A moment in history… Modernising pensions?

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Outline

- Some history
- Moving away from traditional investment thinking
- Challenges facing pension fund trustees
- Alternative investment approaches
- Controlling downside risk
- Conclusion

Pension basics

- What is a pension?
- **Social insurance** to prevent poverty: Government role
- **Long-term savings vehicle:** individual role
- Paternalistic employers took on social insurance in final salary schemes – to reward lifelong workers
- Led to expectations of employer pensions
- UK Government relied on employers shouldering burdens and cut state pensions

Pension history…

- Schemes raided by successive Governments
  - Government added new costs, removed safety valves
- UK final salary pensions cost > 25% of salary
  - Each year pension costs rising 5% pa at least!
- Final salary scheme surpluses gone – wake up to deficits
- Actuarial valuations were easy, accounting valuations now
- Employers see pensions as company ‘cost’ not ‘benefit’
  - Average job tenure 5 years – open ended commitment
- Employers looking for a way out!

Regulatory burdens increased

- Corporate activity can be threatened by pensions
  - These are real liabilities
- New rules require higher standards from trustees
- Need increased security – contributions or assets
- Must agree recovery plan with employer
- Regulator watching closely
- Work on more modern investment approaches?
  - Not just hoping for the best

Investment history…

- Historic over-reliance on equities for high returns
  - Unprotected against sharp setbacks – no insurance
- Focus on outperforming markets or manager benchmarks
  - Fine in bull markets but…!
- Assumed rewards for taking equity risk would be high enough to meet pension liabilities
- Seemed to work well for decades
- Deficits from unexpected asset falls and liability increases

What went wrong?

- Investment returns underperformed rising liabilities
- Sensitivity to interest rates and inflation not recognised
  - 1% fall in interest rates -> 20% rise in liabilities
  - 1% fall in interest rates -> 5% rise in assets
- Huge mismatch!
- Can't rely on equities to generate consistent returns
- 'Expected returns' not the same as *achieved* returns!
- Not enough 'what if' scenario analysis

Muddled thinking on risk

- Traditional attitude: Manage returns and **TAKE** risk
  - Passive acceptance or even welcoming of risk
  - High 'expected' returns from risky equities
  - Don't worry about setbacks

- Modern approach: Manage returns AND **MANAGE** risk
  - Not 'take risk' but 'control risk'
  - Measured, managed control of risk relative to liabilities
  - Reduce risk of *not* meeting liabilities/large deficits

Problems of relying on equities

- Equity returns carry two kinds of risk – only one rewarded

1. **volatility** associated with equity risk premium: *rewarded*
2. risk of **not keeping up with liabilities**: *unrewarded*

- Pension liabilities have special risks
  - Inflation, duration, longevity – not equity-related
- Need downside protection for asset falls *or* rising liabilities
- Maybe smooth positive trend better than sharp rises, followed by sharp setbacks

Avoiding big losses important

- If market halves then doubles, only back where started
- If can protect from severe falls, required returns lower

	£100 invested	£100 invested	£100 invested
Yr. 1	- 30%	- 30%	- 3%
Yr. 2	+ 30%	+ 43%	+ 5%
End value	**£91**	**£100**	**£101.85**

- Some say must switch to bonds to reduce 'risk'

Switching to bonds misguided

- Bonds reduce 'risk' as measured by <u>volatility of return</u>
  - But in exchange for much reduced upside potential
- Investment risk is not just about volatility
- Bond investments also still contain unrewarded risk
  - Salary inflation, lpi, longevity, duration, capital loss
- So, switching to bonds doesn't match liabilities anyway
  - Could actually make deficits worse – e.g. Boots
- Even if bonds did match liabilities, it's not enough
  - Reducing deficit requires *outperforming* liabilities

Challenges for trustees

- Equities outperforming bonds is not same as outperforming liabilities
  - 2005 - equities rose, but liabilities rose more
- When in deficit, require returns much greater than bonds
  - Therefore need non-bond diversification
- Alternative assets
  - Currency overlay, hedge funds, private equity, real estate, infrastructure
- Much more complex, lot of change, governance

New thinking

- Diversification of sources of investment return and risk
  - Low correlation, wide range of asset classes
- Compare 1980's move to international diversification
- Many sources of investment inefficiency in global markets
  - Seek sources of beta return from inefficient markets
  - Seek sources of alpha from talented managers
- Trustees should take risks they expect to be rewarded for
- Minimise risks that are not expected to generate returns

Downside protection

- Trustees probably need an insurance policy
- Derivatives can offer efficient and effective insurance
- Minimise liability-related risks not expect reward for
- Experienced management of derivatives vital
  - Administration, valuation and collateral very complex
- Want risk-controlled returns, outperforming liabilities
- Asymmetric return profile – limit downside, good upside

Using derivatives for downside insurance

- UK trustees very slow to adopt derivatives:
  - 14% UK, 50% Holland, 70% Sweden, 100% Denmark
- Swaps and derivatives can be helpful to manage interest rate and inflation exposure: minimise unwanted risk
- More liquid and flexible than bonds
- Can better match liability profile – durations, lpi
- Banks to help with transition to modern approaches
- Trustees must find good investment advisers – no one right answer – complexity is fact of life

Conclusion

- It's not easy!
- New investment approaches may provide better chance of paying pensions than relying on gilts, bonds or equities
- Protection of downside risk vs. liabilities, keep upside
- Alternative approaches using derivatives could help with downside protection, asymmetric returns
- Need more reliable returns targeting liabilities over time
- Challenges for pension industry to help trustees with new investment approaches

Any questions?

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