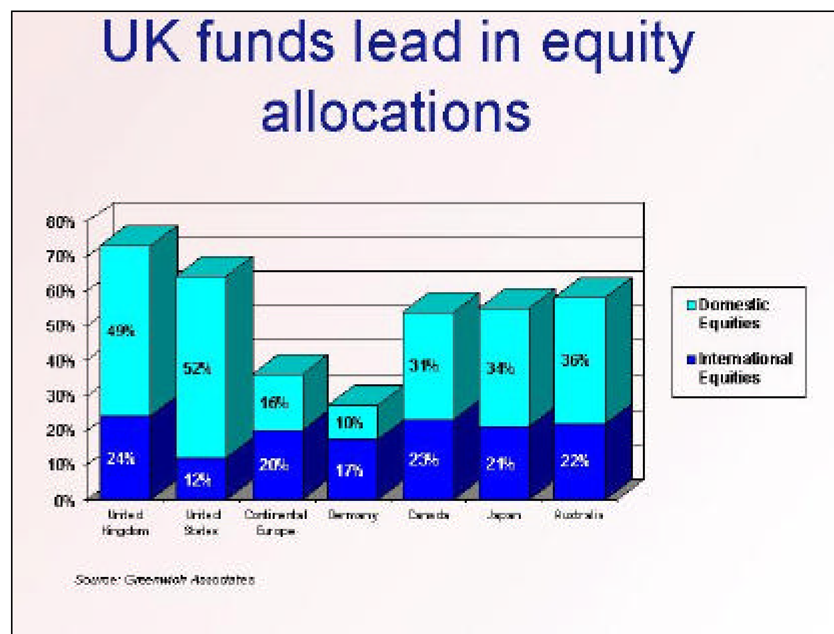
LIFE AFTER MYNERS

Intro

What effect will the Myners Review have on 'life' as we, in the investment industry, know it? The topics covered are vitally important to the UK economy.

The Review was instigated by the Treasury, to look at Institutional Investment in the UK. There was a recognition of the strong international performance of UK institutional funds and an appreciation of the UK's relatively comfortable global position in terms of future funding and affordability of pensions. This is, in large part, due to the UK investment industry having a highly developed equity culture. Our institutions have had the courage to invest in equities and benefit from the superior long-term returns provided by this asset class.



You can see from this Slide that we have the highest allocation to equities of all major countries. But lower inflation and lower equity returns are causing some anxieties about future performance.

The Treasury was concerned about a number of issues. These included:

standardisation of institutional investment portfolios ('herding')

whether there were factors distorting institutional investment decisions, and inhibiting efficient portfolio management

whether investment decisions were being taken in an efficient and flexible manner

and whether there was a lack of domestic institutional support for UK venture capital and a reluctance to invest in small and medium sized firms.

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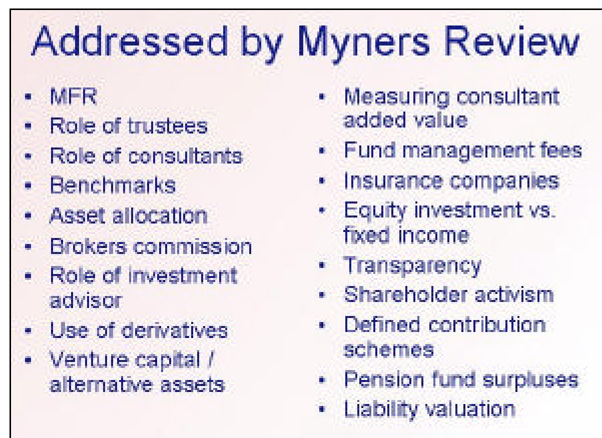
The work involved in the Review and the Report produced, turned out to be much lengthier than originally envisaged. The wide-ranging inquiry was a fascinating and worthwhile project and has been useful in starting the debate on improving the operation of the UK institutional investment industry. The management of pension funds, in particular, is a crucial area to address, especially given the significant demographic changes around the developed world. To the extent that we can better harness the opportunities for long-term funding of pensions through the asset markets, we will be much better-positioned to meet the costs of an ageing population in coming years.

The many topics covered by the Review included all those shown here:



Depending on who you ask, you will get many different answers as to which were the most important ideas and recommendations! There is something for everyone to think about.

The Review was not designed to provide all the answers and the government has embraced its findings, but called for consultation on the proposals. This will be an evolutionary process, rather than a radical short-term shake-up.

Essentially, the problems found by the Review relate to incentives and behaviour. For example, the Report stresses that 'clearer incentives and tougher customer pressures are required throughout the savings and investment industry'. It states that a greater diversity of asset allocation policies would be desirable (not specifically venture capital, but including hedge funds and other assets). It recommends that investment decisions should be 'rational, well-informed, undistorted and subject to correct incentives' and that institutional clients need to apply clearer and more rigorous discipline to broking commissions.

