ASSET ALLOCATION SURVEY
EUROPEAN INSTITUTIONAL MARKETPLACE OVERVIEW 2013
2013 has so far provided investors with something of a respite from the risk-on/risk-off behaviour that has characterised markets since the onset of the financial crisis. Indeed, investor sentiment has improved to such an extent that commentators have started talking of a “great rotation” from bonds into equities (although there is scant evidence for such a shift). One of the main drivers of this improvement in sentiment seems to be an assumption that financial “tail risks” have been reduced by the explicit commitment of central bankers to “do whatever it takes” to alleviate periods of market stress. However, despite strong returns for most financial assets over the past six months or so, the global economy faces many significant challenges, and timely decision-making by policymakers remains critical both to market stability and to ensuring a sustained recovery takes hold in the developed world. Eurozone investors, in particular, are frequently reminded of the difficulties in deleveraging their economies, with Cyprus being the most recent casualty of an unsustainable financial position.

Against this uncertain macroeconomic backdrop, investors are faced with the challenge of generating real returns while managing risk. Unprecedented monetary stimulus on a global scale may be necessary to nurse the developed world back to economic health, but a sustained period of negative real interest rates, or “financial repression”, presents a major headwind for investors. In response, pension plans are making use of an increasingly broad range of asset classes and tools in both the growth and matching portfolios; seeking to ensure that their strategy can be dynamic in response to changing market conditions; and expanding the range of inputs into the risk management process, often including scenario and stress test analysis.

This is the 11th year of our survey and the eighth year since we started including data on non-UK European pension plans. The survey provides a comprehensive overview of asset allocation trends across the European pension industry and offers some valuable insights on the likely direction of travel.
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EQUITY ALLOCATIONS CONTINUE TO FALL
There remain powerful incentives for pension plans to reduce equity-related volatility, in particular the regulatory environment and a desire on the part of corporate sponsors to mitigate the impact of pension plan volatility on their balance sheets. In addition, rising equity markets over the course of 2012 and early 2013 will have generally lifted funding levels, providing some of those plans on a path to a lower risk position with an opportunity to reduce equity allocations.

EVOLUTION OF BOND PORTFOLIOS
Although pension plans have, in general, been loath to add meaningfully to traditional government and corporate bond allocations very recently, given the low yields on offer, investors have continued to allocate to a range of assets that can help match their long-term liabilities. Sophisticated liability-driven investment (LDI) strategies are now commonplace among plans in the UK and the Netherlands and, to a lesser extent, in Germany and Ireland.

INCREASING BREADTH IN ALTERNATIVE ASSETS
Pension plans across Europe now allocate to a vast array of alternative asset classes in order to access an increasingly diverse range of return drivers. In particular, plans have been expanding the range of asset classes within their fixed income portfolios to include high yield, emerging markets debt, private debt, and less constrained bond mandates. Investors are also increasingly comfortable allocating to niche hedge fund strategies, and real asset portfolios now include exposure to long-dated property leases, infrastructure, timber, agriculture assets, and natural resources.

GREATER USE OF DELEGATION TO MEET THE GOVERNANCE CHALLENGE
Delegated decision-making now plays an important role in many aspects of a pension plan’s investment strategy. Within the alternatives portfolio, diversified growth funds (DGFs) have become a popular means of introducing diversification and dynamism for small and medium-sized plans with a limited governance budget. LDI strategies increasingly incorporate a degree of delegation, whether in relation to instrument selection (for example, swaps versus government bonds) or for the implementation of interest rate and inflation hedging when given yield triggers are breached. And at a strategic level, many plans now delegate the implementation of changes to the growth/defensive asset allocation (often in response to funding level changes) to a subcommittee, investment manager, or fiduciary manager.

SIGNIFICANT DIFFERENCES REMAIN BETWEEN LARGE AND SMALL PLANS
Although small and medium-sized plans now make use of many of the same investment tools as their larger counterparts (for example, de-risking plans, LDI, alternatives), there remain significant differences in approach. In particular, larger plans make use of a greater number of investment managers with more aggressive outperformance targets, have more sophisticated LDI portfolios (often managed on a segregated basis), have more broadly diversified alternatives portfolios, and also review their investment strategy more frequently.

DIRECTION OF TRAVEL IS CLEAR
Responses to the forward-looking questions in this year’s survey suggest that investors will continue to reduce equity allocations in favour of bonds (in particular, inflation-linked bonds and other matching assets) and alternatives (with UK plans continuing to allocate to DGFs). We also expect to see increased interest in a wider range of fixed income assets against a backdrop of falling yields and spread contraction (versus government bonds) across the credit spectrum.
SURVEY PARTICIPANTS

This year our survey covers more than 1,200 plans in 13 European countries, representing assets of more than €750 billion. The charts below show the composition of the survey participants both by country and size of plan assets.

As illustrated in Chart 1, UK plans, representing 46% of survey assets, remain the largest group of participants by country. When broken down by plan size, as illustrated in Chart 2, the largest category of survey participants (by number) is plans with assets below €50 million, representing 44% of all plans — down from just under half of all participants in 2012. However, Chart 3 highlights the fact that although smaller plans make up the largest category of participants by number, they still represent a small proportion of the total assets under review.

There is inevitably some turnover in the survey participants from one year to the next. However, the majority of plans remain part of the survey, allowing us to identify trends and changes in asset allocation behaviour over time based on a robust core of data.

