

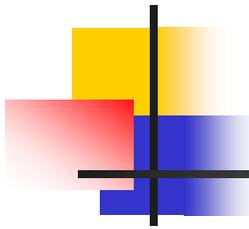
# Delivering Members' Pensions The View of End Users

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PwC Pensions Managers Conference  
Coombe Abbey, Coventry

27<sup>th</sup> March 2007

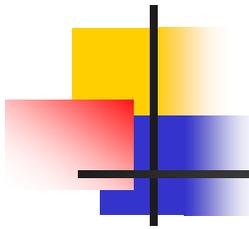
Dr. Ros Altmann



# Disclaimer: my opinions, not advice!

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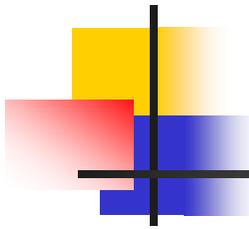
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# Overview

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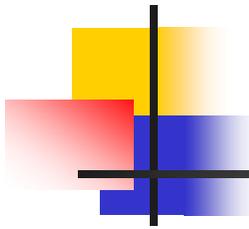
- Brave new world
- Where have all the surpluses gone?
- Risk
- The future
- Conclusion



# New world for trustees and members

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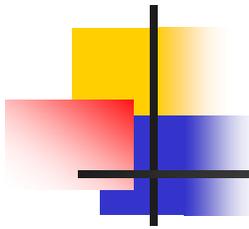
- Deficits and maturing schemes
  - Pension funds are unsecured creditors
- Pension Protection Fund
  - Big improvement, but still risks to pensions
- Trustees have more power and more responsibilities
  - Recovery plans, contingent assets, TKU
- Must consider employer's financial strength
  - New analysis, new advisers
- Governance and professionalisation
  - Align interests, avoid conflicts



# Pension fund trustees face problems

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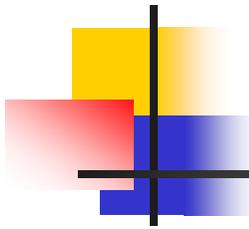
- Surpluses relied on too heavily
- Lack of protection for members
- Over-emphasis on investment returns from equities
- Mis-match between assets and liabilities
- Pension liabilities were too often considered 'optional'
- Now moving from HR to FD
  - Company cost, not company benefit!



# Trustee balance sheet didn't balance!

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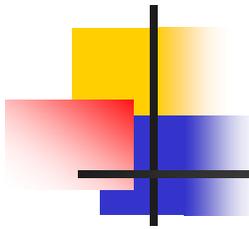
- Focus far more on assets than liabilities
- Assets
  - Contributions
  - Investment returns
- Liabilities
  - Paying all pensions
  - Salary inflation, mortality, duration



# Surpluses gone

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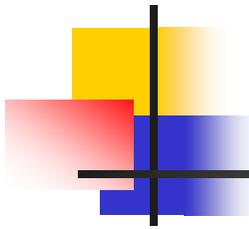
- Were they really surpluses?
- Regulatory burdens damaging
- Tomorrow's pensions in immature schemes
- Contribution holidays
- No insurance policy



# What caused deficits?

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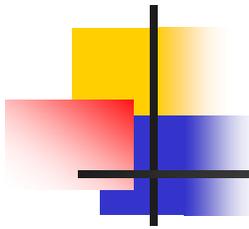
- Mis-match – not enough ‘what if’ analysis
- Unexpected falls in assets
  - ‘Expected returns’ not the same as *achieved* returns
  - Over-reliance on high risk equities
  - No defence against bear markets
- Unanticipated rises in liabilities
  - Interest rates
  - Longevity
  - Annuity rates



# Will surpluses return?

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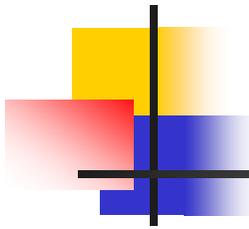
- Probably unlikely
  - Buyout basis
- If reducing asset-liability mis-match, less likely to have exceptional returns, seek stable, positive returns
- Less downside tolerance – can't afford worsening deficits
  - avoiding losses valued higher than foregone *potential* returns
- If surpluses return, may require inordinate risks



