Trustee challenges – facing up to deficits

Managing pension fund risk and returns

European Pension Fund Investment Forum
Marlowe, 10th July 2006

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Outline

- Trustee challenges
- Traditional thinking – risk and return
- Trustee investment decisions in future
- Focussing on the liabilities
- Example of new thinking in practice

Investment challenges for trustees

- Traditional investment approaches with big deficits
- No protection against sharp falls – 2000-2002 experience
- What if sponsor is weak?
- Over-reliance on equities for superior returns
- Assumption that rewards for taking equity risk would be high enough to meet pension liabilities
- Explicit consideration of liabilities – paying the pensions

Traditional thinking

- Traditional attitude to investment was:
  - Manage returns and
  - **<u>TAKE</u>** risk (acceptance of risk – equity risk)
  - Almost *welcome* risk, in expectation of high returns

- Modern investment approach would be:
  - Manage returns AND
  - **<u>Manage</u>** risk (active risk control, choose which risk)
  - Try to reduce the **risk of not meeting liabilities**

Problems of traditional investment approach

- ‘Expected’ returns, not same as *achieved* returns
- Not enough consideration of different scenarios
  - Downside protection - falling assets **or** rising liabilities
- Relied on equity risk premium to outperform liabilities
- Ignored main sources of risk in liabilities
  - inflation, duration, longevity
- Is switching to bonds the way forward to meet liabilities?

Switching to bonds to 'reduce risk'

- Bonds are imperfect 'match' for liabilities – will underperform liabilities and require higher contributions
- If sponsor weak, scheme closed or large deficit, could make things worse – lock in deficit
- May reduce 'volatility' but increase risk of not being able to pay pensions!
- Bonds reduce 'risk' in exchange for huge reduction in expected return – what upside potential?
- Bond investments still contain 'unrewarded' risk
  - Salary inflation, lpi, longevity, duration, capital loss

But just relying on equities too risky

Equity returns carry two kinds of risk

1. volatility and uncertainty associated with equity risk premium – trustees can hope to be rewarded for this
2. risk of not keeping up with liabilities, as interest rates, inflation and mortality change – this is <u>unrewarded</u> risk

Pension investors only likely to benefit from one risk

Other risks caused damage because not been controlled

Trustee investment reality check

- Liabilities rising 4-5% each year (bond rate) + longevity
- Returns must exceed this to reduce a deficit
- Modern investment approach to manage risk and return targeted explicitly at outperforming liabilities
- Long-term risk that sponsor not support closed schemes
- Need to avoid large losses – especially if sponsor weak
  - Avoid larger deficits with downside risk control

Avoiding big losses important

- Falling markets are very damaging
- If market halves then doubles, only back where started
- If can protect from severe falls, required returns lower