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For my talk today, I will just cover a selection of topics, but I will be happy to answer questions on any other aspects that you are interested in later. The areas I will specifically consider, in the 'post-Myners world' will be particularly focussed on pension funds and will be:

A brief word on the MFR
Defined Contribution Pension Schemes
Consultants
and Benchmarks

Plus a few words on two areas which I feel are crucial to address, to improve the outlook for investment in the UK and ensure better pension provision. These are:
the Concept of Retirement
and Financial Education

I will finish by highlighting some major Challenges for the future, which will determine the quality of 'Life After Myners'.

I want to stress that the comments I make are my own personal views and are not given in any way as a representation of the Review or any official body.

MFR

MFR Removal
Hooray!
- Tried to protect too much
- Why should DB members expect complete protection?
  - Other investors don't
- MFR doesn't give full protection anyway
- Non-retired members may not even get their contributions back on insolvency

Let us start with one of the Reviews recommendations which has been almost unanimously praised - the removal of the MFR.

It is clear that schemes do not want it, it does not do what it was designed to do and the basis on which it is calculated has led to investment distortions. Using only UK equities and gilts as the reference assets has distorted decision-making and is also thought to have distorted the gilt market. The MFR makes no allowance for the maturity or size of schemes, strength of sponsor covenant or trustee investment strategy. The standard assumptions used to calculate the level of funding could also be wrong. Of course, as the Review states, 'providing security for members of Defined Benefit (DB) schemes is an essential objective for any responsibly run pensions system'. Such security is important, but I believe that a major problem with the MFR is that it tries to protect pensions too much. Retired members are supposed to be paid in full (including LPI increases) and others

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should have a 'reasonable expectation' of receiving their full rights. The costs of meeting these liabilities with deferred annuities, and the lack of matching assets, means that even if a scheme is fully funded on the MFR basis, it will only, in practice, meet a fraction of its liabilities (this was demonstrated well recently in the case of the failed chemical company, Blagden, which was 100% funded on the MFR basis, but could only meet about 70% of the liabilities to active and deferred members). In fact, even with the MFR, it is possible that an insolvent scheme's members will not receive anything at all (not even a return of their own contributions) since pensions in payment take priority. This full protection for pensioners seems rather over-generous.

Anyway, why should members of DB pension schemes be offered such complete protection, when all other members of society have nothing like it?

The Deposit Protection Scheme, for example, only guarantees 90% of the first £20,000 if a bank fails (regardless of whether you have £1,000,000 in your account with them!) and the Investors Compensation Scheme will only pay out up about £48,000. If members of DB schemes which fail were only entitled to certain maximum amounts too, it would be much simpler and cheaper to provide a safety net.

The Review's recommendation for the MFR's replacement – the Transparency Statement - has not been universally acclaimed. The central theme of the proposal is that there should be a 'long term, scheme-specific approach, based on transparency and disclosure, with no centrally-dictated set of reference assets distorting investment decisions.'
This sounds reasonable enough doesn't it?

Each scheme would be expected to publish a 'Transparency Statement' attached to its Statement of Investment Principles (SIP) which would cover all the issues shown here:

The Review also recommends that the scheme actuary should have an enhanced 'duty of care' to ensure adequate funding. This runs the risk of leading to an overly-conservative investment stance, set by the actuary! In addition, the Review's proposal does not deal adequately with the issue of calculation of transfer values, which are currently calculated on the MFR basis. I would expect that, unfortunately, the 'Transparency Statement' is likely prove very expensive and time-consuming to prepare. The rationale for it is that 'judgment of assumed investment returns' will provide the key to pensioner protection and 'the better

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the trustees think through their investment strategy, the better the protection for DB scheme members'.

I must confess, I cannot agree that this process actually can reliably provide any level of protection at all! The Review states that funds would have to make clear both their current financial position and their future plans, which would reveal if they are planning to pursue *inappropriately risky strategies*'. But – in whose opinion?! One can always find an 'expert' to justify one's investment stance, with reasonable sounding assumptions. We all know that!

With the best will in the world and smartest brains in the universe, no-one can actually reliably predict the future for investment markets. Consensus forecasts are often inaccurate and experts do get things wrong, therefore, schemes would be exchanging a cumbersome and sub-optimal level of funding security, for no security at all. If pensions in payment still must be met in full, active and deferred members may again end up with nothing if the investment assumptions turn out to be wrong.