1 Charts in this report may not add up to 100% due to rounding, unless otherwise specified. Values provided in this survey are quoted in euros. Data provided in this survey were collected during January 2013.
ASSET ALLOCATION BY COUNTRY AND PLAN SIZE

HIGH-LEVEL STRATEGIC ASSET ALLOCATION BY COUNTRY

Chart 4 shows the average allocation to broad asset categories.

At an individual country level, plans in Ireland have the highest allocation to equities, at 44%, with this figure unchanged from last year’s survey. UK plans have historically sat alongside their Irish counterparts in having a relatively high allocation to equities when compared against other European plans. However, UK plans have continued to reduce their allocation to equities over the year since our last survey, with the (unweighted) average allocation falling by 4% to 39% of total assets. As a result, Swedish and Belgian plans now allocate more to equities (on average) than do UK plans. Average equity allocations across all other regions covered in the survey are (in round figures) between 10% and 30%.

Equities and bonds continue to dominate pension plans’ investment strategy, typically accounting for around 80%–90% of assets across almost all countries. Property allocations vary in size from zero (in Spain and Belgium) to 15% (in Norway and Switzerland). Cultural, regulatory, and historical features of pension provision in each market explain a large part of the differences in asset allocation across countries.

Looking forward, given the prevailing level of bond yields and the equity-unfriendly nature of the regulatory environment, it seems likely that allocations to alternative asset classes will rise over time as investors seek to generate real returns in the face of financial repression. Alternative investments is a theme we will return to later in the report.

2 We show data for German Contractual Trust Arrangements (CTAs) separately given their different regulatory treatment. A CTA is a special-purpose vehicle into which the sponsoring employer transfers assets for the sole purpose of securing the pension liabilities under a direct commitment plan. Employee benefits remain ultimately secured by the employer.
DETAILED STRATEGIC ASSET ALLOCATION BY COUNTRY

Charts 5 and 6 show the broad strategic asset allocation by country at a more granular level. The domestic/non-domestic equity split varies considerably across different countries. However, at an aggregate level, the domestic allocation represents, on average, around 40% of the total equity portfolio for European plans. A gradual reduction in the domestic component of equity portfolios has been particularly clear in the UK, where the average domestic allocation has fallen from around 50% to 35% of the total equity portfolio since 2010. Although the greater use of global equity mandates has been a large part of this shift, emerging markets, low volatility strategies, and, to a lesser extent, small cap equities have also become important parts of pension plan equity strategy.

Within bond allocations (as illustrated in Chart 6), a significant domestic bias remains prevalent. This is to be expected given the liability-focused role that bonds generally play in pension plan portfolios. Plans in the UK and Ireland display materially higher allocations than other European countries to index-linked government bonds. This largely reflects the nature of the pension promise in these markets (which typically incorporates some degree of inflation linkage) and a desire for pension plans to better

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**Chart 5: Strategic asset allocation by country**

- United Kingdom
  - Domestic equity: 14
  - Non-domestic equity: 25
  - Bonds: 47
  - Property: 3
  - Cash: 11
- Germany
  - Domestic equity: 4
  - Non-domestic equity: 7
  - Bonds: 68
  - Property: 10
  - Cash: 11
- Germany (CTA)
  - Domestic equity: 12
  - Non-domestic equity: 17
  - Bonds: 57
  - Property: 2
  - Cash: 12
- Finland
  - Domestic equity: 7
  - Non-domestic equity: 17
  - Bonds: 56
  - Property: 9
  - Cash: 10
- Norway
  - Domestic equity: 2
  - Non-domestic equity: 7
  - Bonds: 70
  - Property: 15
  - Cash: 3
- Denmark
  - Domestic equity: 3
  - Non-domestic equity: 20
  - Bonds: 70
  - Property: 8
  - Cash: 19
- Sweden
  - Domestic equity: 18
  - Non-domestic equity: 23
  - Bonds: 50
  - Property: 3
  - Cash: 11
- Netherlands
  - Domestic equity: 5
  - Non-domestic equity: 18
  - Bonds: 66
  - Property: 2
  - Cash: 8
- France
  - Domestic equity: 17
  - Non-domestic equity: 12
  - Bonds: 59
  - Property: 2
  - Cash: 6
- Ireland
  - Domestic equity: 12
  - Non-domestic equity: 32
  - Bonds: 46
  - Property: 2
  - Cash: 4
- Portugal
  - Domestic equity: 15
  - Non-domestic equity: 9
  - Bonds: 64
  - Property: 5
  - Cash: 8
- Spain
  - Domestic equity: 22
  - Non-domestic equity: 10
  - Bonds: 61
  - Property: 4
  - Cash: 3
- Switzerland
  - Domestic equity: 13
  - Non-domestic equity: 18
  - Bonds: 46
  - Property: 15
  - Cash: 2
- Belgium
  - Domestic equity: 17
  - Non-domestic equity: 24
  - Bonds: 56
  - Property: 3