# Muddled thinking on investment risk

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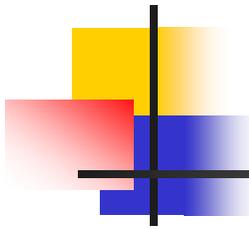
- Traditional attitude: **Manage returns and TAKE risk**
  - Passive acceptance or even welcoming of risk
  - High 'expected' returns from risky equities
  - Long-term investors ignore setbacks
- Modern approach: **Manage returns AND MANAGE risk**
  - Active attention to risk control **relative to liabilities**
  - Diversification of sources of alpha and beta
  - Reduce risk of not meeting liabilities/large deficits



# Relying on equities too 'risky'

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- Equity returns carry two kinds of risk
  1. volatility 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 unrewarded risk
- Pension investors only likely to benefit from first risk
- Lack of control on mis-match risk

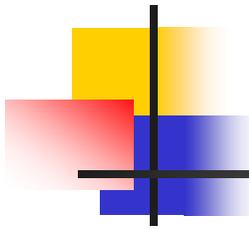


# Avoiding big losses important

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

|           | <u>£100 invested</u> | <u>£100 invested</u> | <u>£100 invested</u> |
|-----------|----------------------|----------------------|----------------------|
| Yr. 1     | - 30%                | - 30%                | - 3%                 |
| Yr. 2     | + 30%                | + 43%                | + 5%                 |
| End value | <b>£91</b>           | <b>£100</b>          | <b>£101.85</b>       |

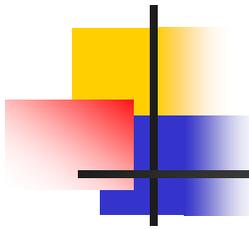
- Is switching to bonds right way to control downside?



# Switching to bonds may be harmful

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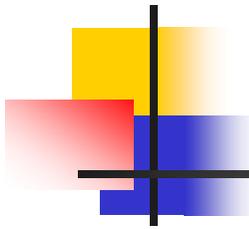
- Bonds reduce 'risk' as measured by volatility of return
  - But in exchange for much reduced upside potential
- Bond investments also still contain 'unrewarded' risk
  - Salary inflation, lpi, longevity, duration, capital loss
- So, switching to bonds doesn't match liabilities anyway
  - Could actually increase risk of bigger deficits, lock in
- Reducing deficit requires *outperforming* liabilities
  - Without taking highest risks, sustained positive returns



# The Future

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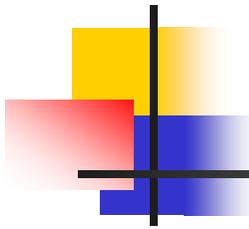
- Mature schemes – unsecured creditor needs security
  - Very few actives, if any
- Trustees managing legacy investments
  - Liability focussed investments – liabilities + 3%
- More emphasis on downside risk control
  - Retain upside, consistent absolute returns
- Professionalisation of trustees, better governance
- Better dialogue with employer
- These are still real liabilities – not optional!



# Risks for trustees and members

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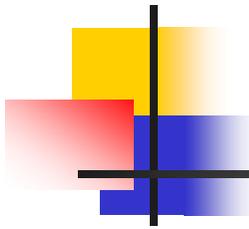
- Not being able to pay pensions
- Investment risk – previous focus
  - Now need to control risk *relative to liabilities*
- Sponsor risk – PPF
  - Members' benefits at risk, need finance advice
- Regulatory risk – TKU
  - Informed amateurs, expert advisers



# New adviser relationships

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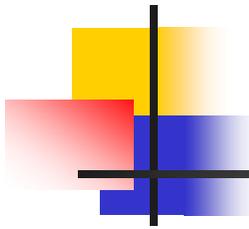
- Align incentives
- Performance fees for advisers as well as fund managers?
- Avoid conflicts – ensure independence
- Complexity of decisions – it's not easy
- Make sure you question advisers thoroughly
- Ask Regulator for help too, if unsure



# How to increase member security

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- Contingent assets
- Better matched investment strategy – alternative approaches focussed on outperforming liabilities
- Professionalisation and improved governance
- Careful analysis of sponsor risks
- Beware of PPF
- Buyout?



# Conclusion

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- Members were left unprotected for too long – unsecured creditors need increased security
- Trustees focussed too much on assets, too little on liabilities – unrecognised and unrewarded risks
- Need new advice - diversification, complexity, protection
- Professionalisation and careful monitoring of sponsor
- Focus more on the risk of not being able to pay pensions