Several alternative proposals for replacement of the MFR have been proposed. The front-runners include:

- converting DB schemes to DC on insolvency
- making all scheme members preferred creditors
- introducing a rating system for pension funds (like the AAA type ratings for bonds)
- a central discontinuance fund

But my number one preferred solution would be

- insolvency insurance.

Insolvency Insurance

- Insurance for DB
  - Up to maximum monetary amount
- Premiums depend on funding level
- Set for 5 or 10 years at a time
- Look more creatively at insurance option

The Review rejected insurance on several grounds, including the difficulty of finding a mutual insurer to ensure funding, the extra cost burden on DB schemes and the possiblie distortion of investment decisions, if the insurer scrutinises funding too frequently. However, if scheme members and pensioners were only entitled to a fixed maximum reimbursement or payment on insolvency, insurance should become a much more viable option. Moral hazard issues could be addressed by not insuring 100% of the liabilities and

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by making premiums higher for poorly funded schemes. The insurance company would need to quote for cover to last at least 5 or 10 years, to give some stability to the investment profile. Of course, this insurance would only be needed to top up any shortfalls in the actual fund, since all pension funds have some assets, protected in trust. Premiums should benefit from the pooling of risk (since only a tiny proportion of DB scheme sponsors become insolvent). The insurance should be compulsory and schemes which could not obtain or renew their insurance would need to be wound up or join with larger schemes. I do believe it would be worth revisiting the idea of insurance in a more imaginative and creative manner.

One big concern with the MFR was that it would cause companies to close their Defined Benefit schemes and switch to Defined Contribution (DC) provision. However, with Review's proposals there is a similar risk. The costs to DB schemes entailed in preparing the Transparency Statement and payment of trustees might have similar effects. I must admit, I also fail to understand how paying a trustee will make them better able to make investment judgments! Providing education and training might be more appropriate. Furthermore, trustees are paid as part of their normal job and allowed time off to carry out their duties. It is possible, however, that paying them extra will mean firms are reluctant to allow time off from normal work duties for trustee duties. The trustees would then be having to fit in their meetings outside working hours and this could make them worse off than before! Thus, just as with the MFR, I fear that measures which are introduced to protect members of DB schemes, might actually end up radically reducing their security, by taking away the employer's guarantee. The government certainly does not want to encourage this trend, but – even after the removal of MFR – there is another change which I think could be even more damaging to DB provision. That is the new accounting standard FRS17. Many corporate Boards will be reluctant to have the volatility of pension fund gains and losses affecting their balance sheets. The Accounting Standards Board has introduced this new measure to require companies to report the gains and losses on pension fund assets every year in a 'Statement of Recognised Gains and Losses – STRGL' which is attached to the balance sheet. This reporting standard has to be implemented by 2003 and will mean that the volatility of DB asset values can no longer be smoothed away. This could directly affect corporate valuations on an annual basis.

The introduction of FRS17, coupled with maturing of schemes and increasing longevity, suggest to me that the move away from DB is inevitable. The only question is how fast it will happen.

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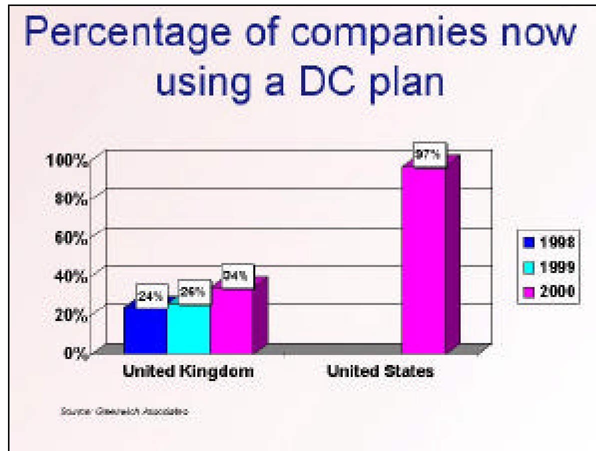
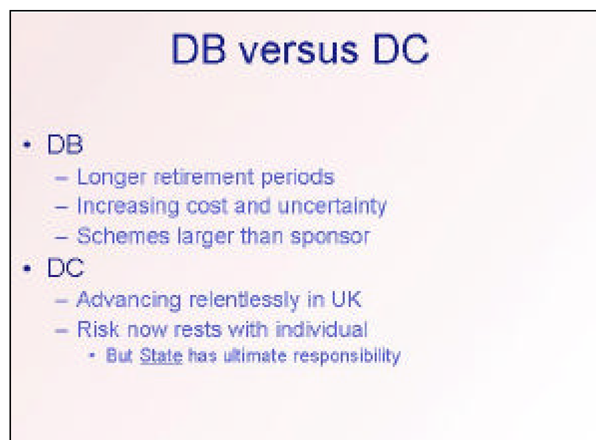
DB vs DC

Given this view, I really believe it is imperative that we address the issues of DC pension provision as soon as possible, The Review did look at this topic but I am convinced that there are still significant challenges ahead here.



