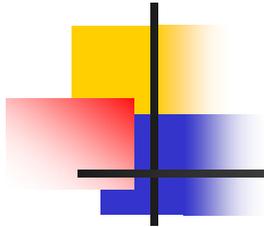


A practical view of pension investor concerns, investment objectives and current market conditions

Lehman Brothers Pension Fund Seminar
27th January 2005

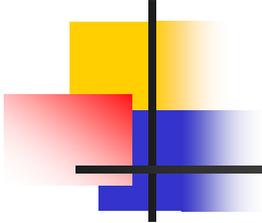
Dr. Ros Altmann

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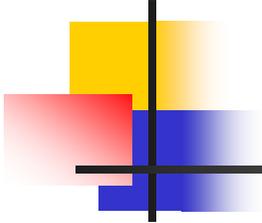
Introduction

- Current concerns
- Traditional investment approach
- Investment objectives for DB and DC
- Alternative opportunities
- Summary



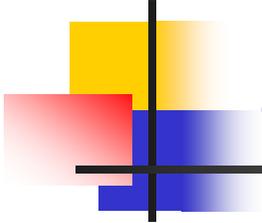
Current situation

- Traditional company pension provision falling
- Deficits
- Too much risk for maturing schemes
- Pension liabilities drag on corporate performance
- Finance directors recognising true costs
- Moving away from defined benefit schemes



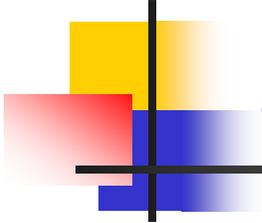
UK Pension Funds - Concerns

- Concerns for trustees
 - How can we ensure pensions are paid?
 - Deficit funding issues and conflicts of interest
- Concerns for employers
 - Cost control
 - Risk reduction
- Concerns for members
 - Will I get my pension?
 - What is impact of moving to DC?



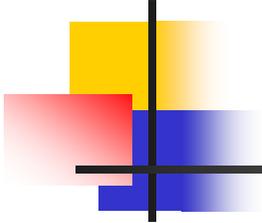
Traditional investment approach

- Aim to maximise returns
- Outperform index or peer group benchmarks
- Rely on long-only equities to deliver long term outperformance
- Long-only returns disappointed
- Risk concentrated in one area



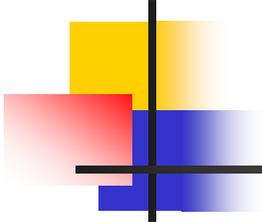
Problems of traditional approach

- Ignores modern capital market developments
- Too much reliance on equities – one source of alpha
- No downside protection – beta exposure
- Just adding more bonds not enough
- Need to look for alternative sources of added value
- Lack of flexibility to back investment judgment



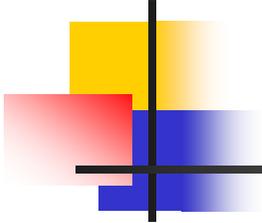
Objectives of DB Pension Fund Investment

- To be able to afford to pay the pensions
- Not just to maximise returns or outperform an index
- Maximising returns won't necessarily mean higher pensions
- Match or outperform pension liabilities
- Risk control – define risk



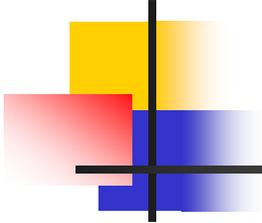
New Approach

- More sophisticated focus on liabilities
 - not just rely on equity risk premium
- More matched investment strategy
- But, no perfect match for liabilities
 - Inflation
 - Duration
 - Longevity
- Trustees to decide extent of mis-matching they accept
- Find alternative ways to add value



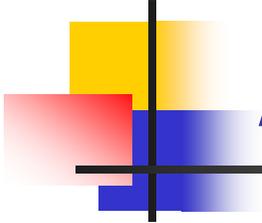
Implications for asset allocation

- Long-only too restrictive – index constraints
- Decline of long-only active mandates
- Increased use of liability based benchmarks
- Scheme-specific asset liability models
- Diversification and risk reduction
- If want to reduce risk, do so in most efficient way
 - To get lowest reduction of expected return



