European Pensions

European Pensions

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As the year ends, we have been looking back at European pension provision issues over the past 12 months, from the post-ponement of Solvency II-style capital requirement regulation to EIOPA's decision to increase its focus on DC provision (p16).

A worrying trend that continued this year was the appropriation of occupational pensions by governments in order to plug national deficits, with Poland the latest country to do so. Our cover story (p20 explores what this could mean for occupational pensions industries across Europe if this continues.

This year also saw pension funds turn to the energy sector as an area full of opportunities for investors (p29). Attracted by the steady returns this can provide, and the growth in this industry to meet the increasing demand for energy, this is a part of infrastructure investment we're likely to hear more from in 2014.

Laura Blows, editor

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Pensions 'Solvency II' reduces long-term funds appeal

CAPITAL REQUIREMENTS WOULD REDUCE SMALL SCHEMES' APPEAL FOR LONG-TERM FUNDS

European Long-Term Investment Funds (ELTIFs) could be attractive for small and medium-sized pension schemes, but potential solvency capital requirements could lessen their appeal, PensionsEurope has warned.

The European Commission has proposed creating European Long-Term Investment Funds as a new type of collective investment framework allowing investors to put money into companies and projects that need long-term capital.

Small and medium schemes could benefit from the economies of scale and "asset specific knowledge and expertise" these funds could provide, PensionsEurope said. The pooling of existing knowledge could allow institutional investors to profit from each other's expertise in different areas.

"However, we believe that the ongoing IORP revision will play a significant role in determining the effective IORPs investment level in ELTIFs," PensionsEurope said in response to an EC consultation. "In particular, the application of Solvency II-like rules would limit IORPs investment in ELTIFs, requiring high capital requirements in case of investment in illiquid assets," PensionsEurope added.

The European pensions association "fully supports" the creation of ELTIFs, though suggested a few changes to the proposed regulations.

Suggested changes included differentiating between different types of investors, as retail and institutional clients will have different needs for transparency and protection.

Institutionals investing in the same ELTIFs as retail investors would have to receive the same standards, which PensionsEurope said would likely increase costs and reduce investment universe.

"Moreover, institutional investors and retail investors may have very differing risk-return profiles. As a result, we suggest creating two different types of ELTIFs: one for all investors and one only open to institutional/professional investors to which softer standards in terms of diversification, leverage and transparency requirements could apply."

Requirements on European Long-Term Investment Funds-eligible assets should also be relaxed, PensionsEurope said, and exemptions from a future financial transactions tax should apply to both buying ELTIF shares and redeeming securities.

Written by Matt Ritchie

CDC 'unsustainable and inferior to individual DC'

COUNTRIES SHOULD MOVE FROM DB STRAIGHT TO INDIVIDUAL DC, SURVEY FINDS

Collective DC (CDC) is unsustainable in the long run and countries moving away from DB systems should go straight to individual DC, according to asset managers.

A Cerulli Associates survey of 18 asset management firms running more than €1.4trn in European pension assets found a high level of agreement that individual DC is "inherently cleaner" than CDC in defining risk taking and distributing rewards from investing.

On a scale of one to five, the suggestion that countries moving away from DB should go straight to individual DC rather than CDC scored 3.5. The statement that CDC is unsustainable in the long term returned the same score.

'Introducing a CDC pension system would encourage more people to save in pensions for their retirement' scored 3.0.

Cerulli Associates senior analyst David Walker said policymakers across Europe are examining how best to get their citizens saving enough to finance their own retirement.

"Some of the options being discussed would fundamentally transform the DC pensions systems in numerous countries. The changes could also have a major impact on opportunities for asset managers that are trying to serve Europe's growing DC pension markets."

The survey found the British and Dutch DC markets are currently considered the most addressable for fund managers, although respondents feel the UK market offers more opportunities for incumbent managers than new entrants.

Multinational employers want to use premium pension institutions (PPIs) for cross-border products, the survey found, but establishing cross-border pooling vehicles is too expensive for many asset managers.

However, 14.3 per cent of respondents said they were looking at developing a cross-border solution in the next one to two years via a PPI, while 28.6 per cent were looking to do so via another vehicle. The other 57.1 per cent were not presently considering it, but might do so in future.

The report also asked asset managers about their plans for making and selling decumulation products. Some said it is not too early to start manufacturing decumulation products and they named an array of possible distribution channels for the nascent product line.

Written by Ilonka Oudenampsen

ESB workers' DB pension rights secured

STRIKE ACTION AVOIDED AFTER PENSION SCHEME MOVE FROM DB TO DC REVERSED

Workers at Irish energy company ESB have been assured that their pension scheme is to be treated and accounted for as a defined benefit plan, following months of negotiations.

ESB and Unite, the largest union for ESB staff, have been in talks as a result of workers demanding that the company reverse changes to its accounting procedures, which showed the workers' defined benefit pension scheme as a defined contribution arrangement, thus transferring all of the risk onto ESB workers.

Staff at the ESB were angered by the company's decision to pay €478m in dividends to the government while its defined benefit pension scheme is €1.6bn in deficit.

In a letter to shareholders, concerned ESB active pension fund members said the ESB's actions were "unlawful" and that the company was refusing to deal with the shortfall.

"Thanks to the intervention of the Labour Relations Commission, we now have an assurance that the scheme will henceforth be accounted for and described as a defined benefit scheme," Unite official Richie Browne said.

"The unions were given an overwhelming mandate by workers to use all means in our power to achieve that aim, and we have done so."

ESB would have been facing strike action if the row over pensions had not been addressed, as a ballot overwhelmingly approved strike action. The ballot of union members in the defined benefit scheme achieved a return of 81 per cent, with 87.5 per cent of respondents voting in favour of industrial action.

The unions had said that ESB had breached agreements and procedures by "unilaterally the main staff pension scheme as a defined contribution scheme".

Written by Adam Cadle and Matt Ritchie

Company director receives suspended jail sentence

SWIFT STRUCTURES DIRECTOR PLEADS GUILTY TO FAILING TO PAY PENSION CONTRIBUTIONS

A company director has received a suspended jail sentence for failing to remit employee contributions to the Construction Workers Pension Scheme.

The Pensions Board announced that Swift Structures director Eugene O'Neill pleaded guilty and received an 18 month jail term. The sentence was suspended for a period of 18 months upon O'Neill entering into his own bond in the sum of €200. A further term of the sentence being imposed was that the sum of €20,000 would be paid over to the trustee of CWPS.

The regulator said Swift Structures, which is in liquidation, had deducted pension contributions from the wages and salaries of its employees between July 2006 and August 2008 for remittance to the trustee of CWPS but had failed to remit the contributions to the trustee within the statutory time frame.

Written by Matt Ritchie

NPRF records fund value of €15.6bn

IRELAND'S NATIONAL PENSIONS RESERVE FUND EARNS 4.5% RETURN OVER THE YEAR

Ireland's National Pensions Reserve Fund's total fund value has been recorded at €15.6bn as at 30 September 2013, its latest portfolio update has revealed.

The Directed Portfolio, comprised of public policy investments in Allied Irish Banks and Bank of Ireland made at the direction of the Minister for Finance, was valued at €9bn.

Figures showed the discretionary portfolio was valued at €6.6bn at 30 September accounting for 42 per cent of the total fund value.

Results for the discretionary portfolio show the fund earned a preliminary return of 1.8 per cent in the third quarter and 4.5 per cent in the year to date.

Since the fund's inception in April 2001, the discretionary portfolio has delivered an annualised return of 3.9 per cent per annum.

Cash accounted for 27.5 per cent of the portfolio, private equity 10.9 per cent and 19 per cent was large cap equity.

Since 2009, the fund has invested €20.7bn in preference shares and ordinary shares in Allied Irish Banks and the Bank of Ireland.

Written by Adam Cadle

PensionDanmark invests in energy firms

THE DANISH LABOUR MARKET PENSION FUND INVESTS IN WIND FARMS AND GAS PIPELINES

The end of the year saw PensionDanmark enter into a couple of infrastructure energy deals, investing in wind farms and offshore gas pipelines.

The Danish labour market pension fund announced in December that it is to buy a 49 per cent stake in six UK wind farms, in an investment worth around £153m.

The investment will be made via the fund Copenhagen Infrastructure I, founded in 2012 and managed by Copenhagen Infrastructure Partners. The wind farms in Scotland and Wales will be acquired from Falck Renewables S.p.A which has wind assets in several European countries.

PensionDanmark said the transaction is subject to certain conditions and approvals which are expected to be satisfied within the first quarter of 2014.

"Our investments in different types of infrastructure ensure our members an attractive and inflation-linked return for many years," PensionDanmark CEO Torben Moger Pedersen said.

In November PensionDanmark entered into a deal to acquire Abu Dhabi-based energy company TAGA's 40 per cent stake in the Dutch pipeline system NGT.

NGT consist of 470 kilometres of offshore pipelines with a daily gas capacity of around 42 million cubic metres. The pipelines carry gas from the Dutch sector of the North Sea to a treatment terminal on the north coast of the Netherlands, from which it is distributed through the Dutch gas network.