The trend to DC is advancing, but is still in its early stages, with only about a third of schemes in the UK being DC, whereas in the US the figure is 97%. It is amazing that there are no comprehensive UK data on the size of assets in DC arrangements, or their investment profile. This is partly because most DC schemes are in small companies (until recently anyway) and they are immature, so the proportion of *assets* is *much* lower than one third.



DB schemes are suffering from several negative influences. Demography and earlier retirement imply a longer period of retirement and much more expensive pension provision . In addition, many schemes have become so large that they are dwarfing the size of their sponsor companies and contribution holidays are coming to an end. Add to this the changes in the regulatory environment (LPI, taxation of surpluses, removal of ACT relief) and employers are bound to be attracted to DC.

In DC schemes, the risk of inadequate income in retirement and investment shortfalls rests with the individual, rather than a company as in DB, but ultimately, of course, the final risk

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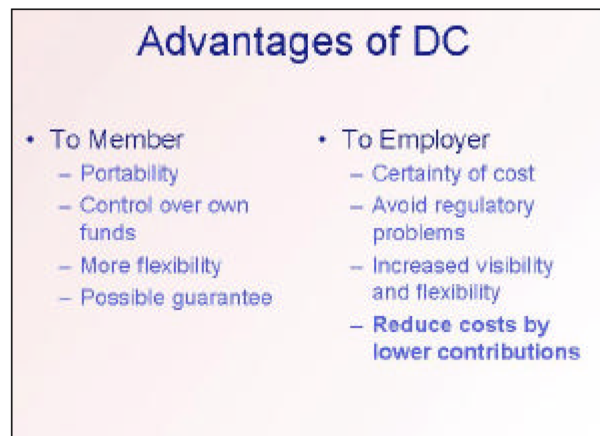
lies with the State. If occupational pensions are inadequate, the elderly will fall back on means-tested income support. Therefore, it is in the interest of society as a whole to ensure DC pensions turn out to be adequate.

Although DB schemes have always provided better pensions for members than DC, this does not have to be the case. There could, in fact, be potential advantages of DC provision, if it can be structured correctly, but the way it is provided at the moment in the UK is not optimal. Much could be done to improve the pensions provided by DC arrangements. Members should, in theory, benefit from portability, more control over their investments, more flexibility over retirement age and could even have return or benefit guarantees.



There are also advantages to an employer of providing a DC rather than a DB scheme. Employers can benefit from

More certainty of and control over costs of pension provision
Fewer problems of compliance with regulations
Increased visibility of contributions to employees
Ability to offer more flexible benefits packages
and – perhaps crucially – the opportunity to
Reduce costs by lowering contributions

UK schemes are not nearly as well-developed as those in the US and members of DC schemes here suffer several disadvantages, with lower employer contributions – meaning less put aside to provide the pension, lack of well-designed investment options and no employer to make up any investment shortfall.

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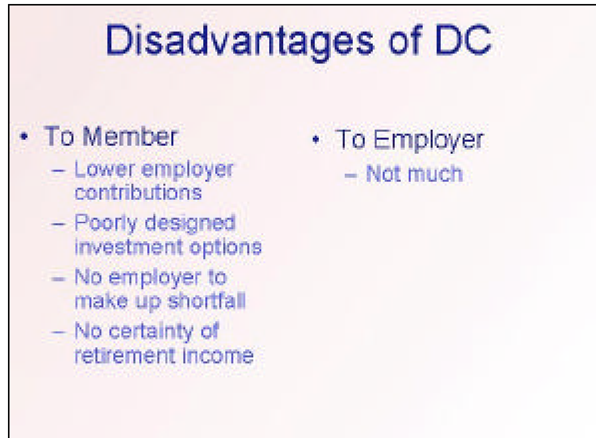


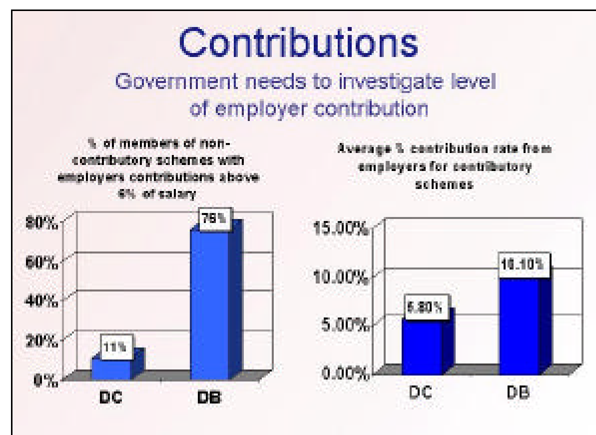
However, from an employer's point of view, there are not really many disadvantages of switching to DC, other than, perhaps the actual inconvenience of setting up and administering a new scheme.

