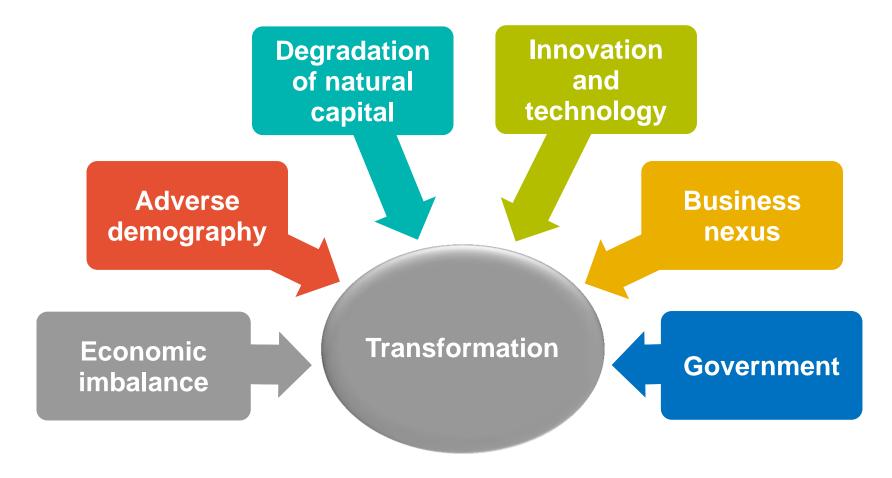
- Risk is not volatility
- Risk is permanent impairment to mission
- Need better risk framework
- Need better risk governance
- Need better tools





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### Position yourself for transformative change



Thematic approach helps us to understand, and anticipate structural changes

Our themes are ones we expect to be important over the next decade and beyond

# TW's thematic framework (1)

**Economic imbalance** 

Adverse demography

Rebalancing & leverage

- Rise of developing relative to mature economies
- · Sectoral imbalances of certain nations resolved
- Deleveraging in west, releveraging elsewhere

Demand for safety

- Supply of, and demand for safe assets
- Altered perceptions of safety
- Safety from inflation is critical

Population growth

- 700 million additional people over the next decade
- Occur mostly in developing nations
- Drive continuing urbanisation, but also resource constraints

**Ageing** 

- Ageing is always predictable and sometimes stark
- Critical for relative growth rates, consumption and savings patterns

## TW's thematic framework (2)

# Resource scarcity

- Continued convergence in living standards and growing populations
- Reactions will be twofold: i) resource price inflation; ii) innovation

# Climate change

- Increasing pressure to internalise externalities of environmental impact
- Non-linear/unpredictable impact

# Globalisation & technology

- Technology has enabled global business models
- · Rising intra-country inequality which may create political tensions

# New technology

- Transformational new technologies have the potential to come on stream
- Source of opportunity and risk

# TW's thematic framework (3)

Business nexus

Government

Sustainable business models

• Businesses and economies managed in a sustainable – in the broad sense – manner are most likely to succeed over the long-run

Labourcapital relations

- The relative scarcity of labour and capital is an important driver of returns to capital
- Developing talent and using capital efficiently is likely to be key

Regulation

Greater regulation of environmental, societal and financial outcomes

Intergenerational equity

- Long-term sovereign finances of key mature economies are a key source of intergenerational inequity
- · Changes to entitlement, taxation and environmental policies

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