The overall system, which also comprises two offshore platforms and a treatment terminal, is owned by a small number of energy companies, including GDF Suez, which operates the NGT pipelines. TAQA acquired its 40 per cent stake from Royal DSV N.V. in 2009. PensionDanmark's acquisition of this 40 per cent stake depends upon EU approval and Ancala Partners advised PensionDanmark on the transaction.

These recent deals follow PensionDanmark's DKK350m (€46.9m) agreement to finance Danish export contracts for an Armenian copper mining project, and its partnership with Burmeister & Wain Scandinavian Contractor to construct a £160m new-build biomass power plant in Lincolnshire, England.

PensionDanmark A/S manages labour market pensions under collective and corporate agreements on behalf of 637,000 members in 27,000 businesses within the private and public sectors in Denmark. Premium income totalled DKK10.7bn ($1.94bn) in 2012, and members' savings total more than DKK145bn ($26.26bn).

It currently has direct and indirect infrastructure investment worth just over $1.8bn and is expecting to invest a further $1.44bn in infrastructure over the next four years.

Written by Adam Cadle and Laura Blows

Danish funds quit UNPRI over governance issues

SIX DANISH FUNDS LEAVE UNPRI DUE TO THE ORGANISATION'S 'GOVERNANCE FAILINGS'

Six Danish pension funds are to leave the organisation behind the UN-backed Principles for Responsible Investment, citing ongoing governance failings.

ATP, Industriens Pension, PensionDanmark, PFA Pension, PKA, and Sampension issued a joint statement saying they will continue to follow the principles, but remain outside the organisation until it "lives up to basic requirements for good corporate governance".

"Despite numerous attempts to improve the conditions within PRI, we must, unfortunately, acknowledge that these attempts have not been successful," the investors said.

"Therefore, we have chosen to leave the PRI organisation until the organisation re-establishes the fundamental principles of governance that existed before the organisation in 2010-11 on its own initiative radically changed the organisation's constitution without the involvement or consent of its members at the time."

In 2014 the investors will not be able to report to the PRI on implementation of the principles. However, they will continue to report on how they work with responsible investment, including their compliance with the six UNPRI principles.

"Should the PRI organisation at a later stage endeavour to substantiate that the governance of the organisation has improved to a satisfactory level, we will as individual investors give serious thought to re-entering the organisation."

The PRI said it was "deeply disappointed" the funds had chosen to exit. Managing director Fiona Reynolds said the board and council are committed to improvements, and plans to go ahead with a previously arranged meeting with the funds in January.

"Given the important work of the Danish pension funds in responsible investment, we hope that the funds concerned will reconsider their decision at some point in the near future," Reynolds said.

Written by Matt Ritchie

Dutch investment funds' assets hit record €627.4bn

MANAGED ASSETS INCREASE 3.9% IN Q3 BUT HEDGE FUNDS DECLINE, SAYS DNB

Assets managed by Dutch investment funds hit a record of €627.4bn in the third quarter, according to the Netherlands' central bank.

De Nederlandsche Bank statistics showed that managed assets increased 3.9 per cent quarter-on-quarter, or €23.6bn. The increase was attributed to price gains on investments and net deposits.

Investment funds realised total returns on invested assets of 1.6 per cent quarter on quarter in the three months to September, DNB said, after negative overall returns of -1.9 per cent in the previous quarter.

Net deposits into investment funds amounted to €16.9bn in the third quarter, compared to €600m in the three months to June.

Dutch investment funds issued units to the total of €593.5bn in the third quarter. De Nederlandsche Bank said domestic pension funds are by far the largest investors in Dutch investment funds, with their €474.1bn holding representing 79.9 per cent of units issued.

DNB said the large pension fund holding is due to the fact pension funds have placed roughly half of their investments with Dutch investment funds. After pension funds, insurers and investment institutions are the largest investors at €58.3bn and €25.9bn, respectively.

Dutch households hold €20.8bn of the units issued, while other, particularly foreign, investors placed €14.5bn with Dutch investment funds in the third quarter.

The central bank also found that pension funds led net deposits into Dutch investment funds for the first nine months of the year.

Figures from De Nederlandsche Bank showed total net deposits of €21.9bn for the first three quarters, with €17.1bn attributable to pension funds. Insurers accounted for €10.6bn worth of net deposits.

Net deposits in Dutch investment funds totalled €17.2bn overall for the first nine months of 2012.

In contrast, total assets managed by Dutch hedge funds decreased by 2.9 per cent quarter-on-quarter to €21.5bn in Q3 2013, DNB revealed.

The decrease reflected negative overall investment returns of 3.4 per cent quarter-on-quarter. The number of Dutch hedge funds fell by seven in Q3 to 97.

In the third quarter of 2013, 77 per cent of the assets of Dutch hedge funds were reinvested in other investment funds, mainly foreign hedge funds.

A total of 14.9 per cent of assets of Dutch hedge funds were invested in equities, and 6.1 per cent in cash deposits and other liquid assets. The remaining 2 per cent of assets were composed of investments in mainly derivatives and bonds.

Dutch pension funds were the largest investors in Dutch hedge funds in the third quarter, holding 92 per cent of the units issued by Dutch hedge funds.

According to latest ECB data, total managed assets of hedge funds established in the euro area stands at €157.2bn.

Written by Matt Ritchie and Adam Cadle

Netherlands leads pension asset to GDP growth

OECD AREA PENSION FUND ASSETS GREW 7.4% ANNUALLY BETWEEN 2009 AND 2012

OECD area pension fund assets achieved annual growth of 7.4 per cent from 2009 to 2012, according to new figures.

A new report from the organisation shows the weighted average asset to GDP ratio for pension funds increased from 73.5 per cent in 2011 to 77 per cent in 2012.

The Netherlands achieved the highest ratio last year, at 160.2 per cent. The Netherlands also recorded the largest growth in its assets to GDP ratio over the past decade, growing from 102.6 per cent in 2001.

Iceland and Switzerland were the other countries to achieve ratios of over 100 per cent, at 141 per cent and 113.6 per cent, respectively. The United Kingdom exceeded the OECD weighted-average asset-to-GDP ratio of 77 per cent, with 95.7 per cent.

After the Netherlands, Iceland displayed the second fastest growth over the decade having had a ratio of 84 per cent of GDP in 2001.

It declined in Hungary, from 3.9 per cent of GDP in 2001 to 3.3 per cent last year after reaching a peak of 14.9 per cent in 2010. Belgium declined from 5.5 per cent of GDP in 2001 to 4.6 per cent in 2012, and Portugal's ratio fell from 11 per cent of GDP in 2001 to 8.8 per cent last year.

The OECD attributed Hungary's decline to the government's decision to close the mandatory private pension system at the end of 2010, and Portugal's to the transfer of banks' pension fund assets to the state retirement plan in 2011.

Written by Matt Ritchie

Finnish earnings-related pensions assets grow

ASSETS INCREASE BY €8.8 BILLION DURING FIRST NINE MONTHS OF 2013, TELA FINDS

Earnings-related pension assets in Finland have grown by a total of €8.8bn during the first nine months of 2013, The Finnish Pension Alliance (TELA)'s investment analysis has shown.

Figures from TELA show earnings related pension assets now amount to €158.4bn despite a challenging investment environment. The annual growth rate from 2003 to 2012 was €7.9bn. Around one fourth of all Finnish earnings-related pensions are financed by previously funded pension contributions and their investment returns.

"In the years to come, the return from investments will play an increasingly larger role on how earnings-related pension assets develop and how pensions are financed," TELA said.

TELA analyst Maria Rissanen added that investments in shares, in particular listed shares and hedge funds, yielded the best return during the first three quarters.

The proportion of investments in shares and share-like instruments grew by 1.4 percentage points or €4.2bn at the close of September with real estate accounting for 10.5 per cent of the overall earnings-related pension investment portfolio.

"The global improvement of the stock market is the main underlying reason for the boost in investment returns," she said.

Written by Adam Cadle

Greece urged to remove remaining pension exemptions

OECD FINDS 2010 REFORMS STRENGTHENED PENSIONS, BUT INEQUALITIES REMAIN

Removing remaining pension exemptions is among measures suggested for Greece to further improve its pension system, following an OECD review of the country.

The report said "comprehensive" reform in 2010 strengthened the long-term viability of the pension system, by reducing generosity and elements such as the increase and equalisation of retirement ages and enhanced equity.

However, the report found inequalities remain as some professional groups kept their more generous schemes. Despite the reforms, there remain 93 sectoral systems under six broad pension funds with different social security contributions.

"Removing remaining pension exemptions applying to specific groups would promote distributional fairness, besides contributing to fiscal consolidation," the report said.

"Subject to budgetary constraints, reforms could also seek to harmonise and rationalise the contribution rates to the various pension and sickness funds, as benefits seem to have been equalised to a large extent. The pension contributions of many professionals – engineers, for example face flat contributions regardless of earnings – could usefully be rationalised."