So what are the key issues, which we need to get right if DC pensions are not going to cause major disappointment and problems in years to come?

1. Level of Contributions
2. Investment performance – net of fees
3. Cost of annuities chosen to buy the pension.

I will not deal with annuities here, as this is a large topic and was not really covered by the Review.

As for contributions, the Government urgently needs to investigate the level of employer contributions. They are simply too low.



Survey evidence shows that, for non-contributory schemes, only 11% of employers contribute more than 6% of salary, compared with 76% in DB, and the average employer's contribution level in contributory schemes is only 5.8% in DC, but 10.1% in DB.

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These contribution rates are far too low and suggest that DC will not provide adequate pensions. In fact, a study by Blake, reported in the Economic Journal 2000, estimated the contribution rates needed to provide a pension of two-thirds of final salary.

Contributions Needed to Achieve a Pension of Two-thirds of Final Salary

Age at commencement of contributions (Male)	Required contributions (% of salary)	Maximum contributions permitted by current legislation (% of salary)
25	10.9	17.5
30	13.4	17.5
35	16.8	17.5
40	21.7	20
45	28.9	20
50	40.8	25
55	64.1	30
60	129.8	35

These assume a male retiring at age 65, with no previous contributions into any other scheme, salary increases of 3% per annum and investment returns of 6% per annum.

You can see from these results, that contribution levels of 6% are nowhere near enough. In fact, Blake's estimates of the pension contributions needed suggest that, if starting at older ages, no-one is likely to be able to put enough into their fund to earn a two-thirds pension, because the contributions required after age 40 are higher than the maximum permitted by the current legislation.

Of course, even if contributions are sufficient, it is also essential that the monies are invested effectively. Investment performance is a major issue.

Investment Performance & Products

- Investment performance of:
  - DB affects SECURITY of pension
  - DC affects AMOUNT of pension
- Need for:
  - Education and guidance
  - Best practice guidelines
  - US "Safe Harbour" regulations

In DB, investment performance will affect the SECURITY of your pension, but
In DC, investment performance will affect the AMOUNT of pension

So, for occupational schemes where trustees make the investment decisions, the trustees' investment expertise is, arguably, even more important in DC than in DB. And many schemes (including stakeholders) rely on individuals to choose their own investment

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allocation. If the Myners Review questioned whether pension fund trustees could adequately understand investment issues, even with the help of professional advisers, how can ordinary DC scheme members, without advice, be expected to address the investment issues properly?

They need education and guidance, perhaps with the authorities issuing 'Best Practice' guidelines for trustees and members. A useful starting point may be to introduce measures modelled on the US 'Safe Harbour' guidelines. I think trustees should realise that they run the risk of being sued in a few years' time, if they have not provided proper opportunities for DC schemes to optimise their investment choices.

The US Safe Harbour regulations basically require a DC plan to offer the following:

at lest 3 investment alternatives
each of these must be diversified, with different risk/return characteristics
members must be able to control the assets and change investment choices
members must receive good information
investment choices must allow creation of an appropriate portfolio
the combination of choices should allow portfolio risk minimisation through diversification.

As long as they meet these requirements, trustees cannot be sued for investment negligence.

At the moment, however, UK schemes do not meet these criteria. In some schemes, trustees offer no choice of investment, just one product. The Watson Wyatt 2000 Pension Plan Design Survey showed that 23% of DC schemes offered no investment choice at all – even though it is the member who bears the investment risk! This is inadequate.

There is an urgent need to develop a range of suitable investment products specifically for DC. These products should provide for differing risk, asset and time horizon requirements and must surely include passive as well as active options, to allow capture of the full market movement of an asset class, if desired. Alternative assets, such as venture capital, hedge funds and even Socially Responsible Investment vehicles, could also be included in the form of Investment Trusts, for example.

Also, for those who do not feel able to take their own decisions, there should be well-developed default options. Over 75% of DC members use their scheme's default option, but in some schemes this is just a 'balanced fund', measured against the peer group benchmark of DB schemes. This is not really suitable. Other schemes offer 'lifestyling' options, whereby the fund is switched increasingly into bonds in the years before retirement age. This is also often an inappropriate investment strategy and takes no account of increased longevity, different risk preferences, other assets held by the members, or whether they are going to switch into drawdown on retirement and therefore go back from bonds to equities as soon as they retire!

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Trustees' Choice of Investment Provider in DC

Big responsibility. Big risk!

