

# Continental drift

Richard Bruyère presents the results of the tenth annual I&F survey of the institutional marketplace in France  
**Asset Allocation Survey**

Every year, I&F publishes the reference survey of French institutional investments. The panel of our 2011 review covered 194 institutions that manage close to €1.8trn of assets.

This article will highlight the key results of our latest survey, analyse the trends likely to shape the short-term future of the institutional market and draw implications for the asset management and institutional investment communities.

## Stability conceals long term shifts

Over the past decade, the French institutional market appears relatively stable, as epitomised by asset allocations and the manner in which investments are managed.

Fixed income asset classes represent between 70% and 80% of investments. This reflects the lack of real long term institutional investors in the market.

About half of institutional assets are entrusted with affiliated asset managers. This is due to the structure of French savings and the integral role played by insurance companies.

That said, a number of fundamental shifts are taking place in the aftermath of the financial crisis. Some have already come to materialise, whilst others still remain beneath the surface.

The forthcoming implementation of the new insurance regulatory framework, Solvency II, has had a clear impact on institutional asset allocations which, over the short term, appears irreversible, as illustrated in figure 1. This evolution has been widely documented and we will repeat it in detail. It is nevertheless useful to remember that 78% of institutional assets in France fall under the insurance regulatory umbrella (a unique situation in the EU) and will therefore be subject to the Solvency II regulations starting 2013.

A second challenge for the French institutional asset management market is the pension situation. The French pay-as-you-go system has been subject to a scissor effect over the past three years which have led to massive withdrawals of money from the technical reserves run by the AGIRC-ARRCO (French second pillar) institutions:

On the one hand, the financial crisis resulted into a lower rate of employment since 2008, hence a drop in contributions;

On the other hand, the 2008-2010 period coincided with the start of the baby-boomer retirement wave.

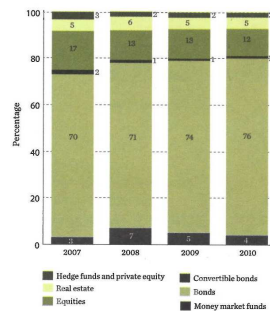
As a result, up to €11bn will vanish from institutional reserves by the end of 2011.

2010 was a year of intense negotiations over the pension issue culminating with a new law on pensions enacted in October. A direct impact of this reform is the forthcoming dismantlement of the Fonds de réserve pour les retraites (FRR) by the end of 2024. €2.1bn of reserves will be paid out annually by the FRR to alleviate social security debts ring fenced with the CADES.

Over the short term this situation has profound consequences for the institutional asset management market:

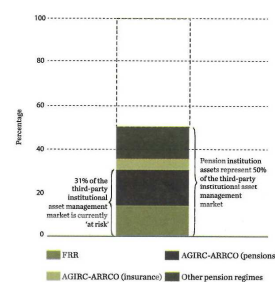
Up to 30% of institutional reserves are cur-

## 1. Institutional asset allocation in France (all segments)



Source: Image & Finance, 2011

## 2. Pensions and third-party asset management market 'at risk'



Source: Image & Finance, 2011

rently 'at risk' according to our estimates. Despite the fact that the pension institutions segment (including FRR and ERAFP) represents a mere 12% of the institutional asset base in France, it makes up more than half of the third-party asset management market (see figure 2).

Pension regime imbalances are leading to a change in asset allocations, which reflects a shorter investment outlook. This results in less equities overall and shorter duration for fixed income investments. These changes may be enshrined into new investment guidelines for AGIRC-ARRCO institutions by the end of the year. Similarly, the annuitisation of the FRR entails an LDI-like approach to asset allocation, with a liability-hedging portfolio for about 60% of assets and a reduced performance portfolio. Against this relatively dark background, there

still are reasons to hope for asset managers.

Changes in pension investment outlooks entail large scale portfolio rebalancing and asset reallocations. The institutional mandate and segregated fund market is therefore extremely busy at the moment. Moreover, as trade union and employer representatives eventually came to an agreement last month about the implementation of the reform for the second pillar regimes, a move back towards equilibrium is not excluded over the medium term, although the employment rate remains the single most critical parameter to restore institutions' technical reserves.

Finally, as the 2008 hangover lingers among institutional investors, new investment themes are rising which offer development opportunities for asset managers.

## New investment themes

The questions raised following the 2008 annus horribilis translate, for institutional investors, into a thirst for diversification and a willingness to try new things.

Top of the agenda has been geographical diversification. Like most other European investors, French institutions have increased their allocations to emerging markets. It is the case for equities where the latter now account for 4% of investments and, perhaps more significantly, up to 20% of the equity open fund competitive market. It is also true in fixed income even though the move towards emerging debt is less compelling (and more recent) due to more hampering regulations. It has however clearly been strengthened this year by the 'PIIGS' crisis.

A second long lasting trend is the move towards 'smart' beta (in the sense of customised performance benchmarks). Even though the financial crisis has not fundamentally questioned risk-return assumptions used by institutions when building their strategic asset allocation, it has shed new light on the inadequacy of market indices as asset management benchmarks for long term investors. With this in mind, a few pioneering institutions are issuing tender offers for non-benchmarked mandates. The use of tailor-made performance references is also widespread among leading insurance companies for the management of their own account investments, even though these practices do usually not directly spill over in the third-party asset management market.

In this area, absolute performance products are one way offered to investors to extract themselves from the 'tyranny' of pro-cyclical indices. In the French institutional market, absolute performance products are expected to share the following characteristics:

- Clear performance objectives (in absolute terms or reference to a money market indicator);
- Strong risk constraints (2-8% volatility range);
- Liquid instruments only;
- No leverage.

On that basis, we estimate that this niche segment now represents 4% of the competitive open funds market.

Whilst their institutional clients still cope with the aftermath of the financial crisis and face growing regulatory constraints, asset managers need to be proactive and demonstrate their ability to come up with specific investment solutions. In a market which appears more challenging, significant inflexions to the development strategy and business model of asset managers are required, lest they run the risk of disintermediation by nimbler competitors, on the one hand, low value-added replication factories or internal providers, on the other hand.

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