Written by Matt Ritchie

Portuguese pension funds grow to €14.2bn in Q3

APFIPP FINDS PENSION FUNDS' ASSETS INCREASE 1.2% IN THE FIRST NINE MONTHS OF 2013

Net assets of Portuguese pension funds grew 1.6 per cent to €14.2bn over the third quarter, the country's industry body has revealed.

The Portuguese pension fund association, APFIPP, has published data showing a 1.2 per cent increase in the first nine months of the year, and 6.5 per cent growth compared with the end of last September.

Closed pension funds had the largest amount of assets under management at €12.9bn. Other open pension funds ranked second with €964.8m, and retirement savings only funds were third with €353.5m. The number of funds in activity fell to 190, one more than at the end of June 2013.

Pensõesgere was the management company with the largest market share at 30.1 per cent, with total net assets of €4.29bn. CGD Pensões was second, with net assets of €2.32bn giving it a 16.3 per cent share, and BPI Vida e Pensões was third with €2.04bn and a 14.3 per cent share.

SGF registered the highest quarterly percentage growth of the management companies, with a 3.8 per cent increase. The largest growth in total net assets belonged to Pensõesgere, which added €119m for 2.9 per cent growth.

BPI Vida e Pensões had the highest growth over the nine months to September with 6.2 per cent, and also registered the largest growth on a net asset basis adding €119.9m.

Written by Matt Ritchie

Diary dates: January 2014

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IAPF Investment Seminar 2014

14 January

Shelbourne Hotel, Dublin 2, Ireland

This morning seminar will look at the outlook for global economies and markets in 2014 and, most importantly, what that might mean for risk and returns of Irish pension schemes. The event will take place in the form of a panel discussion and Q&A. Samantha McConnell, IAPF Investment Committee, will chair the seminar, while David Greene of Pioneer Investments and Nick Bullman of CheckList will present.

MORE INFO: **www.iapf.ie/events**

Pensions Age Awards 2014

27 February

Milennium Hotel, London, UK

The *Pensions Age* team is proud to announce the launch of its inaugural Pensions Age Awards. The awards aim to reward both the pension schemes and providers that have proven themselves worthy of recognition in these challenging economic times. By putting themselves forward for these awards, the most dynamic, dedicated and innovative UK pension schemes will be given the opportunity to showcase their successes and demonstrate the lengths they have gone to in meeting the investment, regulatory and governance challenges facing all UK pension schemes today, while the providers that work tirelessly to meet the needs of their clients and display innovation, vigour and a passion for UK pension provision are encouraged to do the same. The deserving winners will then be announced at a prestigious Winter Gala on 27 February.

MORE INFO: **www.pensionsage.com/awards/**

Mercer Global Investment Forum 2014

12-13 March

Sydney, Australia

Mercer's investment forum will address how investors may benefit from the upswing in economic recovery. Topics on the agenda include new opportunities to investing in fixed income, what to expect from equity investments, building multiple return drivers into investment portfolios and assessing investment manager's effectiveness. The global investment forum will feature distinguished keynote speakers including behavioral economics expert Dr Nick Southgate.

MORE INFO: **www.mercersignatureevents.com**

Pensions Age Spring Conference: A Change of Pace

11 April

Hilton London Tower Bridge, London, UK

The Pensions Age Spring Conference: A Change of Pace offers pension funds and professionals a valuable opportunity to learn and share knowledge at the start of what promises to be an exciting year. All aspects of the pensions industry are currently undergoing scrutiny. On the DB side, the focus is on scheme governance and the removal of risk, for DC it's the current investigation into whether DC is 'fit for purpose', fees and the nature of default funds. And both DB and DC face the search for steady returns with low volatility, while ensuring high data quality and effective scheme communication. These uncertain times come on top of thousands of employers and millions of employees about to face auto-enrolment this year. This conference will provide those immersed in the industry with valuable guidance as they seek to tackle these challenges. It is aimed at pension scheme trustees, pension scheme managers, FDs, consultants, human resource management and advisers to the industry. The event is free to attend for pension funds, sponsoring employers, consultants, independent trustees, pension lawyers and actuaries.

MORE INFO: **www.pensionsage.com/springconference/**

Shorex Wealth Management Forum Paris 2014

21 May

Hotel du Collectionneur, Paris, France

For the first time, the annual forum for the wealth management industry will take place in Paris, France, on 21 May 2014. The event will attract over 300 participants from France and Europe. The exhibition and conference are a unique platform where professionals can network to explore new services, products and ideas.

MORE INFO: **www.shorexparis.com**

The Irish Pensions Awards 2014

27 November

The Shelbourne, Dublin 2, Ireland

In its third year in 2014, the Irish Pensions Awards aim to give recognition to those pension funds and providers who have proved their excellence, professionalism and dedication to maintaining high standards of Irish pension provision.

MORE INFO: **www.europeanpensions.net/irishawards/**

People on the move...

LATEST NEWS OF PEOPLE ON THE MOVE

Hyesik Ryu

M&G Real Estate has appointed Hyesik Ryu as managing director to lead its business in South Korea. Ryu has previously worked for Korea Development Bank, Koramco and Ascendas. Prior to joining M&G Real Estate, he was a director with Hyundai Securities where he managed the project financing, loan structuring and acquisition of real estate assets.

Steve Charlton

Vanguard Asset Management has appointed Steve Charlton as defined contribution (DC) proposition manager for Europe. In his new role, Charlton will build and evolve Vanguard's DC proposition in markets across Europe with a particular focus on the UK. Charlton has over 20 years' experience in the UK pensions industry.

Noël Luchena

Threadneedle Investments has appointed Noël Luchena as sales director institutional clients based in Zurich. He joins from Credit Suisse where he spent 15 years, with the last 13 years working as a relationship manager with institutional clients. He also has knowledge of alternative investments (derivatives, commodities and hedge fund beta strategies).

Ljiljana MacDonald

Cordea Savills has appointed Dr Ljiljana MacDonald as a director within the business development team. MacDonald has a mandate to develop client relationships with European institutions and create investment propositions to meet their requirements. MacDonald joins Cordea Savills from Lambert Smith Hampton.

Silvia Wagner

Alceda has appointed Silvia Wagner as managing director of Alceda Fund Management S.A. in Luxembourg subject to the approval of the Commission de Surveillance du Secteur Financier (CSSF). She will be responsible for structuring & portfolio management and central administration. She has over 30 years of experience in the financial services sector.

Tony Hobman

Lincoln International Pensions Advisory has appointed Tony Hobman as a senior advisor. Hobman, who was chief executive of The Pensions Regulator in the UK from its inception in 2005 until December 2010, will advise on the pensions advisory business. Hobman has held a number of senior appointments within the financial services arena.

Mirko Cardinale

Russell Investments has announced the appointment of Mirko Cardinale as head of asset allocation, EMEA. Cardinale joins from Aviva Investors where he was head of strategic asset allocation for four years and the lead fund manager for the company's UK with-profits and diversified growth funds. Prior to this, he worked at Watson Wyatt.

Jack Inglis

The Alternative Investment Management Association has announced that Jack Inglis will be the new CEO of the organisation. Inglis joins from Barclays where he was a member of the global executive committee for prime services and was previously CEO of Ferox Capital between 2007 and 2010. Inglis also spent 16 years at Morgan Stanley.

When should companies implement de-risking?

Rohit Mathur and Amy Kessler explain why plan sponsors should take bold steps to de-risk now

The recent equity markets rally and increase in interest rates have helped improve the funded status of many pension plans. Nevertheless, history remains unkind to defined benefit (DB) plan sponsors around the globe. Consider this: twice in the past 12 years, US corporate pensions have lost over 30 per cent of funded status in market downturns.[1] Sponsors in the FTSE 350 also lost over 25 per cent in funded status during the financial crisis.[2]

Given recent funded status improvements, some sponsors may be delaying potential de-risking actions — such as implementing LDI combined with longevity protection, or purchasing a buyout — to take advantage of improved market conditions that could help close funding gaps.

These sponsors may be misjudging the risk they are taking because specific market conditions must exist for plans to experience funded status improvement. An interest rate increase for long-duration, investment-grade corporate bonds and a simultaneous rise in equity markets would benefit sponsors. Case in point: the recent surge in interest rates has caused pension liabilities to decline. In fact, US plans experienced an 8.5 per cent funded status improvement from April to July 2013, while UK plans had a 5.5 per cent improvement from May to July 2013.

Relying on improvements in market conditions to close funding gaps is risky, however, as equities and interest rates are volatile. An opposite phenomenon occurred in 2011 when the funded status of US and UK plans deteriorated by 14.2 per cent and 8.5 per cent, respectively, in a short period of time.[3]

We examined a hypothetical US DB plan, 80 per cent funded, to measure the likelihood of improved market conditions enhancing funded status. This plan has 65/30/5 per cent allocation to equities, fixed income and cash, respectively, and liabilities of 58 per cent retiree/42 per cent active employees.

We conducted 1,000 Monte Carlo simulations of equity returns and interest rates in the US to determine how this plan's funded status would change over 10 years, assuming no contributions are made, yet benefit payments are disbursed.