- Should depend on three main factors:
  - Availability and quality of advice
  - Broad range of investment products
  - Level of charges
- Past performance should not be over-riding factor

The Trustees also have a big responsibility in choosing which investment provider should manage the assets on behalf of members. I would suggest that their choice should depend on 3 main factors:

1. the availability and quality of advice provided to members (risk modellers, individual financial counselling etc)
2. the breadth of their investment products range
3. the level of charges (high charges have a significant detrimental effect on investment performance over the long term).

Past performance should not be an over-riding factor.

Perhaps the investment consultants can take a lead here in recommending a better design for DC investments.

This brings me to another area which I'd like to take a quick look at today. The role of consultants.

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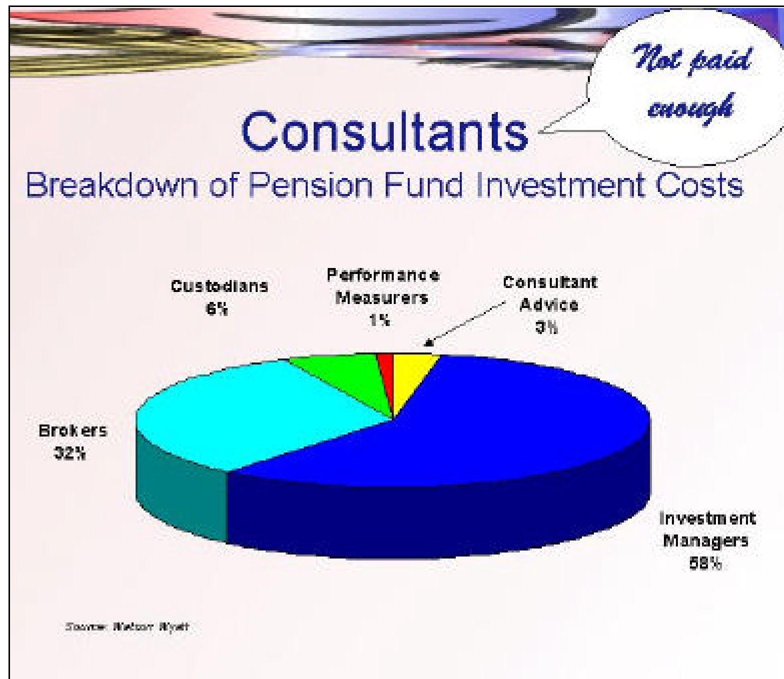
CONSULTANTS

The Review makes a number of comments about consultants and actuarial firms. Some of these should be rather popular with many of you. For example:



The Review states that clients do not pay enough for their asset allocation advice!

The annual average cost of consultant advice (for a £200million pension fund) is estimated by Watson Wyatt at 1.5 basis points out of a total of 47 basis points, which is just about 3%. This compares with 57% for fund management, 32% for brokers and 6% for custody. The 1.5 basis point reward for investment advice certainly does seem low. Of course, it is offset, to some extent, if the actuarial firm advising the fund is earning high fees on its actuarial business, and it is certainly the case that decision makers (like fund managers) are normally paid more than advisers, but the disparity does seem large.

Several suggestions, with regard to consultants are made in the Review, including:

a recommendation to split actuarial and investment advice, so that firms compete separately for each type of business

payment of higher fees to investment consultants

formal assessment of advisers' performance and measurement of consultants' added value on manager research and selection

trustees should only take advice on an asset class from an investment consultant who has specific expertise in that asset class.

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In many funds, there seems, perhaps, to have been an emphasis on the 'low risk' end of the equity spectrum, but markets have developed rapidly in recent years. The Review felt it necessary to go so far as to recommend that trust deeds should no longer contain investment restrictions which prohibit the use of instruments like derivatives, options and futures. The idea that such holdings only *increase* risk is out-dated and a recognition of their role in risk reduction is certainly overdue.
*
The Review calls for 'intellectual competence' from investment advisers. It found that the major UK consultants have lagged behind their US counterparts in recommending alternative assets, such as hedge funds and venture capital, so there have not been enough specialists in these areas in the UK. I did find it amusing to hear the rationale for this. Trustees say they have not really considered investments in hedge funds or venture capital because it was not suggested for consideration by their advisers and the advisers say they have not recommended investment in them because the trustees have not shown interest in these asset classes!

There has been too little assessment or measurement of the effectiveness of investment consulting advice, either on asset allocation or manager selection and it would be helpful if we could come up with recommended criteria to use. Perhaps the increased use of multi-manager funds offers an opportunity for measurement of manager selection and asset allocation added value.

If we have not yet designed methods of measuring advisers or trustees' performance, we certainly have plenty of ways of measuring the performance of investment managers.