---

**Chart 6: Bond portfolio allocation by country**

- United Kingdom
  - Domestic fixed interest government bonds: 15
  - Domestic index-linked government bonds: 28
  - Domestic corporate bonds: 3
  - Domestic index-linked government bonds: 36
  - Non-domestic government bonds: 4
  - Non-domestic corporate bonds: 14
- Germany
  - Domestic fixed interest government bonds: 62
  - Domestic index-linked government bonds: 25
  - Domestic corporate bonds: 4
  - Domestic index-linked government bonds: 4
  - Non-domestic government bonds: 5
  - Non-domestic corporate bonds: 5
- Germany (CTA)
  - Domestic fixed interest government bonds: 33
  - Domestic index-linked government bonds: 3
  - Domestic corporate bonds: 52
  - Domestic index-linked government bonds: 2
  - Non-domestic government bonds: 8
  - Non-domestic corporate bonds: 8
- Finland
  - Domestic fixed interest government bonds: 7
  - Domestic index-linked government bonds: 27
  - Domestic corporate bonds: 29
  - Domestic index-linked government bonds: 37
  - Non-domestic government bonds: 7
  - Non-domestic corporate bonds: 3
- Norway
  - Domestic fixed interest government bonds: 5
  - Domestic index-linked government bonds: 12
  - Domestic corporate bonds: 57
  - Domestic index-linked government bonds: 27
  - Non-domestic government bonds: 3
  - Non-domestic corporate bonds: 13
- Denmark
  - Domestic fixed interest government bonds: 5
  - Domestic index-linked government bonds: 79
  - Domestic corporate bonds: 94
  - Domestic index-linked government bonds: 6
  - Non-domestic government bonds: 12
  - Non-domestic corporate bonds: 10
- Sweden
  - Domestic fixed interest government bonds: 52
  - Domestic index-linked government bonds: 2
  - Domestic corporate bonds: 12
  - Domestic index-linked government bonds: 4
  - Non-domestic government bonds: 27
  - Non-domestic corporate bonds: 7
- Netherlands
  - Domestic fixed interest government bonds: 41
  - Domestic index-linked government bonds: 5
  - Domestic corporate bonds: 47
  - Domestic index-linked government bonds: 7
  - Non-domestic government bonds: 4
  - Non-domestic corporate bonds: 3
- France
  - Domestic fixed interest government bonds: 65
  - Domestic index-linked government bonds: 5
  - Domestic corporate bonds: 24
  - Domestic index-linked government bonds: 5
  - Non-domestic government bonds: 3
  - Non-domestic corporate bonds: 2
- Ireland
  - Domestic fixed interest government bonds: 55
  - Domestic index-linked government bonds: 2
  - Domestic corporate bonds: 36
  - Domestic index-linked government bonds: 2
  - Non-domestic government bonds: 2
  - Non-domestic corporate bonds: 2
- Portugal
  - Domestic fixed interest government bonds: 78
  - Domestic index-linked government bonds: 4
  - Domestic corporate bonds: 15
  - Domestic index-linked government bonds: 3
  - Non-domestic government bonds: 15
  - Non-domestic corporate bonds: 3
- Spain
  - Domestic fixed interest government bonds: 20
  - Domestic index-linked government bonds: 36
  - Domestic corporate bonds: 25
  - Domestic index-linked government bonds: 19
  - Non-domestic government bonds: 2
  - Non-domestic corporate bonds: 2
- Belgium
  - Domestic fixed interest government bonds: 20
  - Domestic index-linked government bonds: 36
  - Domestic corporate bonds: 25
  - Domestic index-linked government bonds: 19
  - Non-domestic government bonds: 2
  - Non-domestic corporate bonds: 2

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3 Index-linked government bonds refer to government bonds that have some linkage to an inflation index (typically in the coupon and redemption payments).
match their liabilities. Plans in the UK shifted their government bond allocations from a fixed/index-linked split of 45%/55% in 2012 to the 35%/65% allocation shown in this year’s survey, indicating that a number of plans took the opportunity to increase the degree of inflation exposure in their assets over the course of the year.

There is a significant degree of variation by market in terms of the importance of corporate bonds in the overall bond portfolio. Illustrating this point, corporate bonds on average make up over 50% of the total bond portfolio in five countries and less than 30% of the bond portfolio in six countries. Although we have seen some moves towards greater diversification in corporate bond portfolios in recent years, non-domestic allocations remain a small part of most investors’ bond portfolios (notable exceptions include Denmark, Finland, Norway, and Switzerland).

This year we have explicitly captured allocations to “other matching assets” within our analysis of bond portfolios. This category reflects allocations to derivative-based liability hedging strategies that would typically sit within an investor’s LDI portfolio. The survey results suggest that such LDI strategies are now an important part of the overall investment strategy for investors in the UK and the Netherlands and, to a lesser extent, in Germany and Ireland. We comment further on the use of LDI strategies later in the report.

The gap between what small and large plans are willing and able to do in terms of investment strategy has reduced over time, but there remain some noticeable differences in strategy across the size spectrum, as illustrated in Chart 7. The key points of interest are as follows:

• The largest plans (those with more than €2.5 billion in assets) tend to have around 10% less invested in equities than smaller plans. This in part reflects the fact that larger plans tend to have the governance budget to consider a wide range of asset classes, resulting in a more broadly diversified investment strategy with less exposure to equity markets. The domestic allocation also tends to be a smaller proportion of the total equity portfolio for larger plans.

• Non-domestic corporate bonds are a meaningful component of bond portfolios only for plans with more than €250 million in assets. For plans with more than €2.5 billion in assets, non-domestic corporate bonds now reflect almost a third of the corporate bond portfolio. In addition to introducing a greater degree of regional diversification into corporate bond portfolios, forward-looking investors have been exploring “buy and maintain” approaches that seek to mitigate many of the problems inherent in benchmark-oriented credit strategies.

• Plans of all sizes now have access to LDI strategies (captured by the “other matching assets” category), with allocations becoming more material for plans above €250 million in assets. Small plans (with less than €50 million in assets) still largely rely on government and corporate bonds in their defensive portfolio.