We found there is a 63 per cent probability the plan's funded status will deteriorate at the end of 10 years. Moreover, there is a 43 per cent likelihood that funded status will decline 25 per cent or more. This illustrates how specific financial market conditions are required to improve funded status. As markets are cyclical, the most likely outcome is that these favorable conditions do not persist.

Given this risk, delaying de-risking while waiting for interest rates to rise may have no discernible effect for some sponsors. For plans with meaningful positions in fixed income that 'well match' the retiree liability, there may be advantages to transferring risk now. Currently there is ample capacity for transferring risk to insurers and reinsurers. While capacity is likely to be available in the future, cost may increase as pressures mount on the supply-demand imbalance for long-dated corporate bonds. Furthermore, the business mix of insurers may shift as their own exposure to longevity risk increases, causing capital to become less abundant and command a higher return.

The time to start preparing for a lower risk future is now.

[1] Milliman 100 Pension Funding Index.

[2] "Aon Hewitt Global Pension Risk Tracker," https://rfmtools.hewitt.com/PensionRiskTracker

[3] June to September 2011 in the US and July to August 2011 in the UK. Total return for S&P 500 Index between June and September 2011 was -13.3%.

WRITTEN BY ROHIT MATHUR, SENIOR VICE PRESIDENT, GLOBAL PRODUCT AND MARKET SOLUTIONS, AND AMY KESSLER, SENIOR VICE PRESIDENT, HEAD OF LONGEVITY REINSURANCE, PRUDENTIAL FINANCIAL, INC.*

**Prudential Financial, Inc. of the United States is not affiliated with Prudential plc which is headquartered in the United Kingdom.*

A blueprint for a European personal pension product

BERNARD DELBECQUE DISCUSSES THE DETAILS OF EFAMA'S PROPOSAL FOR THE OCERP AND THE STANDARDS IT SHOULD MEET

The promotion of long-term savings and the strengthening of the European market for pensions have been at the heart of EFAMA's priorities for many years. In this context, EFAMA has published a new report entitled *The OCERP: a Proposal for a European Personal Pension Product*.

The concept proposed in the report – the so-called Officially Certified European Retirement Plan (OCERP) – is intended as a blueprint for a 'European brand' of personal pension products to be distributed on a cross-border basis. Building a regulatory framework for pan-European personal pension products would help to respond to two major problems facing Europe: the funding gap of the existing pension schemes, which is a challenge for the ageing populations of Europe, and the reduced ability of banks and governments to supply long-term financing, which is essential to bring the economy back to sustainable growth.

In a nutshell, the OCERP is a personal pension product which can be offered by insurance companies, banks, pension funds and asset managers. Unified standards for such a product should allow individuals to choose between several investment options, foster well-informed choices, and ensure that providers maintain a robust governance framework and administrative systems. Products that meet these standards could be distributed throughout Europe with an EU passport.

The proposed standards (summarised in a box at the end of this article) are based on the principles of consumer protection and good governance, taking into account academic research in the domain of pensions and behavioral economics, good practices identified by EIOPA and OECD's recommendations. They cover three levels of responsibilities in the provision of pension products: the product level, the provider level and the distribution level.

An EU legislative framework for the OCERP

EFAMA does not propose to harmonise all types of existing personal pension products. That would be an overly ambitious goal. Instead, the aim should be to create a new type of pension product that could be offered to EU citizens in addition to the products that are currently available at national level. That could be achieved with a specific EU legislative framework that would specify the rules for a personal pension product to qualify as an OCERP and the conditions under which financial institutions could provide OCERPs across Europe.

The European Commission should decide which legislative form such harmonised rules should take. The rules defining the OCERP as a product could be included in a fully harmonised directive, a regulation or with a so-called second regime. A pragmatic choice should be made on the basis of an analysis of the merits and limitations of each option. In undertaking this appraisal, the Commission should explicitly look at the experience accumulated with the UCITS Directive, which provides an interesting precedent in the sense that this directive did not aim at covering all existing categories of collective investment undertakings. In following this approach, an OCERP Directive – or regulation – could apply only to personal pension products that would comply with the rules laid down in the legislation. In this way, existing personal pension products would continue to be regulated by national laws, or put differently, only the products created by OCERP providers with a view to be marketed across Europe would fall under the OCERP Directive.

Concerning the regulatory requirements for the OCERP providers, the most cost-efficient solution would be to allow insurance companies, asset managers, banks and pension funds to provide OCERPs under the existing EU legislation applicable to these institutions.

The way forward

In July 2012, the European Commission asked the European Insurance and Occupational Pensions Authority (EIOPA) to deliver advice on what legislative changes are needed in the areas of prudential law and the protection of personal pension products in order to create a single market for these products. In response to this request, EIOPA has launched a task force on personal pensions, which is expected to deliver a preliminary report in early 2014 with a view to receiving a formal Call for Advice from the Commission. EFAMA hopes the OCERP report will provide useful input to the EIOPA task force in assessing what is the best approach to create a new segment in the single market.

As a blueprint for a European brand of personal pension products, the creation of the OCERP would help overcome the current fragmentation of the European pensions market and, thus, improve the cost-effectiveness of these products and their portability between member states. By proposing that banks, insurers, pension funds and asset managers expand their product offering towards the OCERP, EFAMA proposes to follow an inclusive approach to serve the interests of all European citizens. We recognise that there are legal, prudential and tax hurdles for the emergence of a single market for personal pension products. Yet, this shouldn't hold back the European authorities from proposing the creation of a European personal pension product, for three reasons. Firstly, existing personal pension products at national level are very much similar to the OCERP. Secondly, providers should be able to find ways to cope with differences in national tax arrangements, for instance by helping OCERP holders comply with the tax treatment of their OCERPs at national level. And thirdly, the creation of an OCERP would also benefit non-mobile EU citizens as it would introduce an additional retirement savings product to choose from, thereby fostering competition in national markets and reducing costs.

Bernard Delbecque is director of economics and research at EFAMA

Proposed standards for OCERPs

Standards for investment

- Individuals should be offered an adequate choice of investment options to address their specific pension needs, without creating an overwhelming, potentially confusing range of options.
- OCERPs should always offer an appropriate 'default' investment option to help people who are unable or unwilling to make an investment choice. Ideally, a default option should allow keeping pension investment simple from the perspective of the individual, while allowing some flexibility in allocating investment according to the individual's needs. The most appropriate default option should be age-dependent and therefore consistent with the goal of reducing investment risk as the holder is approaching retirement.
- Each investment option offered by an OCERP should be categorised according to a clear risk-reward profile to ensure that individuals are able to understand what the risks are and what they might get back, and to facilitate the comparison between different investment options and different OCERPs.
- Individuals should be offered the possibility to change their investment option at an acceptable and transparent cost during their investment period.
- The investment options should be built using a broad range of existing investment products such as UCITS and the European Long-Term Investment Fund (ELTIF) recently proposed by the European Commission.
- The investment options should comply with the prudent person rule in terms of risk management, possibly complemented by quantitative investment limits provided that these limits would be exclusively inspired by prudential concerns and applied uniformly across the EU.
- The OCERP could offer options to protect against investment and biometric risks as well as a range of solutions for the payout phase.

Standards for communication

- OCERPs should be accompanied by clear and consistent pre-enrolment information, based on a Key Information Document.
- OCERP providers should provide easily accessible and comprehensive on-going information to OCERP holders.
- OCERPs should disclose all cost items in a form that individuals can easily understand.

Standards for governance and administration

- OCERP providers should establish clear and transparent internal governance rules about issues such as responsibilities, risk management or complaints handling.
- They should also maintain efficient, effective and solid administrative systems.

Standards for distribution

- Uniform rules on advice should be applied to OCERPs and all other personal pension products, aligned with the EU regulation on advice.
- Insurance companies, banks, pension funds and asset managers complying with the OCERP standards should be allowed to operate as OCERP providers on an equal basis.
- OCERPs should be transferable between providers, and ideally also between member states.
- OCERP providers should be able to market OCERPs throughout the European Union with a fully harmonised passport.

The year in pensions

Nick Martindale looks back on all that has happened in the European pensions space in 2013

The year currently drawing to a close has certainly been eventful, whether at a pan-European level or in the various initiatives that have taken place in individual countries. The decision in May by the European Commission to at least temporarily scrap proposals for a Solvency II insurance-stye system around capital requirements for occupational pension schemes, in the review of the Institutions for Occupational Retirement Provision (IORP) Directive, was broadly welcomed by the industry.

"The proposals introduced the concept of the 'holistic balance sheet' which would seek to put a value on security mechanisms such as employer covenant," says Mercer retirement consultant Anne Bennett. "However, countries such as the UK, the Netherlands and Germany were very strongly opposed to the proposals, arguing that the implications for defined benefit scheme funding would be disastrous."

Yet although the so-called first pillar was excluded, the second and third pillars – which relate to governance and disclosure rules – have yet to be resolved. These could have significant implications for defined contribution (DC) schemes, suggests Towers Watson senior consultant Paul Kelly, by imposing additional governance on trust-based plans and a standardised format and content for key information documents. "One fear is that this will inhibit more creative approaches to employee communication," he says.

