Quarterly Pensions Investments Review

Expected Investment Performance - Q4 2024

Introduction

The Quarterly Pensions Investments Review is a comparison in expected risk and return investment.

Key Findings

- **Comparing pension funds and regions:** North American pension plans show relatively high expected returns, compared to mainland Europe due, among other things, to differences in asset allocation.
- **Comparing quarter on quarter:** Overall, the equity outlook improves due to anticipated further easing of financial conditions and an upward revision in long-term expectations. The government bond return outlook improves because of increased long rates, following a slower anticipated pace of monetary policy easing. On the other hand, the corporate credit return outlook worsens following tightened credit spreads of anticipated pro-business policies under the Trump administration.
- **Integrating climate risk in the investment policy:** 2024 saw record-high global temperatures and extreme weather events, highlighting the growing impact of climate change on Pension Funds. Ortec Finance's climate risk assessment for 30 Canadian Pension Funds warns of significant financial risks, including potential portfolio declines of up to 44% by 2050 for these funds, emphasizing the need to integrate climate risk into investment policies for long-term resilience.
- For details, please see below

If you're interested in learning how your pension fund is performing relative to others, please contact us for more information.

Expected Investment Performance – Risk and Return Results

The charts below show the expected investment return vs. the expected investment risk - from the top 30 largest pension funds per region.

Comparing pension funds and regions

Looking at general trends, the difference in expected returns between regions is stark. Expected returns and volatility among pension plans in North America and the UK are relatively high, while pension plans in Switzerland and the Netherlands show more moderate expectations.

This quarter we focus our attention on North America.

The chart shows that most **US pension plans** are grouped around a relatively high expected return of around 7.5%. In the United States, many of the largest pension plans are public plans. These plans strategically allocate a major portion of their assets to riskier categories like Public Equities and Alternatives, in a search for yield. The resulting high expected returns are reflected in the discount rates.

Critics argue that this approach may increase solvency risks in the long-term. Hence, in recent years, there has been a trend among some public plans towards adopting more conservative market discount rates, such as the yield on high-quality corporate bonds, similar to the approach that US corporate pension plans already use. This aligns with new accounting standards, encouraging a focus on the risk-free rate or rates that reflect the duration of the pension liabilities. It is important to note that the 'market discount rate' approach serves as a complement to the fixed discount rate approach rather than a replacement.

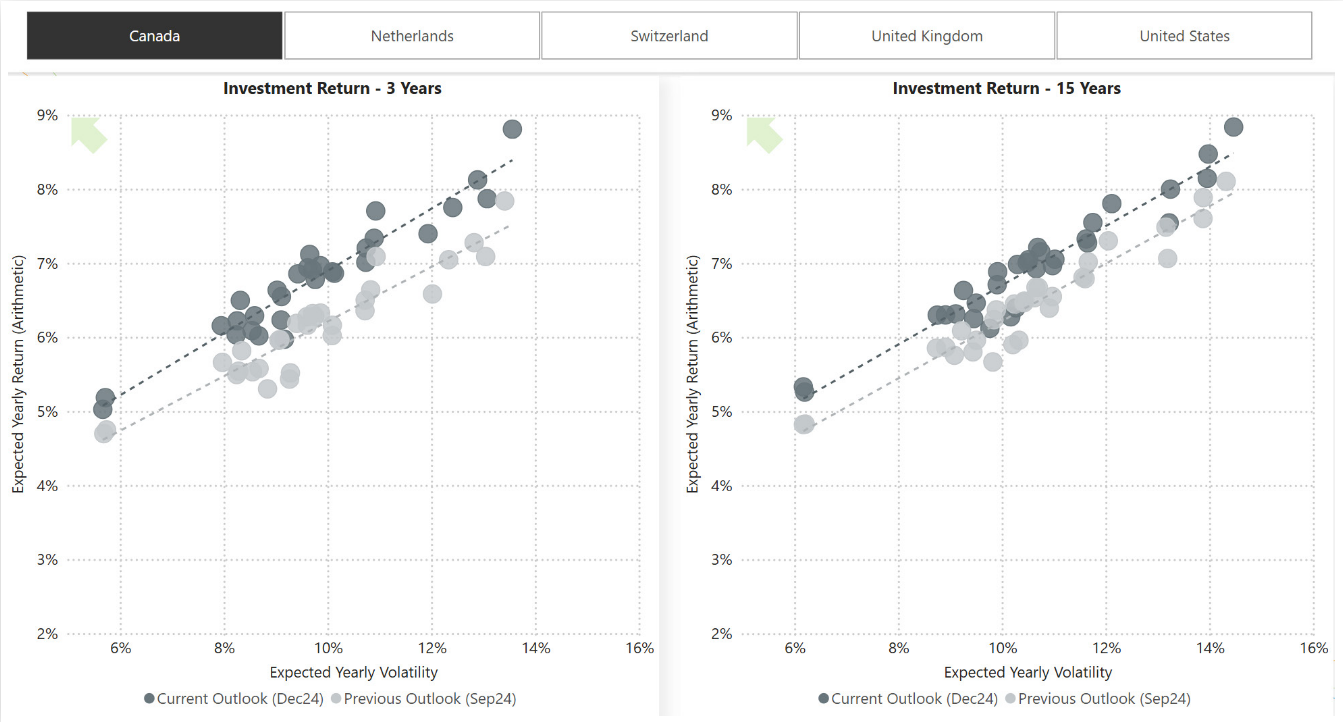
In general, **Canadian pension plans** show relatively high expected returns. Unlike many European plans that require large, fixed income exposures to hedge market discount rate risk, Canadian plans allocate a major amount (20-40%) of their assets to Alternatives, not in the least in an attempt to hedge inflation risks.