• Property and alternative asset allocations are more significant for larger plans. Plans below €50 million in assets have an average combined allocation to property and alternatives of 7%, compared with 19% for plans with more than €2.5 billion in assets.

![Chart 7: Strategic asset allocation by plan size](chart.png)
As illustrated in Chart 8, the long-observed downward trend in equity allocations continues in this year’s survey, albeit the magnitude of the reduction in equity exposure was, at an aggregate European level, more muted than that seen in last year’s survey.

Last year we noted that reduced equity allocations had largely been used to fund an increase in the alternatives portfolio, with bond allocations broadly flat. The message from this year’s survey is roughly the opposite — reductions to the equity allocation have primarily been used to fund an increase in bond portfolios, with the alternatives allocation slightly down from last year’s numbers. The small reduction in alternatives allocations is likely due to the strong performance of equities over the year (outperforming most alternative assets). As a result, the alternatives portfolio has become a smaller proportion of the whole, with equity gains being rebalanced into bond portfolios in response to funding level improvements over the past 12 months.
Chart 9 illustrates a longer history for pension plan asset allocation in the UK. This clearly shows the downward trajectory in equity allocations of UK pension plans over the past decade, from 68% in 2003 to 39% in 2013. This reflects a combination of factors (regulation, maturing of plans, accounting practices) that have led to a reduced tolerance for volatility on the part of trustees and corporate sponsors. Bond investment has been seen as a way of better matching the liabilities of a plan and reducing the volatility of the overall portfolio.

In last year’s survey, we tentatively suggested that UK investors were adopting a “wait and see” approach to liability matching, hoping to achieve a more attractive entry point for bond investment. Extending this (admittedly subjective) judgement to this year’s survey results, we might suggest that investors have given up waiting for yields to rise and have instead decided to move ahead with their hedging programmes regardless of the level of yields. In reality, part of the explanation for the rise in bond allocations is likely to be found in the moderate improvement in funding levels over the course of the year, which will have prompted plans with some form of trigger-based de-risking framework in place to re-allocate assets from the growth portfolio to the bond (or matching) portfolio.
As mentioned earlier, the trend away from domestic towards non-domestic equities (especially notable in the UK) continues. Management of overseas currency risk therefore remains an important consideration for pension plans. Chart 10 illustrates the percentage of non-domestic equity exposure that is hedged for those plans with some form of currency hedging programme in place. Almost 50% of plans have a currency hedge in place. We note that, where currency risk is hedged, a ratio of between 50% and 100% is most common, with the largest number of plans (36%) targeting a 50% currency hedge ratio.

Currency risk is a topic that many plans keep under regular review, although the general pattern of hedging ratios tends to be broadly consistent from year to year. Given the potential for governments to use covert currency depreciation as a policy tool and the unprecedented scale of monetary easing being undertaken across the developed world, a reassessment of the approach to currency hedging may be justified in the current environment.
Alternative assets now represent an important part of pension plan investment strategy from both a return generation and a risk management perspective. In this section, we focus on the evolving behaviour of pension plans in relation to the broad range of asset classes and investment strategies that fall within the “alternative investments” universe.

In this year’s survey, we have sought information on allocations to more than 20 different alternative asset classes. To assist the reader in interpreting the data, we have subdivided the alternatives universe into five main areas:

- **Private equity**: fund of funds and direct private equity investments
- **Growth-oriented fixed income**: fixed income assets/strategies focused on return generation
- **Real assets**: investments in which the return is expected to come largely from the yield on a physical asset, including property (both core and income-focused mandates), infrastructure, agriculture, and natural resources
- **Hedge funds**: fund of funds and single strategy hedge funds
- **Multi-asset**: dynamic multi-asset strategies including DGFs, diversified beta funds, balanced funds, and long-only absolute return funds

Chart 11 shows the average allocation to each of the five broad categories of alternative investment for all European plans captured in this year’s survey. The chart shows the proportion of plans that have a strategic allocation to a given area as well as the average allocation to the asset class for those that have made an allocation.

Unsurprisingly, real assets (which includes traditional property) is the area to which the greatest number of plans allocate some part of their assets, with 30% of plans having an allocation. However, the area attracting the most significant size of average allocation is the multi-asset category. This is largely explained by DGF allocations made by UK plans. Indeed, DGFs are fast becoming a significant part of the growth strategy for many UK investors, being perceived as offering a low-governance approach to accessing a broad range of asset class exposures with a degree of dynamic allocation between them. Their similarity (in concept at least) with traditional balanced funds, popular with UK pension plans in the 1990s, reinforces Mark Twain’s observation that “history does not repeat itself, but it does rhyme.”

Although private equity appears to be the least popular of the broad alternative asset categories across all plans, it is among the most popular alternatives with the very largest plans in our survey (those with more than €2.5 billion in assets), with over 50% of these plans having an allocation.
“The interest from our clients in diversified growth funds shows no signs of slowing down. The range of approaches used by these strategies means that, as a collective, they can fulfil many investor objectives such as providing diversification, exposure to alternative sources of return, and enhanced reactivity to changing environments, normally within a transparent, liquid, and competitively priced framework. Some of the approaches do come with a degree of complexity that investors may not be used to, so it is important for investors to ensure that they are comfortable with the strategy adopted. DGFs are no longer just a UK phenomenon, with increasing demand from North America, Europe, and Australia in particular — we believe this trend is set to continue. The true test for the popularity of these strategies, however, will be when they are faced with a sustained equity bull market, as most DGFs will struggle to keep up with fully invested equity strategies.”