PERFORMANCE BENCHMARKS

Performance Benchmarks

- Peer group benchmarks not appropriate for DB
- Should be tailored to each fund's needs
- Deliver a return related to each scheme's liabilities
- Use of tracking errors and risk controls needs looking at
- Herding

This is an area which, I believe, is very important for 'Life after Myners'. We need to ensure that the use of benchmarks for performance measurement is better thought through. Peer group benchmarks are NOT appropriate for DB (and certainly not for DC). Benchmarks should be tailored to each fund's needs and should be structured to deliver a return related to each schemes liabilities, not just to outperformance of a peer group. It is clear that the standard approach has led to herding, just trying to outguess the competition, investment distortions and, in many cases, payment of active fees for quasi-passive management.

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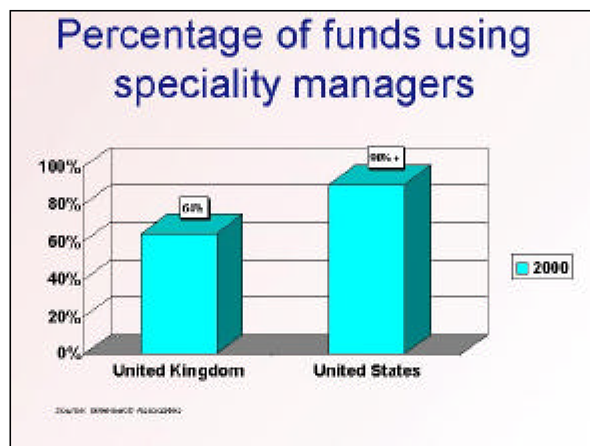
The use of tracking errors which are too tight to allow genuine active investment decisions, the business risk of underperforming by too much and lack of reward for substantial outperformance, have created a situation where active managers all follow very similar strategies.

Certainly, the use of tracking errors and risk controls needs to be looked at carefully in the context of the overall portfolio.

A core-satellite approach would seem to me to make most sense for the majority of funds. A core of passively managed funds, to cheaply capture the basic index movement and then a selection of satellite funds, run by specialist managers, to try to add value above the benchmark returns. The concept of 'risk budgeting' where the different types of risk are aggregated into a single overall risk measure, that is consistent with the total fund's risk tolerance, and the use of alternative assets to construct a truly well-diversified portfolio, is likely to prove to be 'best practice'. The US is well advanced down this route of structuring the management of institutional portfolios.



Last year, over 90% of US funds were using specialist managers, but less than two-thirds of UK funds were. The US is also well down the route of specialisation and better diversification as shown here.

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Percentage of funds using each type of mandate

Speciality Mandate	United Kingdom	United States
Domestic equity index	33%	67%
Enhanced index	3%	21%
Large cap stocks	12%	83%
Small cap stocks	11%	73%
Emerging markets	13%	29%
High-yield bonds	7%	24%
Hedge funds	2%	11%

Source: Greenwich Associates

US funds have a wide range of satellite managers, around the core passive mandate and have well-diversified investment styles. The multi-manager approach is also being increasingly used, for those trustees or individuals who do not wish to choose their own managers and this will include a wider range of assets than the standard balanced mandate.

Equity vs. Bonds

- Review predicts increased use of fixed income
- Use of fixed income as strategic, rather than tactical asset
- Equities still outperform over long term

As well as suggesting consideration of alternative assets, the Review forecasts that fixed income will become a much more important asset class in the UK and that our fund management industry will need to develop its skill-base in this area. In the past, high UK inflation and budget deficits have made gilts rather unattractive investments relative to equities. But, page 95 of the Review predicts that the growing maturity of DB schemes, increased demand for predictable returns and concerns as to whether equities can maintain their historic outperformance, will all mean that fund management firms will need to build up their fixed income management and credit skills. They will require more expertise in management of corporate debt portfolios, using fixed income as a strategic, rather than just a tactical asset.

However, I still believe that equities will outperform fixed income in the long term and that holders of equities will be rewarded for the higher risks they take on aggregate. I also believe that the move to DC schemes does not have to imply an increase in fixed income