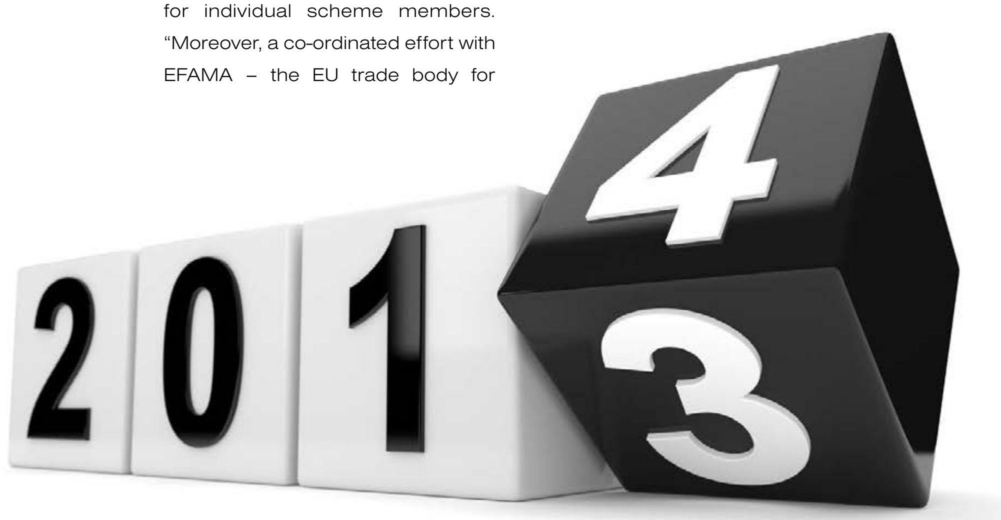
The general feeling in the industry is that the existing IORP Directive works well from a cross-border pensions perspective, says Aon Hewitt's UK international retirement practice leader and partner Paul Bonser. "Where it is less satisfactory – and where we would like some change – is in enabling the way past service benefits from previous pension arrangements are consolidated," he says. "This is a key element for increasing the popularity and effectiveness of cross-border arrangements, with all the economies of scale and improved governance that they can bring."

Alongside this, the European Insurance and Occupational Pensions Authority (EIOPA) worked to focus more on DC pensions and the importance of improving member communications and developing methods to mitigate risk for individual scheme members. "Moreover, a co-ordinated effort with EFAMA – the EU trade body for asset managers – is in place to develop a European DC-plan for the third pillar, which would be compliant in 30 EU member states," says Robeco director of European pensions Jacqueline Lommen.

UK

In the UK, the biggest development has undoubtedly been the rollout of auto-enrolment among larger firms; something that has been mainly successful. "Some had anticipated widespread compliance failures combined with high opt-out rates," says Pensions Management Institute technical manager Tim Middleton. "In the event, employers demonstrated that they were able to execute successful implementation projects and in some cases achieved great success through innovative communication programmes. The end of the year has seen The Pensions Regulator serve just one enforcement notice, and the industry has been greatly encouraged by low opt-out rates."

As a result of the move, some 500,000 people now belong to the Nest scheme created specifically for



those employers looking to enrol staff as a result of the plan, with a similar number of new members signing up to commercial schemes, says PTL managing director Richard Butcher. "The combined reported opt-out rate has been lower than 10 per cent with some employers reporting rates significantly less than that, although there have been whispers that the three-month opt-out rate is drifting quite a lot higher," he says. "This has all been done with relatively few problems, at a macro level anyway." The real challenge could come next year, however, he warns, when large numbers of smaller employers are due to enrol staff.

Auto-enrolment has also sparked off a growing awareness of the need for the UK to get on top of its looming pensions crisis. "It has focused the UK regulator to look at defined contribution arrangements generally through the latter part of 2013," says Premier senior consultant John Reeve. "Regulation and consultation has been issued looking at the management of these arrangements, the options available to members at retirement and the expenses paid by members. High-profile press coverage means that all of these are now in the public eye."

This has also led the government to consider the merits of a collective defined contribution (CDC) scheme, under which employers and members would pay a fixed contribution and members would receive a targeted – but not guaranteed – outcome. "The CDC plan pays out pensions to members rather than requiring an open market annuity purchase, with bonus increases if the experience has been good but with reduced increases or even a cut to the face value of pensions if it has been bad," says Aon Hewitt partner Matthew Arends.

Such a plan could eventually lead to conflict, though, warns State Street Global Advisors managing director and head of UK defined contribution Nigel Aston, with greater certainty of outcome likely to attract higher charges, running counter to other initiatives seeking to minimise these. "Many plans are starting to believe that the answer, surprisingly, exists in some of the sophisticated tools more likely to have been found in defined benefit plans," he says. "The use of institutional indexed rather than retail building blocks, volatility controls, diversification and dynamic asset rotation can achieve a more harmonious blend of risk, return and cost. Within the constraints of the proposed regulation may lie the seed of innovation."

"This year has seen various initiatives across Europe aimed at increasing investors' appetite in infrastructure investments"

The Netherlands

In the Netherlands, a national investment institute was set up as a national fund for institutional investors, designed to encourage more local investment from pension funds and other investors. "Local loans could make sense from a liability matching perspective and, as the Netherlands has a large collective mortgage debt and at the same time the highest pension savings ratio versus GDP, a link between the two could make sense," suggests Vanguard Asset Management head of institutional Simon Vanstone. There are, though, potential risks, including a home-biased approach to investment at the expense of a more diversified portfolio, he adds.

The precise details have yet to be formulated, in particular around the government incentives that will be used to encourage such investment. "Investors will demand a yield to justify the investments over alternatives and as compensation for the risk," says ING Investment Management International strategic advisor for institutional investors Tjitsger Hulshoff. "The government will end up paying for this yield. With government now able to borrow in the market at all-time lows, this appears a complex way of changing the low government rates into high yield like rates."

Elsewhere in the Netherlands, the Dutch regulatory framework forced underfunded pension funds to reduce pension rights for all their members, including retirees, while after several years of discussion agreement was reached on modifications of the current pension deal. "The new regulatory framework is best described as a middle ground between the two main standpoints; the real and the nominal contract," says Cardano head of innovation Stefan Lundberg. "This closed the Dutch pension contract; a debate that spanned several years."

Finally, new fiscal changes are currently being debated which could see the partial reduction of the Dutch national budget financed by cuts in the fiscal treatment of pension contributions. "These propose to lower the build-up rate to a maximum of 2.15 per cent instead of the current maximum of 2.25 per cent for career average wage pensions," says Lundberg. "They also propose to remove fiscal incentives for pension contributions on the part of the income that exceeds €100,000." The outcome of the debate is uncertain, he adds.

Ireland

In Ireland, the decision not to end the controversial levy imposed in 2011 on pension assets in occupational and personal pension schemes in 2014 as planned, but instead to increase this by 0.15 per cent to 0.75 per cent in 2014 and to apply a further levy of 0.15 per cent in 2015, dominated the agenda.

"We have had confirmation from the social protection minister Joan Burton that shortfalls in certain defined benefit schemes will be funded from this levy," says Source Pensions sales director Barry Ennis. "The question being asked now is whether we can believe the government promise that 2015 will see the end of this levy. At a time when the government is highlighting the fact that pension coverage in Ireland is so poor and increasing the state retirement age, they are penalising those who are trying to provide for themselves."

Alongside this, the Irish Pensions Board published its consultation into the future of DC pensions in August, highlighting the large number of very small or single-person pension arrangements in Ireland, and the subsequent large number of indivi-duals acting as trustees. "Ireland has more small and single-member schemes than any other country in Europe," points out Ennis. "As of 31 July 2013, there were 145,331 registered pension schemes, with a total of 866,405 active members."

"The Pension Board's consultation on the future of DC schemes is a sensible step that focuses on the correct issues," adds Principal Global Investors head of institutional business, UK & Ireland Stephen Holt. "Hopefully the board's ultimate actions will also be sensible, avoiding over-regulation and unnecessary complexity and encouraging DC provision in Ireland."

France

France also found itself making the headlines in 2013, when President Hollande's state pension reform package was narrowly voted through the lower house in November. The proposed changes maintain the statutory pension age at 62 – rather than 60 as it had been until 2010 – and focus on increasing the actual retirement age by requiring longer contribution periods for a full pension entitlement, says Bennett, as well as raising employee and employer contributions.

"France has been under strong pressure from the European Commission to make changes to its first-pillar pension system, to avoid projected deficits of around €20 billion by 2020," she says. "However, the EC has professed disappointment in the scope of the measures put forward, which fall short of their recommendations which had called for more fundamental structural reform, including a review of the separate provisions covering public sector employees."

From a funding perspective, a typical scheme's level improved by around 5 per cent in 2013, says Aon Hewitt partner Lynda Whitney. "This may not sound a lot but may represent the deficit decreasing by a third," she says. "In the first quarter this did not look a likely outcome as gilt yields continued to fall but they recovered in the summer, leaving liabilities broadly flat over the year to date." Schemes that have improved their funding level have increasingly looked to de-risk, she says, from the third quarter onwards. "We found schemes moved fairly quickly from being some distance away from their de-risking triggers to them being enacted," she adds.