What is even more noticeable is the wide and quite equal distribution along the return axis, all the while keeping the risk/return ratio comparable. These risk/return ratios show Canadian pension plans to be relatively efficient compared to other regions. Key drivers may be relatively high leverage and relatively high exposure to private assets, which may boost diversification.

For Canada and the US, long-term return expectations generally exceed those of mainland Europe. This is driven by higher interest rates and GDP growth which, in turn, are linked to demographic changes and expectations for capital and productivity growth. Combined with a home bias, this may give Canadian and US pension plans an edge.

This Quarterly Pension Investment Review is based off an asset-only scenario analysis and does not assess the match with liabilities. With an Asset Liability Management (ALM) study, we can uncover the tradeoff between contributions, benefits, and investment risk; increasing the likelihood of meeting future obligations, while keeping the plan affordable. Our mission is to enable you to manage the complexity of strategic decision-making.

Comparing quarter on quarter



Market developments and other events

In Q4 of 2024, US equities outperformed, and credit spreads tightened on strong macro data and Trump's election success, fueling expectations of tax cuts, deregulation, and a protectionist trade approach. Japanese equities also rose on improved export prospects from a weak yen. In contrast, emerging market equities underperformed amid trade policy risks and a stronger US dollar. European equity returns declined following Trump's election, the fall of the German and French governments, and muted economic prospects.

Growth is moderating and inflationary pressures eased in major economies, although core inflation remains sticky for most regions. Developed market central banks continued easing monetary policy, with the US Federal Reserve and European Central Bank lowering interest rates by 0.5%. Resilient US growth, sticky core inflation, and political uncertainty tempered expectations for rapid rate cuts. In December, the Fed's forward guidance diverged from the market's anticipated pace of monetary easing, triggering a sell-off in capital markets and sending long rates higher.

Outlook for growth, inflation, and interest rates

The OFS probability distribution is broadly aligned with a reference to climate scenarios in a 2 to 3°C global warming range where the impact of climate change is expected to materialize at a more rapid pace than previously anticipated. As such, the trend indicators for interest rates and inflation have been revised upwards, resulting in a 0.25% average annual increase.

Moreover, we have updated our long-term expectations following the developments in recent years, including emerging global trends such as the energy transition, elevated geopolitical risks, deglobalization, and demographic shifts.