Atul Shinh, Senior Alternatives Specialist, London
Charts 12, 13, and 14 provide further detail on plan allocations to specific strategies falling within growth-oriented fixed income, real assets, and hedge fund portfolios. A number of interesting observations arise from these results:

- High yield and emerging market debt remain the most popular parts of the growth-oriented fixed income universe; over 10% of European plans have an allocation to these assets, with the average level of allocations being around 5%. However, given the strong performance of both high yield and emerging market bonds in recent years, investors have started to consider other parts of the credit universe such as senior loans and private debt, as well as multi-asset credit portfolios.

- Traditional property mandates (captured under “core property”) are by far the most significant component of most plans’ real assets portfolios. Given the extent of the monetary stimulus being applied by the world’s major central banks, there remains a desire to introduce a greater degree of inflation sensitivity into portfolios, without accepting the negative real yields available on index-linked government bonds. Investors are therefore increasingly considering income-focused (long lease or ground lease) property mandates, infrastructure, and, to a lesser extent, timberland, agriculture, and natural resources. The barriers to allocations rising materially in these areas appear to be a desire to retain liquidity and the paucity of investable, accessible funds.
Funds of hedge funds remain a relatively common approach to accessing hedge fund exposure, with around 10% of plans having an allocation to such strategies. In terms of direct hedge fund allocations, investors appear to be most comfortable with multi-strategy funds, long/short strategies, and global macro funds (including global tactical asset allocation, currency, and commodity strategies), with UK plans appearing to be more willing to make allocations to these strategies than non-UK plans. A few plans have also introduced allocations to strategies that are expected to be lowly or negatively correlated to both risk assets and other hedge fund strategies, such as managed futures, tail risk funds, or insurance-linked securities.

Chart 14: Strategic allocation to hedge funds

<table>
<thead>
<tr>
<th>Strategy</th>
<th>% plans with an allocation</th>
<th>% average allocation to asset class</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund of funds</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td>Multi-strategy</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Long/short equity</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Event driven</td>
<td>0.2</td>
<td>2</td>
</tr>
<tr>
<td>Global macro</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Managed futures</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Tail risk</td>
<td>0.1</td>
<td>3</td>
</tr>
<tr>
<td>Insurance-linked securities</td>
<td>0.3</td>
<td>4</td>
</tr>
</tbody>
</table>

Legend: % plans with an allocation; % average allocation to asset class.
THE USE OF LIABILITY-MATCHING STRATEGIES

As the majority of defined benefit pension plans continue to reduce their allocations to growth assets, plans are moving more into investments whose values are expected to move in line with the value of the plan’s liabilities. This approach is often referred to as a liability-driven investment or liability hedging strategy. The popularity of LDI strategies has increased considerably over time, and the decision to hedge liabilities is often followed by the decisions of when and how to implement the hedge.

THE DECISION TO HEDGE LIABILITIES

Of the survey respondents, 26% indicated that they have specifically allocated a portion of their overall investment strategy to a liability hedging, or LDI, mandate (up from 15% in last year’s survey). These responses did not vary significantly with size; 30% of plans with more than €500 million in assets indicated that they had a specific LDI allocation, while the corresponding figure for plans with less than €500 million in assets was 25%.

Although the majority of survey respondents (74%) do not have a specific LDI allocation, 15% of these plans confirmed that they manage the duration of their bonds through an allocation to a long-dated (over 10-year) bond mandate. This suggests that while an explicit liability-hedging strategy is not in place for these plans, some thought has been given to matching the long-term interest rate sensitivity of the liabilities.

When asked why there was no specific allocation made to an LDI mandate, respondents primarily suggested that other decisions had taken priority, that liability hedging had not yet been considered, or that they are still in the process of deciding whether to make an allocation (as shown in Chart 15).

Regulatory pressures, plan closures, increasing maturity, changes to the accounting treatment for pension deficits, and low sponsor tolerance for volatility in contribution rates can all be cited as reasons why allocations to LDI strategies may be expected to increase over time. However, as illustrated in Chart 16, there continues to be a gap between the current allocation to LDI and the long-term target allocation for the majority of plans.

Chart 15: Reasons for no LDI allocation

- Yields are too low: 16%
- Other priorities: 29%
- In the process of deciding: 23%
- Decided not to allocate: 8%
- Has not yet been considered: 29%
- Other: 26%
Target and current LDI allocations expressed as a percentage of total assets. We note that many plans will also agree on the proportion of liabilities that they intend to hedge (the target hedge ratio) and in some cases will establish hedge ratio targets in relation to interest rate and inflation risk.
THE DECISION OF WHEN TO IMPLEMENT THE LIABILITY HEDGE

In the event that there is a difference between the current and target LDI allocation, pension plan trustees need to decide on the timing for implementing the increase in the liability hedge. The range of implementation options include immediate, phased, trigger-based, or a combination of these approaches, and the decision is often based on the amount of risk that the plan and its sponsor are able to tolerate in combination with their views on the future direction of interest rates or inflation.

As illustrated in Chart 17, survey respondents tended to use a blend of different implementation strategies, though triggers based on funding level and/or market conditions (such as interest rates or inflation levels) were the most popular. It is not uncommon for plans to use an ad hoc approach to build up their allocation over time, seeking input from advisors and investment managers when considering whether to make any changes to the allocation.

For plans that are using funding level or market-based triggers to implement the target liability hedge, conditions need to be monitored on a regular basis so that implementation opportunities are not missed. Trustees might decide to retain the responsibility for monitoring triggers, although as illustrated in Chart 18, it is more common for this task to be delegated to the investment (or fiduciary) manager.