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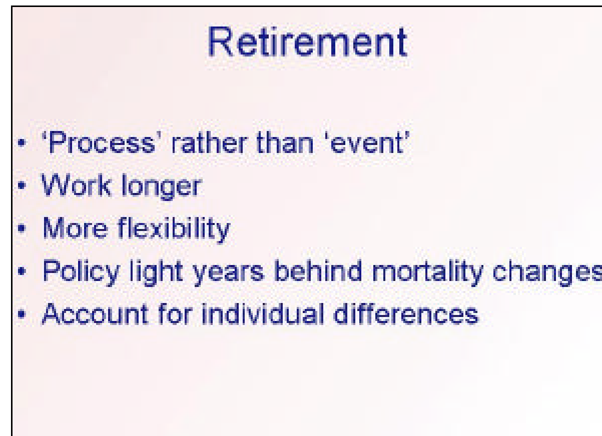
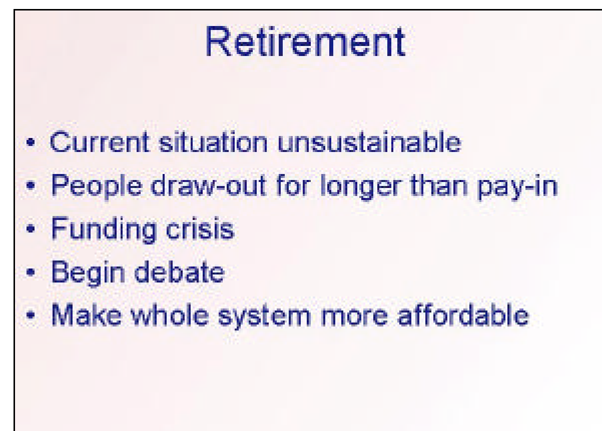
investment in the near term, since investment policy has not yet reflected the fact that 60 year olds are living – on average – to 81 for men and 85 for women!

This leads me to two final points I would like to make – which are not specifically a central theme of the Review, but which I really believe will be crucial parts of 'Life after Myners' – these are the debate about the concept of retirement and financial education.



I have already mentioned the large increases in longevity which have occurred in recent years and also the ageing of the population. This, coupled with the improvements in health status of those over age 50, and the pressures on funding of pensions, suggests that it must be time to re-evaluate the whole area of retirement and I was delighted to see Peter Thomson mention this at the NAPF conference last week.

People should be encouraged to work for longer, in order to build up more assets to support them in later life, in order not to waste society's human resources and to make our pension system more affordable. Retirement should really be a 'process' rather than an 'event' (perhaps people could cut down gradually over a period of years, job-share at older ages with younger workers who are studying mid-career, for example). Cessation of work should not be tied to an arbitrary chronological age and there will need to be much more flexibility. Taking account of individual differences should be an important aim of pension policy, as people try to build up sufficient resources to support themselves later in life. The old saying that 'middle age is half way between adolescence and obsolescence' should be re-thought.



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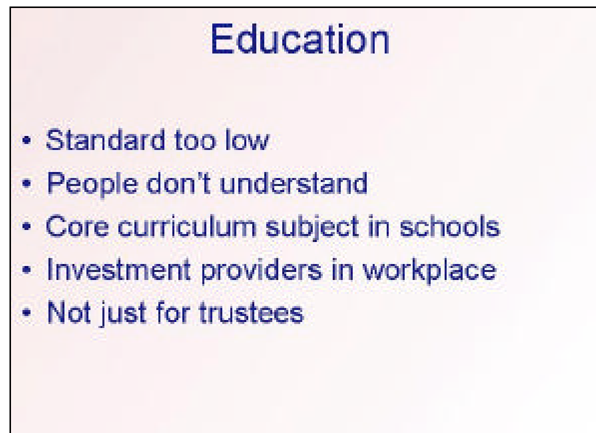
ros@genesys.net

The more years people can spend in the labour force, the more affordable any retirement support becomes. Pension and retirement policy has lagged significantly behind changes in mortality and health status and the costs of pension provision will become unsustainable. People who retire early, in their 50's for example, can end up trying to draw out a pension for more years than they paid into it! Why wait until a financing crisis ensues, why not anticipate it and try to change social attitudes and expectations now?



One last point, which seemed so clear in all the Reviews work, is that the UK does not provide anywhere near a good enough standard of basic financial education for its population. So many products are too complicated (even stakeholder pensions!) and so many people do not realise the benefits of investing for the long term. Finance and investment should, in my view, be part of the core curriculum in all schools – starting in primary school, just as we teach history, geography and science. The FSA really needs to ensure better standards of financial education, information (and even advice) are received, before people make critical decisions relating to their finances. It is not just trustees who need educating more in investment matters! And, as the State tries to encourage individuals to provide for themselves, it is essential that people are aware of why one needs to save for the long term and how to do it. Otherwise, any reform of institutional investment activity will not feed through to benefit society in the way it should.

So I will just finish with what I perceive to be the big challenges facing us in our 'Life After Myners'.

These are:

Ensure any MFR replacement works well
Ensure DC pension provision provides decent pensions
Encourage use of tailored benchmarks and better diversification
Begin the debate on re-thinking retirement
and Ensure financial education is provided widely.

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ros@genesys.net