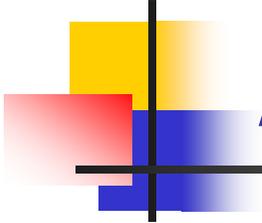
Defined Contribution Schemes

- Aim to maximise value of pension savings
- Individuals bear investment, inflation, longevity risk
- Risk control issues
- Need better designed investment options
- Diversification for portfolio efficiency



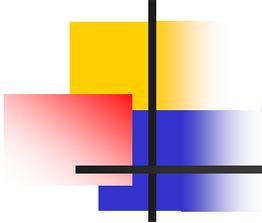
Aims of DC Asset Allocation

- Maximise returns, with controlled risk
- What is risk?
- Good range of investment options for those who want to choose – including alternative assets
- Well-designed default options for members who don't want to choose
- Capital guarantees?



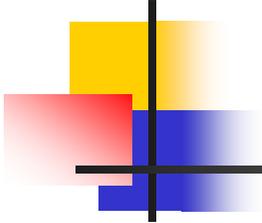
Opportunities for Asset Allocation in Future

- Corporate techniques new to pension funds
- Cash flow matching – swaps, derivatives
- Explicit risk/return objectives set relative to liabilities
- Diversified sources of potential return
- Alternative assets –
 - Hedge funds? Portable alpha?
 - Absolute return? CDO's?
 - Real estate? Private equity?



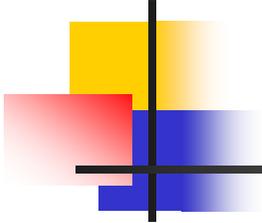
Benefits of including alternative assets

- Improve portfolio efficiency
- Low correlation with traditional assets
- Capture different risk premia
- More than one source of alpha and beta
- Reduce risk in most efficient way – don't sacrifice expected returns



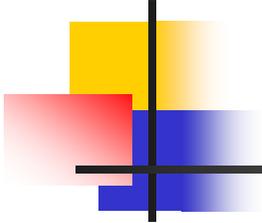
Barriers to alternative assets

- Investors nervous
- Lack of understanding
- High fees?
- Lack of experience
- Due diligence can be expensive and time-consuming
- Need suitable investment vehicles



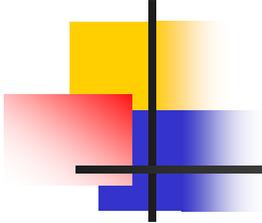
Overcoming the barriers

- Familiarity
- Trustee education
- Focus on risk reduction and return enhancement
- Build trust over time
- Investment banks to structure suitable vehicles



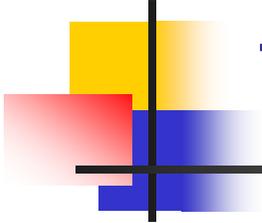
Hedge funds in pension fund portfolios

- Emphasis on uncorrelated, absolute returns
- Over long term, successful absolute return investing should outperform long-only
- Truly active management – not benchmark constrained
- Use in different ways
 - Long/short equity for core-satellite portfolio in preference to long-only active
 - Non-correlated market neutral to aid in risk control



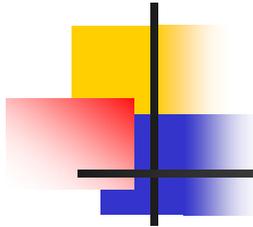
Pension funds have adopted new assets in the past

- Mutual funds: 1950's said too illiquid (weekly pricing) – now appreciate benefits of diversification, spread risk
- International: 1980's said too risky (poor reporting, no transparency) – now appreciate low correlation benefits
- Corporate bonds: 1990's said illiquid, less reliable – now appreciate higher return potential
- ...will alternative assets become mainstream in future?



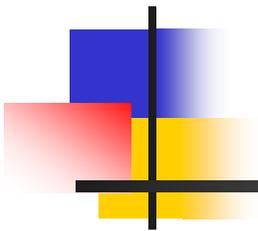
The Future for Alternative Assets

- Still relatively immature
- Increasing acceptance
- Will become mainstream
- All institutional portfolios likely to invest
- Modern money management methods
- Pension funds may need to be more sophisticated



Summary

- Improve portfolio efficiency with alternative assets
- Low correlation with traditional assets
- Diversification of potential sources of return
- More emphasis on risk control and risk budgeting
- Make assets work harder to capture different risk premia
- Deliver better pensions!



Thank you for listening

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