For some plans, monitoring triggers does not automatically result in an increase in liability hedging if and when a trigger is hit. Plans that have some form of trigger monitoring in place (41%) generally call a special meeting for trustees (or a pre-specified subset of decision-makers) when a trigger is hit to discuss potential implementation options and to agree on whether to make any changes.

Chart 17: Strategies for increasing the liability hedge

- Funding-level triggers: 39%
- Phased over medium-to-long term: 13%
- Reallocation in the short term: 12%
- Directing contributions: 9%
- Market-based triggers: 25%
- Ad hoc: 28%
- Other: 2%

Chart 18: Responsibility for trigger monitoring

- Investment/fiduciary manager: 57%
- Main board or trustee: 16%
- Advisor/consultant: 23%
- Other: 4%
THE DECISION OF HOW TO IMPLEMENT THE LIABILITY HEDGE

Once the questions of if and when to hedge the liabilities have been answered, the final decision for trustees is to agree on the range of investments that can be used, sometimes referred to as the “hedging toolkit”. The types of assets that are considered for inclusion in the hedging toolkit are those whose values are highly dependent on interest rate and/or inflation expectations. The most robust LDI solution will often involve the use of a number of physical and derivative instruments, allowing for flexible implementation depending on market conditions such as price and liquidity.

For plans that use derivative investments to hedge liabilities, interest rate and inflation swaps are used most often, while government bond total return swaps and repurchase agreements (repos) are also common, as shown in Chart 19.

LIABILITY MANAGEMENT STRATEGIES

Other risk management strategies could involve a change to the benefits that are paid to pensioners (pension increase exchange, enhanced transfer values) or transferring a portion of the risk to a third party (buy-in, buyout, or longevity swap). Although discussions about liability management might not be a priority for the majority of plans, 15% of survey respondents confirmed that they had either had a high-level discussion or completed a feasibility study on one or more of these strategies. As summarised in Chart 20, buy-in, buyout, and longevity swap strategies are the most common liability management discussions.

Chart 19: Derivative investments used to hedge interest rate and inflation risk

Chart 20: Other liability management strategies considered
TRENDS FOR THE FUTURE

As in previous years, we asked our respondents about the strategic asset allocation changes they expect to make over the next 12 months. We highlight below some of the trends that emerge from analysis of this year’s results.

At a high level, changes to investment strategy over the next year are likely to reflect a continuation of the trends observed in recent years. In particular, the survey results (illustrated in Chart 21) suggest:

• Further reductions in equity allocations (with an emphasis on reducing domestic holdings)
• An expectation of increasing bond allocations, with this being focused on index-linked bonds, corporate bonds, and LDI strategies
• Mixed views on the direction of property allocations, with a slight bias to reducing weightings (particularly domestic allocations)
• Increased allocations to alternative assets

Pension plans in the UK are undoubtedly on a path towards increasingly bond-dominated portfolios (including derivative-based liability hedging strategies within the bond portfolio), with the bias towards reduced equity allocations being heavily driven by responses from UK investors.

Within the bond portfolio, we expect to see a continuation of the move away from fixed interest towards inflation-linked government bonds, although this decision will inevitably be driven to some extent by market conditions. Within corporate bond portfolios, investors are likely to seek greater diversification via “buy and maintain” approaches and non-domestic allocations.

The expected interest in alternatives is analysed further in Chart 22. The chart illustrates quite clearly that growth fixed income and multi-asset portfolios are high on trustee agendas for the next year. In particular, plans are keen to introduce or add to allocations to emerging markets debt, high yield debt, absolute return bond funds, and private debt within the growth fixed income area.

The negative bias expressed in relation to real assets largely relates to core property allocations, with investors being broadly positive on long lease property and infrastructure assets.

There is a clear bias in favour of further allocations to multi-asset strategies, largely reflecting the preference of UK plans to invest in DGFs as a route to greater diversification in their growth portfolios. The wider range of alternative asset classes now being accessed by pension plans across Europe has perhaps crowded out interest in hedge funds, which see relatively muted interest from respondents.
Chart 21: Percentage of plans expecting to change investment strategy

- Domestic equity: Decrease exposure by 30%, Increase exposure by 2%.
- Non-domestic equity: Decrease exposure by 24%, Increase exposure by 7%.
- Domestic fixed interest government bonds: Decrease exposure by 12%, Increase exposure by 13%.
- Domestic index-linked government bonds: Decrease exposure by 5%, Increase exposure by 19%.
- Non-domestic government bonds: Decrease exposure by 3%, Increase exposure by 3%.
- Domestic corporate bonds: Decrease exposure by 7%, Increase exposure by 16%.
- Non-domestic corporate bonds: Decrease exposure by 2%, Increase exposure by 9%.
- Other matching assets: Decrease exposure by 2%, Increase exposure by 17%.
- Property: Decrease exposure by 6%, Increase exposure by 4%.
- Alternatives: Decrease exposure by 7%, Increase exposure by 24%.

