The Future of Pension Fund Asset Allocation

Northern Trust Investment Seminar

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Outline

- Defined Benefit and Defined Contribution
- Asset allocation Issues for Defined Contribution
- Focus on Defined Benefit Schemes
- New approaches

Defined Benefit vs. Defined Contribution

- Defined benefit schemes promise a pension
  - Employer to meet cost of shortfalls
- Defined contribution schemes give a pension pot
  - Individuals suffer any shortfall
- Different attitudes to risk
- Different requirements for liability matching

Defined Contribution Schemes

- Aim to maximise value of pension savings
- Individuals bear investment, inflation, longevity risk
- Control risk
- Need better designed investment options
- Annuity purchase

Aims of Defined Contribution Asset Allocation

- Maximise returns, with controlled risk
- Capital protection as well as growth?
- More emphasis on fixed income
- Good range of investment options for those who want to choose
- Well-designed default options for members who don’t want to choose
- Include capital guarantees, property, alternatives?

Aims of Defined Benefit Pension Fund Investment

- To be able to afford to pay the pensions
- Not just to maximise returns or outperform an index
- Outperform the liabilities
- Employers want to minimise contributions – cost control
- Employers may be able to shoulder more risk than individuals
- Trustees are responsible for paying pensions - conflicts of interest

Burdens on Pension Funds

- No safety valve in the system – revaluation and indexation
- Assets fallen, liabilities risen (interest rates down, longevity up)
- Maturity
- Taxation of surpluses
- Increased costs of buyout: gilts – 0.5%?
- Accounting changes - FRS17 and IAS19
- MFR → Scheme specific funding
- PPF – risk based levy based on asset allocation vs. liabilities
- Policy and actuarial valuation changes may increase risk aversion

Defined Benefit Schemes – Surpluses Gone

- Employer pension promise is open-ended liability
- Strong equity returns were not locked in
- Over-reliance on equities – tried to take big risks in hope of better returns and lower costs
- Contribution holidays
- If in deficit and mature, must reduce risk
- More focus on liabilities needed

Nature of Liabilities

- US pension liabilities bond-like, can use fixed income
- Very long term payout periods – duration c. 20 years
  - Reinvestment risk
- UK liabilities different from US - largely index linked
  - Not indexed to rpi, but limited price indexation (lpi)
  - Deflation risk (lpi floor zero, index linked bonds fall)
- No assets are a perfect match
- Trustees to decide extent of mis-matching they accept

New Aims of Defined Benefit Asset Allocation

- Pension funds becoming more sophisticated
- Boards focussing more on pension fund asset allocation
- Increased use of fixed income
- Liability based benchmarks
- More matched investment strategy
- Asset/liability models, scheme specific
- Trustees want more from bond portfolios

Matching Liabilities

- Liability matching strategy particularly appropriate for better funded schemes
- Bonds alone not good enough for matching
- Require synthetic products, derivatives, swaps etc.
- Extend duration
- Cope with lpi

New Products

- Swaps and bonds as liability matching strategy
- Create more appropriate asset profile
  - Interest rate swaps to match duration of assets to liabilities more closely
- Inflation derivatives to match inflation linked liabilities
- Equity derivatives or hedge funds for capital protection

- Specific UK issue
- Not just index-linked gilts
- Shortage of index linked assets
- Inflation swap overlays to match portfolio cash flow to pension liability matching cash flow
- Index-linked bonds with credit derivatives to enhance yield

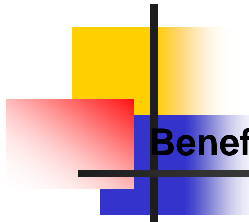
Risks

- Counterparty risk
- Derivatives and swaps require collateral
- Reinvestment risk
- Liquidity risk
- Lack of inflation linked corporates
- Lack of long dated corporate bonds outside financial sector

Why Consider Hedge Funds?

- Hedge funds can reduce risk and enhance returns
- Emphasis on uncorrelated, absolute returns attractive
- Improve efficient frontier
- Truly active management – not benchmark constrained
- Use long/short in core-satellite portfolio in preference to active long-only?
- Use non-correlated market neutral to aid risk control

Hedge Funds Complement Traditional Investment Portfolios



Efficient Frontier

Benefits of Incorporating Hedge Funds in a Classical Portfolio of Stocks, Bonds and Cash

10 years to July 2002

12
11
10
9
8
7
6
5

Annualised Return [%]

20% allocation to Hedge Funds

Equity &
5% Cash

0% allocation to Hedge Funds

Bonds &
5% Cash

3 5 7 9 11 13

Risk (Annualised Standard Deviation [%])

Hedge Funds: HFRI Fund Weighted Composite Index
Bonds: JP Morgan Global Bond Index
Equity: S&P 500 Composite
Cash: 3 month Interbank Eurodollar Deposit Rate

Issues of Hedge Funds

- Crucial to choose good managers
- Good prime brokers and back office
- Detailed due diligence required
- Transparency, high fees
- Fund of funds can perform due diligence
- UK consultants very late to recognise benefits

Summary

- Pension fund asset allocation becoming more sophisticated
- Specific issues for Defined Benefit and Defined Contribution
- Capital protection and well-designed investment options for Defined Contribution
- More attention to risk and fixed income for Defined Benefit
- Extend duration of assets to match liabilities
- Alternatives in addition standard asset classes

Thanks for listening

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