The global growth outlook is balanced by, on the one hand, robust activity in the US and easing global monetary conditions, and on the other hand, moderate growth prospects in the EU and China. A soft-landing scenario where inflation continues to decrease, and growth converges to moderate levels seems achievable.

In the medium term, inflation is expected to stabilize somewhat above central bank target, owing to, amongst others, anticipated upward fiscal spending pressures associated with the energy transition and elevated geopolitical risks.

For the coming years, long rates are expected to either move around their recent levels, or somewhat decline for the majority of developed markets. This reflects higher for longer dynamics as inflation is anticipated to slowly converge to target. Short-term interest rates are expected to decline, consistent with continued forward guidance on prospective monetary easing.

Outlook for financial assets

The current economic cycle deteriorates as weakened investor sentiment outweighs continued monetary easing. The short-term outlook slightly improves as monetary easing and increased purchasing power are expected to improve economic activity.

Compared to the third quarter, the equity outlook improves due to anticipated further easing of financial conditions and an upward revision in long-term expectations. Accordingly, expected equity returns remain positive, despite somewhat stretched equity valuations.

The government bond return outlook improves because of increased long rates, following a slower anticipated pace of monetary policy easing. The corporate credit return outlook worsens following tightened credit spreads of anticipated pro-business policies under the Trump administration.

The outlook for financial assets remains clouded by elevated volatility and downside risk due to global political uncertainty and elevated geopolitical tensions; for example, the conflict in the Middle East escalating, potentially turning into a full-scale regional war. This, together with Trump's administration voicing tough foreign policy rhetoric and the collapse of the German and French governments, bring significant downside risks to the outlook.

Integrating climate risk in the investment policy

Hurricane Helene, hurricane Milton and the floods in Valancia are only a few of the major natural disasters that have occurred in 2024. Last year, the global average temperature was 1.6 degrees Celsius higher than before the industrial age. This immediately made 2024 the warmest year on record*. It is the first time the 1.5-degree mark has been exceeded.

Clearly, climate change poses a significant threat for people living in climate sensitive regions but also for Pension Funds. These risks include physical risk, where returns are directly influenced by damage from extreme weather events, but also transitional related risks which have an indirect impact on returns. In the fourth quarter of 2024 Ortec Finance has revealed in a climate risk assessment of 30 Canadian Pension Funds, that in the long-term unrestrained increases in carbon emissions in the absence of further discernable decarbonization will increase levels of physical risk, leading to severe financial impacts by the mid-2030s. In a worst-case scenario, returns in the portfolios of the Pension Funds part of the research, could decline by up to 44%** in 2050.

The embedding of these risks in the investment policy statement is crucial for Pension Funds to mitigate climate risks within the investment portfolio. This includes recognizing the financial impact and setting clear objectives. Next to that, a climate risk assessment in the overall risk management framework throughout the whole investment cycle should be incorporated.

By integrating climate risk into the investment policy, Pension Funds could enhance their resilience to climate-related financial impacts while at the same time contributing to a sustainable future. This proactive approach not only safeguards beneficiaries' financial interests but also aligns with broader environmental and social goals.

If you are interested in integrating climate risk within the investment policy. Please contact us for more information.

** Copernicus: Global Climate Highlights 2024*
*** Figure derived from Ortec Finance's High Warming Stress Scenario*

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Methodology and assumptions

This analysis is based on publicly available data, such as investment policy statements and annual reports, from the top 30 largest pension funds in Canada, the Netherlands, Switzerland, the UK, and the US.

The projections are made with GLASS [Ortec Finance's GLASS](), a forward-looking Asset-Liability Management platform for institutional investors. Plan modeling is based on strategic asset allocations, mapped to public and private benchmarks, and rebalanced annually. For simplicity, active hedging strategies and derivatives are not included in the Quarterly Pension Review.

Returns shown are gross of management fees and expressed in the local currency of the relevant country.

The projections in this analysis are driven by the Ortec Finance Economic Scenario Generator.

Ortec Finance is a leading global provider of technology and solutions for risk and return management, enabling you to manage your investment decisions.

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More information?

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