Chart 22: Percentage of plans expecting to change strategic allocation to alternative asset classes

- Private equity: Decrease exposure by 2%, Increase exposure by 3%.
- Growth-oriented fixed income: Decrease exposure by 1%, Increase exposure by 14%.
- Real assets: Decrease exposure by 9%, Increase exposure by 5%.
- Hedge funds: Decrease exposure by 3%, Increase exposure by 2%.
- Multi-asset: Decrease exposure by 4%, Increase exposure by 19%. 
DIVERSIFYING EQUITY PORTFOLIOS

Although the size of pension plan equity portfolios has fallen over time, their structure has also evolved. In particular, plans have made significant progress in increasing allocations to emerging markets and, to a lesser extent, low volatility strategies (designed to offer some degree of downside protection in falling markets) and small cap equities. Chart 23 illustrates the proportion of plans with an allocation to developed market equities, emerging markets, low volatility, and small caps, as well as the average size of that allocation (as a proportion of total assets) for those that have one. Emerging markets are now a staple part of many plans’ equity portfolios, reflecting the more favourable long-term growth outlook for many of these economies. Low volatility exposure is likely understated by the figures shown, with many investors accessing some form of low volatility bias via a “quality biased” portfolio (that may be captured under the broad global equity allocation) or a “variable beta” strategy (that may be classified as a multi-asset strategy in the alternatives portfolio). We expect diversification by style and strategy to remain an important theme in equity portfolios as investors move away from a simple market cap-weighted or regional approach.
MOVE AWAY FROM MARKET CAP-DRIVEN STRATEGIES

Investors are increasingly recognising the drawbacks of strategies that are in some way built around market cap-weighted indices. As a result, investors are considering “buy and maintain” approaches as an alternative to traditional active or passive corporate bond mandates, alternative indexation in place of traditional index-tracking equities, and unconstrained active strategies instead of benchmark-relative approaches. Take-up of alternative indexation approaches has been relatively modest to date, but we note that between 10% and 20% of respondents have discussed non-market cap approaches to equity or bond investing.

THE IMPORTANCE OF DYNAMISM

Given the challenging outlook for growth across much of the developed world and rising credit and equity markets (arguably driven by the massive injections of liquidity by central banks), generating real returns may require a greater degree of dynamism on the part of investors. A range of strategies now offer investors a delegated approach to incorporating dynamic behaviour within their investment strategy. As noted earlier in this report, DGFs have become a popular means of delegating asset class allocation decisions by small and medium-sized plans. In the credit space, there are now a range of strategies, labelled “multi-asset credit funds”, that seek to add value by allocating to different parts of the credit markets in response to changing market conditions. There is also a recognition that an important aspect of a well-managed de-risking plan is the ability to respond dynamically to improvements in a plan’s funding position and the level of yields. We expect pension plans to incorporate an increasing degree of dynamism within their investment strategy over time.

PLANS THAT HAVE DISCUSSED NON-MARKET CAP APPROACHES

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<th></th>
<th>Equities</th>
<th>Bonds</th>
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<tr>
<td>Take-up</td>
<td>17%</td>
<td>12%</td>
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Plans that have discussed non-market cap approaches.
THE GOVERNANCE OF EUROPEAN PENSION PLANS

Pension plan governance covers a wide range of topics, from the composition of the trustee group and the way in which decisions are delegated to subgroups or third-party providers, to the complexity of the investment arrangements and the number of ideas and opportunities that are considered.

Our survey results continue to highlight a clear link between the size of a plan and the amount of time and resources devoted to the consideration of investment issues.

The management of operational risk is an important role for the pension plan fiduciary, and consideration should be given to a number of operational risks. Chart 24 shows the areas of focus for those plans that reviewed their operational risks in 2012, and it highlights the issues that investors are expecting to address in 2013.

OVER THE PAST THREE YEARS, INVESTORS HAVE INCREASED THE FREQUENCY WITH WHICH THEY REVIEW THEIR INVESTMENT STRATEGY, AS ILLUSTRATED IN CHART 25. ALTHOUGH A TRIENNIAL REVIEW (FOLLOWING THE ACTUARIAL VALUATION FOR UK INVESTORS) WOULD HAVE BEEN SEEN AS THE NORM FIVE OR MORE YEARS AGO, NEARLY 40% OF UK PLANS, AND 50% OF EUROPE EX-UK PLANS, NOW AIM TO REVIEW THEIR INVESTMENT STRATEGY ON AT LEAST AN ANNUAL BASIS.

LOOKING AT THE SPECIFICS:

- The proportion of plans reviewing stock lending remains fairly low, with less than 10% of investors expecting to review this area in 2013. This is not surprising and reflects the fact that many plans have either scaled down their securities lending programme or moved to a very conservative model.

- We have seen an increasing focus on custodian efficiency in recent years. This is a welcome trend as we believe that significant cost savings can be achieved by ensuring that the custodian model is working as effectively as possible. Our experience in this area suggests that the most significant benefit tends to be derived from reductions to fees in emerging markets and from foreign exchange execution.

- Cash management remains a fairly low priority for investors, perhaps reflecting the low-interest-rate environment that has prevailed in recent years.
“Operational risks remain a relatively low priority among pension plan investors, with many preferring to focus their limited time on investment strategy, asset allocation, and manager selection. However, one governance area which has seen an increase in interest over the past few years is investment manager back-office analysis (captured under “operational due diligence” in Chart 24). Demand from investors has grown threefold over the past couple of years but still remains fairly low, with only one in six investors expecting to undertake such a review.”

*Ben Gunnee, European Director of Mercer Sentinel Group*
Unsurprisingly, we see that larger plans tend to review their investment strategy more frequently than do smaller plans. Indeed, the difference in behaviour between the very largest and very smallest plans in our survey, as illustrated in Chart 26, is quite stark: only around a quarter of plans with less than €50 million in assets review their strategy at least once a year, while the comparable figure for plans with more than €2.5 billion in assets is 83%. We note that those investors with a greater governance budget and a more dynamic approach to reviewing their strategy are more likely to be in a position to respond to changing market conditions and emerging risks.