Investment

A number of areas emerged in 2013 as attractive investments, including infrastructure. "This year has seen various initiatives across Europe aimed at increasing investors' appetite in infrastructure invest ments," says Standard & Poor's managing director, infrastructure finance Michael Wilkins.

"The main impetus behind capital market project finance issuance is the European Investment Bank's project bond credit enhancement programme."

Sustainable investments in areas such as resource efficiency and environmental markets were also popular, says Impax Asset Management head of global distribution Ominder Dhillon.

"This is a trend we expect to continue for many years as investors recognise the evidence of new risks and opportunities arising from climate change and issues linked to the scarcity of our finite natural and environmental resources. We have started to see a number of institutions divesting their fossil fuel holdings and re-allocating this capital as they become concerned of the potential stranded asset risk."

Looking to 2014, investors will increasingly have to contend with maximising returns in an environment where interest rates finally start to rise.

"It is important that asset values continue to outpace salary and price inflation," says Holt. "Equity valuations are now close to long-term averages, so the easy money has been made. Further progress needs economic growth and improvements in corporate earnings and, while the picture seems to be improving, there is a long way still to go."

WRITTEN BY NICK MARTINDALE, A FREELANCE JOURNALIST

Pick-pocketing pensions

Since the financial crisis, several governments have been appropriating private pension assets. Ilonka Oudenampsen looks at the latest case in Poland and what this might mean for occupational pensions across the continent

Organisations such as the OECD, the European Union and national governments have been promoting workplace pension saving, in light of longevity expectations and the outlook on government spending on pensions. However, a worrying trend can be spotted across the continent that might undermine confidence in workplace pensions saving and result in worse retirement outcomes for future pensioners. While most instances have gone relatively unnoticed except in their own country, several cash-strapped governments seeking quick and easy fixes to plug their deficits have been unable to resist the temptation of the millions held in private pension schemes.

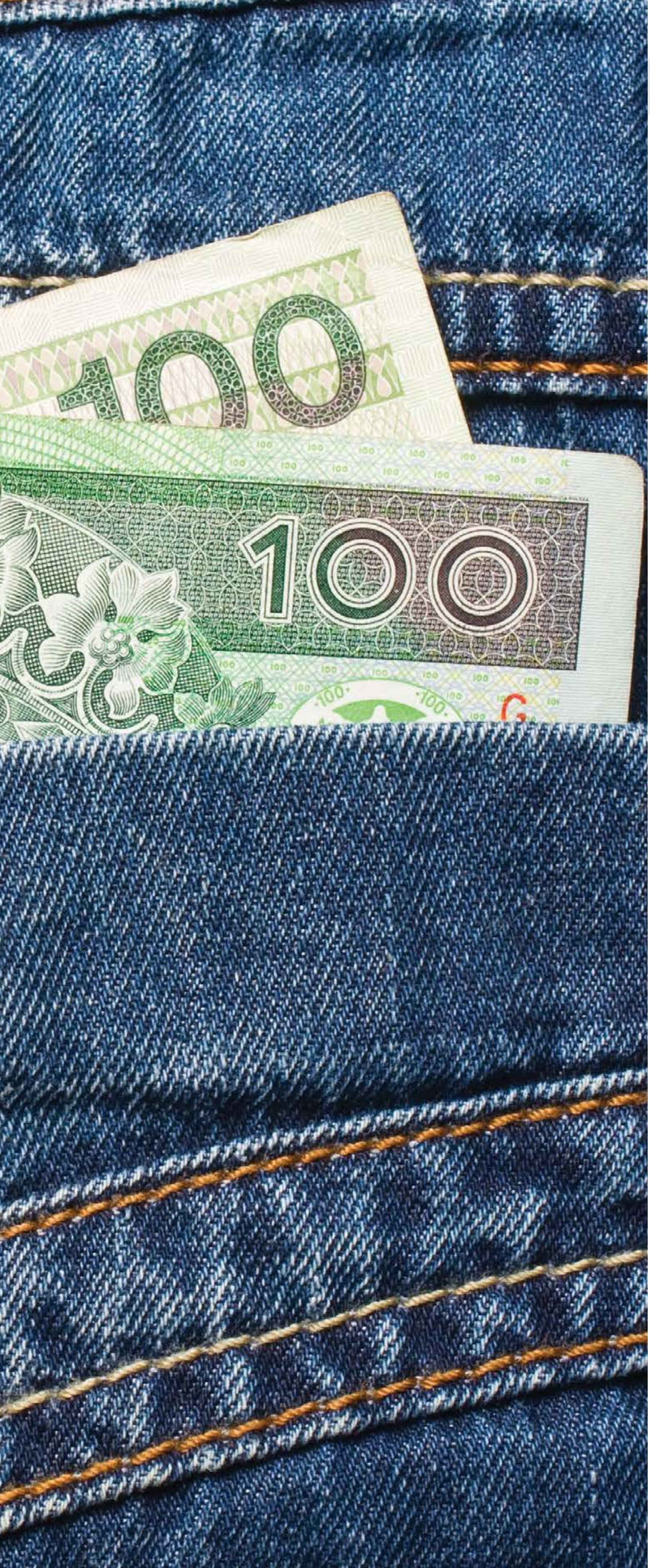
To date, several nationalisations of second pillar assets have taken place. The first took place in Ireland in 2009, when the government bailed out banks with €4.4 billion taken out of the country's National Pension Reserve Fund. A year later, the remaining €2.5 billion was taken out of the fund, while Portugal nationalised the assets of the Portugal Telecom pension fund and France took €33 billion from its National Reserve Pension Fund.

In 2011, Portugal confiscated the pension assets of its largest banks, comprising around three quarters of private pensions, while last year the UK reduced its current budget deficit by taking £24 billion of Royal Mail pension assets.

However, the worst case yet was Hungary, where in December 2010 the government nationalised $14 billion of private pensions to reduce the budget deficit and public debt. The state threatened to bar anyone from the state pension system if they did not agree to transfer their private individual account.

Poland is the latest addition to this list, as it has made plans to appropriate half of the country's private pension funds by nationalising its bond holdings, which will reduce reported national debt to 49.9 per cent of GDP.

Former UK government adviser Ros Altmann explains: "Poland is restricted from issuing more debt once its debt-to-GDP ratio exceeds 50 per cent, so politicians needed to find creative ways to manipulate debt levels down. By taking pension fund bond holdings into public ownership, the state-guaranteed



pension liabilities will be shown in government accounts as national assets, rather than liabilities. This, of course, merely shifts larger costs onto future generations, rather than facing up to financial constraints now, but pensions are a tempting target to raid for any government that can get away with it."

The Polish private pension funds have a value of over 20 per cent of GDP, with 51.5 per cent of assets invested in Polish government bonds. These assets will be taken into the state pension system (ZUS), which will effectively reduce Polish Treasury bond supply and enable the government to increase issuance to fund public spending. Furthermore, all remaining assets in the private pension funds will be transferred to the state during the 10 years prior to an individual's pension age.

Justifying the proposal, Polish Prime Minister Donald Tusk said that the old system was too expensive and made Polish public debt appear higher than it actually is. "We believe that, apart from the positive consequence of this decision for public debt, pensions will also be safer." However, Altmann disagrees and says that this is "mere smoke and mirrors". She notes: "It just passes the costs of pensions onto future generations, without making them safer at all - but it does, of course, reduce pressure on today's politicians to rein in public spending."

The Polish Chamber of Pension Funds (IGTE) has been trying to convince the government to vote against the plans by showing the negative impact the nationalisation will have on future pensioners and on the sustainability of public finances in the long term.

Head of the association Małgorzata Rusewicz says: "When the 50 per cent in treasury bonds

will go to ZUS it will mean that pension funds will need to sell additional equity in a very forced way. And it means that probably foreign buyers would buy those equities and also for lower prices. So we try to show those kind of risks, not for the pension funds but for the future pensioners. However, the parliament didn't want to take this into account."

Rusewicz points out that a survey by the association found that from 35 different age groups only seven will gain under the proposed plan, while more than 20 will have a lower pension in the future. "We are also afraid that when the government will push pension funds to invest only in equities, it will create a danger from the perspective of the future pensioner and that's why one of our goals is to convince the government to let pension funds buy at least 5 per cent or 10 per cent of treasury bonds, to create diversification in portfolios."

At the moment the upper house of Polish parliament has agreed to the proposals, so the association will try to discuss this in the lower house as well, but Rusewicz believes nobody in the parliament is prepared to listen, so she has instead fixed her hopes on the president. "What I hope is that the president will not sign this act and will send it to the constitutional tribunal to find out if this legislation is in line with the Polish constitution."

While the IGTE is lobbying its government, countries surrounding Poland are keeping a close eye on the developments. With Poland being the biggest economy in the region, it can lead to spill over one way or the other in the neighbouring countries, PensionsEurope secretary general Matti Leppälä says.