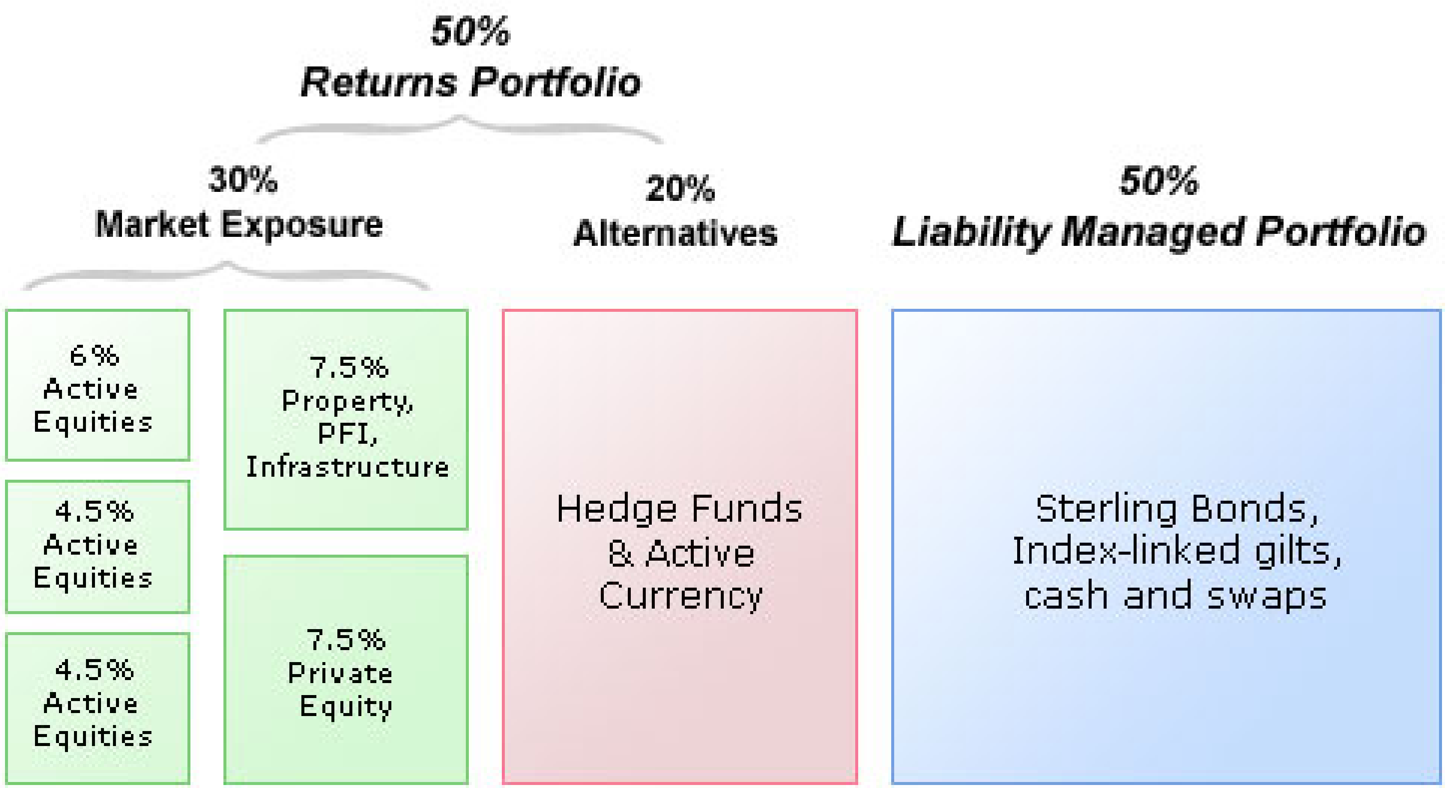
	£100 invested	£100 invested	£100 invested
Yr. 1	-30%	-30%	- 3%
Yr. 2	+30%	+43%	+ 5%
End value	**£91**	**£100**	**£101.85**

- Is switching to bonds right way to dampen volatility?

Asset Allocation in Future

- Equities only one source of risk premium
  - Many different sources in inefficient global markets
- Trustees should take risks they will be rewarded for
- Minimise/eliminate liability-related risks not rewarded for
- Part of assets to match liabilities – liability hedging
  - Swaps hedge interest/inflation risk better than bonds
- Part of assets to generate returns – return seeking
- Diversification
  - Absolute return? Hedge funds? Portable alpha? Unconstrained equities? Currency? Private equity?

Case study – new approach



Case study – practical issues

- Trustees must negotiate with sponsor
- Actuary to work out returns required above gilt-based value of liabilities e.g. gilts + 3% consistently over time
- Governance, education, administration, monitoring problems with swaps and derivative overlays
- Investment banks offer passive liability driven products
- Need good investment adviser – incentive fees?

Case study – performance fee for investment advice

- Performance fees to align interests of trustees and consultant
  - Ground breaking arrangements
- Consultant loses money if fund does not achieve liability related target e.g. gilts + 3%
- Performance fee only paid over 3-5 year period, to encourage consistent adequate returns
- Not incentivised to deliver exceptionally high returns
- More stable, control downside risk, less aggressive

Potential structured LDI solutions

- Modern investment approach to target liabilities explicitly
  - Better than index-linked gilts or bonds
- Extra upside potential to meet deficit/mortality
- Can offer capital and inflation protection – swaps?
- Can still benefit from investment upside potential (and leverage?) in inefficient global markets
- Structured solutions can help with complex administration
- Still access alpha and different sources of beta - diversify

Conclusion

- New investment approaches to help trustees pay pensions
  - Traditional approaches unlikely to deliver enough
- Potential for higher and more reliable returns
- Protection of downside risk, still allowing good upside
  - Manage risks AND returns
- Administrative challenges for trustees-more diversification
- Better chance of paying pensions than relying on gilts or bonds, or just equities – an alternative way forward?

Managing risk and return to meet the liabilities

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