As part of our governance assessment, we also surveyed participants on the complexity of their investment strategies and structures. Chart 27 highlights the fact that larger plans tend to be able to accommodate a more complex and better-diversified investment strategy, incorporating a larger number of mandates across their equity, bond, and alternatives portfolios.

Chart 28 summarises the outperformance targets typically associated with equity and bond mandates, broken down by plan size. As expected, larger plans will typically make greater use of less-constrained mandates (that will typically have higher outperformance targets), which is to a large extent explained by their greater willingness and ability to diversify across a number of managers and to monitor a more complex structure. Reinforcing this point, Chart 29 shows that larger plans make greater use of active managers across their equity and bond portfolios — the smallest plans in our survey manage around half of their equity and bond assets on a passive basis, whereas this figure falls to around 10% to 20% for plans with more than €2.5 billion in assets.
Chart 28: Active manager average outperformance targets by plan size

- <50m: Equity 0.8, Bonds 2.3
- 50m–100m: Equity 1.0, Bonds 2.0
- 100m–250m: Equity 1.0, Bonds 2.5
- 250m–500m: Equity 1.2, Bonds 2.5
- 500m–1bn: Equity 1.3, Bonds 2.3
- 1bn–2.5bn: Equity 1.3, Bonds 2.9
- >2.5bn: Equity 1.4, Bonds 2.7

Chart 29: Proportion of equity and bond assets managed on a passive basis

- <50m: Equity 51, Bonds 47
- 50m–100m: Equity 39, Bonds 45
- 100m–250m: Equity 46, Bonds 48
- 250m–500m: Equity 24, Bonds 43
- 500m–1bn: Equity 20, Bonds 45
- 1bn–2.5bn: Equity 24, Bonds 37
- >2.5bn: Equity 18, Bonds 10
ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE ISSUES

DOES SIZE AND TYPE MATTER?
Plans that actively incorporate environmental, social, and corporate governance (ESG) issues into their investment operations tend to be large and well-resourced within Western and Northern Europe, typically from the public sector. This year’s results show that geographically, this is still very much the case. Of those participants saying they consider ESG issues within their investment strategy, almost 80% are from the UK, Netherlands, and Scandinavia.

By plan type, 73% of respondents considering ESG issues in their investment strategy were from the corporate sector, 18% were from charities and endowments, and the remaining 9% were from the government or the public sector. This breakdown reflects the type of respondents in this year’s survey rather than what we see more generally in the market — in other words, public sector plans are generally more proactive in considering ESG issues.

TIME IS A SCARCE RESOURCE
Trustees generally have limited experience in assessing ESG issues from an investment perspective and limited time in which to improve their knowledge.

This year’s results show that only 50% of European plans are devoting investment committee time to discussing ESG issues. Of this 50%, 74% spent less than one hour doing so, 14% spent one to two hours, and the remaining 12% spent more than two hours on ESG issues. Creating space on busy trustee agendas to discuss ESG issues will continue to be difficult, but our experience suggests that this is a challenge that can be solved.

Trustees wanting to address responsible investment (RI) for the first time need to determine their plan’s position and expectations on RI and ESG issues. Once these have been established, trustees will then be in a better position to monitor their investment managers’ behaviour.
STEWARDSHIP ACTIVITIES ON THE RISE IN EUROPE?

Stewardship or active ownership continues to be high on the agenda in Europe. In 2012 the UK government’s Kay Review6 proposed measures to support long-term value creation in listed companies by encouraging investors to take a longer-term view when setting and managing investment mandates. The European Commission7 also set out its proposed measures in 2012 for improving corporate governance in Europe, with a particular focus on transparency, accountability, and shareholder engagement.

The role of pension plans in this process is set out in guidance such as the UK Stewardship Code8 and the EFAMA9 and Eumedion10 codes, all of which encourage asset owners to question their (equity) managers on the exercise of their active ownership activities, including how managers encourage good corporate governance.

Equity investment managers in particular should be able to demonstrate to clients that they are monitoring portfolio companies for all relevant risks, including ESG risks. Focusing purely on short-term financial factors is no longer adequate, in our view. Trustees should expect to see this information, and if they do not, they should request that this information be provided, for example, within quarterly investment reports. Only 17% of respondents ask managers to report on voting and engagement activities, with 83% not asking for any reporting. This is a reflection of the limited time and attention given to ESG issues but may also be determined by the proportion of assets allocated to listed equities (for which this information is most relevant).

In future surveys, we expect to monitor whether the number of participants asking for information on ESG and related issues increases in response to the government and regulatory guidance in this area.

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5 For an overview of Mercer’s ESG rating process, including data on more than 5,100 global investment strategies covered by our ESG ratings, please see: http://www.mercer.com/articles/ESG-ratings-update

“Mercer believes that environmental, social, and corporate governance factors have an effect on financial performance. We therefore encourage plans to consider these issues within plan governance and investment processes, such as manager selection and monitoring.

We recognise that creating space on busy trustee agendas to discuss ESG issues is a challenge. This year’s results show that less than one hour of investment committee time was allocated to discussing these issues by the majority of our survey’s respondents. In our view, this is inadequate.

We believe plan governance and investment decision-making can be improved by understanding how ESG risks occur within investment portfolios and by managing these risks. A growing number of our clients recognise this and are allocating additional time to trustee training on responsible investment and conducting manager assessments using our ESG rating process.”

Aled Jones, European Head of Responsible Investment
ACKNOWLEDGEMENTS

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