"We've seen that in the debate in Lithuania already. After the Polish reform at least some people in the government or close to the government are considering whether that should have an impact in Lithuania." In the CEE country they are currently in the middle of a reform, so developments in a neighbouring country are naturally "interesting and relevant", he adds.

Leppälä explains that it also creates concerns around possible impacts on deciding on future pension legislation at a European level. "They are full member states of the EU and making legislation just as the other countries. So if we have member states who don't believe in occupational pensions, who have more or less abolished the occupational part of the pension system, I would think it's natural that they would not have the same interest in developing a good framework for those pensions as the countries who do have this part of the pension system in place."

At the moment the final details of the Polish proposal are not known yet. The European Commission has said it will look at its compatibility with relevant EU legislation, but added that, in the end of the day, it is up to the member states to decide the structure and financing of its pension system.

However, Leppälä points out it could do more. "In reality the EU has seen that it has the possibility and capability to give recommendations and put political pressure on the member states on different parts of their pension system, be it retirement age, especially early retirement age, and in some countries also in relation to the contributions to the private funded system. So in some cases the EU seems to have a lot of competence and willingness to tell the member states what they should or should not do, and then in a situation like this, they will say that it's up to the member states."

He believes that the European Parliament can play an active role in the debate and that, if deficit levels and a desire to ease the burden on public debt are the driving factors behind these measures, the industry needs to think about what it can do about this if that is a problem other countries will be faced with as well.

"We think that the Commission should, even in these difficult developments, really support [second pillar pension provision] and put pressure on the member states not to abandon these systems. If the Commission thinks that they are not adequate, if they are not the best possible, I think they should aim to improve the systems, but to abolish the second pillar or occupational pensions, I think, leads to increasing problems with the sustainability of the total pension system."

WRITTEN BY ILONKA OUDENAMPSEN

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Irish Pensions AWARDS 2013

Congratulations to this year's winners!

Following the fantastic success of the first Irish Pensions Awards last year, it was with great excitement that the 300 heavyweights within the Irish pensions industry descended upon the prestigious Doubletree by Hilton hotel in Dublin for the second annual Irish Pensions Awards.

The awards aim to reward those Irish pension funds and providers who have offered high quality service for their clients and members, achieved through excellence, dedication and professionalism, despite the tough market conditions and regulatory pressures.

Back in September, a group of independent pensions experts gathered together to select the most deserving and high quality entries within the categories' shortlist. This resulted in many in-depth debates, though any judge with a conflict of interest in a category was of course asked to leave the room for that category's discussion. The results were then announced at the black tie event, where the celebrations and commiserations continued after the ceremony with a gala dinner, DJ and fun casino.

The evening kicked off with speeches from the editor of European pensions magazine, Laura Blows, and managing director of European Pensions, John Woods, before the crowd was left in stitches by comedian Neil Delamere, who found the funnier side to the pensions industry before he handed out the awards to the worthy winners.

The first prize of the night, for Pension Scheme of the Year, was awarded to the pension scheme, be it DB or DC, who had proved itself to be an innovator in its field and had remained focused on reducing risk and boosting returns.

Due to the high calibre of entries in this category, the judges decided to award a highly commended accolade to Hewlett-Packard Ireland Defined Contribution Plan, for the choice it offers to members and its dedication to the real needs of its membership. However, walking away with the prize was Microsoft, for its proactive approach to managing the scheme and its good level of engagement.

The second award was for what proved to be a much-debated category amongst the judges: the Best Communication Strategy prize. This category aims to recognise the pension scheme that has pushed the boundaries when it comes to its pensions communications strategy, in order to ensure true member engagement. Deserving of this award was Construction Executive Retirement Savings.

The judges awarded this scheme for its well thought-out communication strategy for a highly complex pensions scheme, along with its proactive decision to implement a communications exercise when it was not obliged to do so.

Next up was the Best Use of Risk Management Award, which is awarded to the pension scheme that has best applied risk management practices and risk controls in the running of its scheme, at a time when risk management is higher than ever on

Irish Pensions AWARDS 2013

pension boards' agendas.

Guinness Ireland Group Pension Scheme walked away with this highly-coveted accolade, as the judges described the scheme as an early-mover in some strategies, and in particular had a very active approach to risk management.

Moving on from the scheme to the provider awards, the first of which was for Pensions Consultancy of the Year, one of the most eagerly anticipated awards of the night. It is awarded to the pensions/investment/actuarial consultancy firm that the judges believe has delivered outstanding service to its pension fund clients in the last year; has shown a dedication to the delivery of pension scheme consultancy; and has demonstrated a superior understanding of the market's needs. This year, it was awarded to LCP Ireland. The judges liked this consultancy's different modelling tools for DB and DC, and how each scheme is looked at by LCP Ireland on a case-by-case basis.

Next to be awarded on the night was Citi, which was named as Custodian of the Year for its dedication to the sector and proactive approach in the market.

Following this was another coveted accolade, the Investment Management of the Year award. When rising longevity rates, coupled with investment market turmoil, has put the pressure on investment managers to perform, innovation, dedication, sophistication and foresight have become the essential tenets of any investment manager hoping to succeed. Therefore this award recognises excellence within investment management at one of the most challenging times in Irish pensions history. Shining through in this category was Irish Life Investment Managers, which won for its innovation, dedication and foresight, along with going that extra mile for its clients.

Carrying on on with the investment theme, the Equities Manager of the Year award recognises the leader in the sector over the past 12 months, the firm that has proved itself to be the most exceptional player of all entrants in the industry with its excellence in managing equities, and has proved itself to be truly invaluable to Irish pension funds today. Winning this was Setanta Asset Management, for its good performance and clear investment philosophy.

Next was the Fixed Income Manager of the Year Award, which recognises the manager that offers a real specialisation in this area and can offer its pension clients a variety of solutions to meet the ever-changing market conditions. Pioneer Investments walked away with the prize, as the judges liked its new and refreshing approach, along with its innovation, specialisation and good performance.

Pension Freedom was named the Independent Retail Pension Broker / Pensions IFA of the Year for its real focus on clients and understanding of the market's needs.

After this was the Law Firm of the Year accolade, which is awarded to the firm that stands out in its dedication to understanding the complexities of pensions legislation, and works with its clients to see them through the legal maze. That firm was Eversheds. Having covered a breadth of cases over the year, the judges praised its proactive approach, pragmatism, responsiveness and focus.

The key role of the administrator is often overlooked but without an excellent administration service the pension fund member could not receive the level of service they deserve. The Pension Scheme Administrator of the Year award recognises the firm that has gone beyond the minimum standards required to offer a truly value-added service to their clients. The judges awarded this to IFG Corporate Pensions for its innovation in relation to member communications and its good customer feedback.

The Communication Award was the next to be presented – an award that rewards innovation and/or creativity to help improve pensions communication, be it through a particular product, service offering or overall business approach. The winner was Irish Life Corporate Business for its integrated strategy across all platforms, and its comprehensive and complete communications strategy that is focused on members.

The penultimate accolade was designed in response to the market's volatility and to recognise those firms that have responded to market pressures with originality and creativity. The Innovation Award recognises innovation in the marketplace, be it through a particular product, service offering or overall business approach. Back on stage for this prestigious award was Irish Life Corporate Business, for its increased ease of access and its continued improvement in systems, with demonstrable results in communications.

Finally, the last award of the night, the Personality of the Year award is given to an individual who has truly made their mark in the Irish pensions space over the years and has worked tirelessly to help improve Irish pension provision. The Irish Pensions Awards 2013 Personality of the Year was Paul O'Faherty, the recently retired CEO of Mercer Ireland.

Many thanks to everyone who supported the second annual Irish Pensions Awards, and congratulations to all those who went home with trophies on the night. We look forward to welcoming you all to next year's Irish Pensions Awards, at the new location of The Shelbourne in Dublin, taking place on 27 November 2014.

Irish Pensions Awards 2013 Judging Panel

The Irish Pensions Awards 2013 judging panel is made up of independent judges from across the Irish pensions sphere to include providers, pension funds, consultants and representatives from various pensions and investment associations.

- **Chair: Tim Reay, Secretary, International Employee Benefits Association (IEBA)**
- **Rosalind Briggs, Head of Consulting, Retirement, Mercer**
- **Kevin Coughlan, Vice President, J.P. Morgan Asset Management**
- **Adrian Daly, Founder and CEO, Source Pensions**
- **Fiona Daly, Managing Director, Rubicon Investment Consulting**
- **Malcolm Johnson, Managing Director, Profund Solutions**
- **Emer Kirk AITI QFA, Pension Consultant, Harvest Financial Services**
- **Martin Leech, Vice President, Irish Institute of Pensions Management (IIPM)**
- **Carol Leonard, Business Development Manager, Irish Life Investment Managers (ILIM)**
- **Samantha McConnell, Chief Investment Officer, IFG Corporate Pensions**
- **James McConville, Partner, McDowell Purcell Solicitors**
- **Frank O'Riordan, Trustee, AIB Pension Fund**

Irish Pensions AWARDS 2013

Fixed Income Manager of the Year: Pioneer Investments

Fixed income has always been and continues to be an important part of pension funds' portfolios. Irish pension funds rely on fixed income for a reliable revenue stream, and as a result the fixed income market is now as diverse and sophisticated as any other. This Fixed Income Manager of the Year award recognises managers that offer a real specialisation in this area and can offer their pension clients a variety of solutions to meet the ever-changing market conditions. The winner of this year's accolade was Pioneer Investments, a firm that impressed the judging panel with its refreshing approach of not having a 'house style' to its investment process.

