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Pension funds should allocate towards infrastructure and growth assets as government bonds now provide “return-free risk”, says Baroness Altmann

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Pension assets could support the UK economy in the fight against coronavirus, if they were invested in infrastructure such as social housing and environmental protection, according to Baroness Altmann, who spoke at a pensions conference this month.

Former pensions minister and peer of the House of Lords, Baroness Ros Altmann is a well-known economist and campaigner. Her work has included leading a lobby that secured millions of pounds in compensation for the retirees of the UK's former nationalised steel industry, who faced losing their entire state pensions.

Speaking at the World Pensions Council's virtual conference, the G7 Pensions Investment Summit, Altmann said that pension funds must rethink their allocations in the face of quantitative easing and increased liabilities.

"Markets have become hooked on exceptional monetary methadone," said Altmann. "Modern methods of central bank monetary policy, the experiments that we're in the middle of, which were meant to be temporary, have gone on for more than 10 years."

Quantitative easing was first used in the UK in 2009 when the global financial crisis was threatening the country's economy, with unemployment rates rising and stock markets plummeting.

The Bank of England's first programme of quantitative easing injected GBP75 billion into the economy – a figure that has since risen to GBP745 billion.

At the same time, long-term interest rates have been "artificially depressed", increasing the liabilities for pension funds, as they typically rely on bonds. Sovereign debt also provides the risk-free rate against which other assets are priced, as they offer low risk and also low returns.

"Over the last four years it is jaw-dropping to see the extent of negative yields. It is starting to look more like return-free risk, than risk-free return," noted Altmann.

As of July, more than half of British government bonds carried negative yields, a debt pile totalling GBP1.33 trillion pounds, according to data from Tradeweb.

Falling bond yields create difficulty for "defined benefit" pension plans, which must meet specific payments for their members. With the classic 60-40 equity-bond fund now estimated to return as little as 2.9 per cent a year after inflation over the next decade, according to an analysis by AQR Capital Management, some pension funds are now looking to diversify their allocations to alternative asset classes.

"Conventional wisdom has moved," said Altmann, adding that governments and pension trustees should focus on "using pension assets to boost growth directly".

"Quantitative easing is an indirect route to harvesting economic growth by raising asset prices. Social housing infrastructure, environmental protection and damage mitigation all need either extra government money or extra private money to succeed in boosting growth, and as such they are much better uses of pension assets."

Pension schemes have not invested heavily in growth producing assets, such as infrastructure, because of their riskiness, she explained.

These investments are also less liquid than bonds and equities, which could reduce the cashflow pensions need in order to meet their payments.

Nevertheless, Altmann emphasised the need for returns in pension schemes: "You can get index linked returns from infrastructure. We used to have the idea that you invested to maximise returns, but now we've gone to side of minimising risk."

She continued: "Pension funds should be proud of the fact that they've put money into long-term investment that contributes to the good of the economy. We would be missing a trick if we did not let pension funds and their investors invest in this way."

The UK government has opened a consultation on improving outcomes for defined contribution (DC) pension schemes, which encourages investment in a more diverse range of long-term assets, including illiquid products such as venture capital and green infrastructure. It also includes steps to encourage smaller pension schemes to merge with larger schemes.

Responding to Altmann's statements, another of the event's speakers, Nick Sherry, a former Senator in the Australian Parliament, said he was "staggered and surprised by the position we're in today".

"My concern as I sat in cabinet in Australia during the global financial crisis, through to sitting here 10 years later seeing another crisis, is with interest rates which artificially increase values. In Australia, housing property is a particular concern."

Sherry led reforms to Australia's pensions system, now one of the most highly regarded in the world. In particular, he oversaw the winding down of Australia's defined benefit pension schemes in the public sector. Over 10 years, the pool of such pensions has dropped from 464 to 176.

"There is a correlation between larger funds and higher returns," explained Sherry, adding that he expected to see more consolidation in the UK pensions system over the next few years.