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France: When the dust settles - 1 May 2010

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Richard Bruyère presents the results of I&F's ninth annual survey of the French institutional marketplace

The French institutional asset management market is emerging from two years of turmoil. Now that the dust has begun to settle, it is possible to draw a few lessons from the crisis, to identify the key challenges in this market and to sketch out ways in which it might develop.

The Image & Finance (I&F) 2009 review panel covers 153 institutions managing €1.68trn of assets. Insurance companies represent almost three quarters of the market in terms of managed assets, the rest being split between pension funds (including the Fonds de réserve pour les retraites), banks and a few other long-term investors.

This dominance of insurance companies in the French market can be accounted for by the lack of pension assets; with life insurance contracts playing the role of the supplementary long-term saving vehicle for most French individuals. For the asset management market, this dominance of insurance companies has two consequences:

• As most insurance companies have set up their own asset management subsidiaries, group delegation (captive assets under management entrusted to affiliated managers) represents more than half the share of institutional assets. When taking into account the fact that most institutions also have in-house investment capabilities for vanilla products (primarily government bonds, to a lesser extent, large cap euro equities), the share of external delegation (ie, assets that are entrusted to third-party fund managers) represents less than 15% of the French institutional assets (€227bn as of Q4 2009).

• The French institutional market is primarily a fixed income market, reflecting that fact that, first, very few institutions have a real long-term investment horizon – it is estimated at about eight years for life insurance companies, given the current tax regime for these contracts, although it is probably shorter for most caisses de retraite (pension institutions); and second, French institutions require annual yield, be they insurance companies (to pay out on the contracts) or banks (treasurers usually having annual income generation targets).

In addition to these structural features, the 2008 financial crisis has triggered a flight to quality which led French institutions to rebalance their portfolios away from equities and other risk assets towards safe asset classes (money market, fixed income).

French institutions have followed a one-way investment strategy in 2009:

• They piled up directly into the fixed income primary market in the first half of the year in order to secure extremely attractive yields for buy-and-hold positions;
• They maintained their money market pockets at relatively high levels by historical standards.

Investment grade credit now represents 40% of institutions' fixed income portfolios versus 35% in 2007. This strategy of directly sourcing fixed income assets has resulted in a slight disintermediation of third-party asset managers in 2009. But what are the prospects for 2010-11?

The asset allocation conundrum
With the current tensions in the euro sovereign market and concern about the risk of rising inflation, the one-way buy-and-hold fixed income strategy no longer appears to be an attractive proposition for most investors. In addition, with money market yields close to zero, reallocating excess cash is clearly a key issue for institutions. We estimate that if money market allocations were to decrease to their pre-crisis levels, up to €25bn would need to find a new home.

The challenge is that the equity markets are unlikely to provide that new home, unlike past post-crisis reallocation moves. What is different this time? With a 40% drop in the equity market in 2008, French investors have been badly hurt by losses in the equity markets. This is all the more problematic as a large number of investors with the higher share of equities in their portfolios were actually those with the shorter-term investment horizon. The risk of extreme loss (drawdown) embedded in equity investments is definitely one that most French institutional investors are no longer willing to carry. With this in mind, they have behaved very prudently with regard to the asset class since March 2009, voluntarily missing out on the rebound in Q2, cautiously returning to the market in Q3 and crystallising their capital gains in Q4.

A second negative factor weighting on equity allocations is the impact of Solvency II. According to our calculations, up to €1.26trn of institutional assets in the French market (ie, 75% of the global asset basis) fall under the insurance regulatory requirements. This situation is fundamentally different from other countries where pension institutions, which are exempt from Solvency II, represent a larger share of institutional assets.

The forthcoming enactment of the directive is expected significantly to weigh on the allocation strategy of French institutions and should increase the trend of moving away from the equity markets – unless current mounting political pressure manages to halt a process, but which seems irreversible to most investors.

As a result, the asset allocation question remains mostly unanswered at this stage.

Opportunities for asset managers
Against this tumultuous background, asset managers have an opportunity to restore the faith of investors in their value added, provided they are able to come up with adequate investment solutions that are in line with institutions' expectations.

New areas of interest where development efforts could be focused include volatility-managed products (absolute performance and/or liquid alternative), equity-substitution solutions (convertible bonds, structured products) and diversification vehicles.

Innovation among asset managers appears more than ever as a differentiating factor. It is by listening to each institutional investor's specific constraints and objectives, and in providing tailor-made solutions, that asset managers will best address the needs of their clients.

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