Pioneer Investments has made its mark on the industry as a result of its remarkable fixed income performance over the last several years. What has further separated Pioneer from its major competitors globally is its disciplined approach to, and stringent use of its proprietary risk management tools in overseeing client assets – it is the perfect marriage of performance and risk-management that elevates Pioneer Investments to the very top in its field.

That perfect marriage has also translated into asset growth by way of new client wins over the last several years – 2013 was a banner year for Pioneer Investments, who raised €6 billion in net new fixed income assets from new and existing clients. As a percentage of overall assets under management, this number ranks Pioneer Investments as the most successful fixed income manager in Europe in 2013 – no mean feat given its competition.

The firm launched its Irish Institutional Business in 2008 with a view to providing best-in-class active fixed income solutions to Irish pension schemes.

Pioneer's Investment Grade Fixed Income team in Dublin manages over €29 billion in client assets and their range of strategies all exceeded their respective benchmarks in 2013, marking the fifth consecutive year of outperformance versus benchmarks for the team. A number of prominent investment consultants have recently 'buy-rated' Pioneer's fixed income strategies as a result of their strength, stability and consistency.

Its innovation mainly lies in its investment process, where a series of alpha overlays are applied to each portfolio covering diverse opportunities within fixed income such as inflation, currency, relative value, sovereign spreads, credit spreads and volatility. These alpha overlay strategies seek to deliver performance above that of the benchmark that it replicates in the portfolio. This unique approach, which the firm pioneered back in 2006, enables client portfolios to benefit from the depth of expertise within its fixed income team and to ensure diversification of alpha sources.

Pioneer has a firm commitment to meet and exceed the expectations of Irish pension fund clients and to improve pensions provision in Ireland. It aims to meet this commitment by continuing to deliver strong risk-adjusted performance for their clients; by providing a full range of active fixed income solutions; by offering local access to a world class fixed income team; and through its dedicated Irish institutional client relations team based in Dublin.

Commenting on Pioneer's success, Dave Santry, Pioneer's business head for Ireland said: "2013 has been the break-though year we have all been working towards. Investments and sales have worked very closely together over the past few years – we are all delighted to see these results materialise on the back of this collaboration.

"The most important thing for us is performance for our clients and this will continue to be our focus as we head into 2014. We have had five consecutive years of strong performance and we continue to remain well ahead of our benchmarks over longer periods. We intend to carry on working hard to ensure we protect and further grow our business, our reputation and most of all, our clients' assets."

The judges awarded Pioneer Investment with the Fixed Income Manager of the Year award for its innovation, specialisation and good performance, making Pioneer a well-deserved winner.

PIONEER Investments®

Left: Francesca Fabrizi, Editor in Chief, *European Pensions* (left) presents the **Fixed Income Manager of the Year** award to David Greene, Senior Fixed Income Portfolio Manager, Pioneer Investments (centre) with Irish Pensions Awards 2013 host Neil Delamere (right).

Keeping the lights on

Pension funds can benefit from projects to supply and enable renewable electricity. Matt Ritchie looks at the opportunities and barriers to funds taking advantage of the electricity infrastructure landscape

Accessing capital from conventional energy providers has become more difficult since the global financial crisis. But as electricity supply moves towards a lower carbon future, capital intensive projects like wind farms, solar installations, and the infrastructure required to deliver this power to homes and businesses need funding.

The long-term, stable and inflation-linked returns that energy assets can offer certainly have a role in most pension fund portfolios, but there remains a widely-held view that institutional investors are under-allocating to energy infrastructure projects.

Indeed, the OECD's latest annual survey of large pension funds and public reserve funds found evidence of "serious barriers" to institutional investments in infrastructure.

"This year's survey yet again reveals a low level of investment in infrastructure on average among the surveyed funds, despite evidence of a growing interest by pension fund managers," the OECD said. "This seems to confirm the importance of barriers and disin-centives which limit such invest-ments and the relevance and need for policymakers to address them."

These "barriers and disincentives" are not putting all funds off however. Renewable energy specialist Quercus Investment Partners is seeing increasing interest in the sector from European pension funds, which are catching up on their counterparts from other jurisdictions.

"We probably have more than 70 per cent of funds coming from European pension funds, and we are still seeing a lot of interest and subscriptions are in very good shape," managing partner Diego Biasi says. "I think most of it is due to the success we've had so far, but part of this interest is driven by the real straight interest in the sector itself."

Undeterred

Denmark's fourth largest pension company has made direct energy investing a key plank in its future growth plans.

PensionDanmark responded to the ongoing depression in government bond yields by drastically reducing its exposure to the assets, instead seeking to invest 20 per cent of its funds in real estate and infrastructure.

Chief executive Torben Möger Pedersen says the organisation is focused on accessing long-term risk adjusted returns for the benefit of its more than 630,000 members. The energy investments it has been able to make over the past few years are helping it achieve this goal.

"We have a preference for energy-related infrastructure assets as they are in a regulatory environment regime where you have some kind of government guarantees or subsidies substantially reducing market price fluctuation in, for example, power," he says.

"These assets have a very long time horizon, typically between 20 and 30 years, which fits very well with our obligations as a long term investor."

Recent investments include large stakes in a number of UK wind farms, an offshore gas pipeline servicing the Netherlands, and a new-build biomass plant set for construction in Lincolnshire, UK.

PensionDanmark prefers to make direct investments alongside industrial partners. Möger Pedersen says there is no shortage of projects in which to invest.

"We have limited our universe to North Western Europe and North America. We don't feel comfortable with making direct investments in Southern Europe or emerging markets, at least not yet, as there are so many opportunities in North Western Europe and North America we don't feel the need to divest into other regions for the moment."

PensionsDanmark is not alone in seeing the appeal of energy, particularly renewable energy projects.

The UK this year notched up its highest ever share offer for a clean power company, when The Renewables Infrastructure Group (TRIG) raised £300 million. TRIG's offer broke the record set just months earlier when Greencoat UK Wind raised £260 million with its own IPO.

Mainstream Renewable Power is keen to capitalise on investor demand for clean electricity generation assets, launching a new vehicle to attract institutional investors to participate in its global investment drive.

The company has a global pipeline of generation capacity which will require around €30 billion of capital to complete.

Mainstream Capital has been launched to attract pension funds and other institutional investors to participate in the Dublin head-quartered company's expansion plans. Chief executive of Mainstream's capital arm, and the group's head of corporate finance, Manus O'Donnell says the firm has noticed a change in the way institutions choose to invest in energy projects.

"Traditionally pension funds have invested through fund structures, there are many different fund structures out there to enable them to access renewable energy projects," O'Donnell says. "What we've seen recently is pension funds looking to invest directly in assets, in joint venture arrangements. We saw this first over in the US about 10 years ago and that's spread out more as the larger pension funds invest their own resources internally to enable them to make direct investments."

Policy

The UK government has been vocal in its desire for institutional investors to provide capital for the country's infrastructure plans, and the Netherlands Investment Institute has the backing of several of the country's largest pension funds. The OECD's survey of pension funds is part of a wider initiative to encourage long-term financing for infrastructure by institutional investors.

Most recently the European Commission has taken big steps towards lowering the barriers for energy investments.

European Commission policy officer in the energy department Sebastian Gras says there is an energy infrastructure investment need in Europe of around €200 billion out to 2020. Gras says older infrastructure needs replacing, and the proliferation of renewable plant and the push to create an interconnected European electricity market are also key drivers. Creating a secure system through diversifying the supply of gas and power into countries is another important goal.

While around half of this is expected to be met by the market as it stands, there was a risk identified that the other half may not be delivered. One of the aims of the commission's Projects of Common Interest (PCI) initiative is to attract investment from institutions like pension funds.

The PCIs are 248 predominantly transmission and distribution assets, named by the commission in October, that are deemed to have significant benefits for at least two member states; contribute to market integration and further competition; enhance security of supply, and reduce CO_2 emissions.

PCIs benefit from a streamlined permit approval process, and cross-border cost allocation which sees countries bear the cost of projects in relation to the benefits they receive. PCIs can also benefit from funding via the €5.85 billion Connecting Europe Facility.

"We are preparing an investors' dialogue, where we will showcase those projects that we already have in place. We've just started with this regulation, so there's not much to showcase yet," Gras says.

Outlook

While electricity demand has been flat since the GFC, a drive to reduce the carbon emissions from electricity production across the UK and Europe will likely see old thermal generation assets replaced with renewable plant.

Furthermore, O'Donnell says it is unlikely demand will stay flat forever. As the requirement for electricity increases so will the number of investment opportunities for investors.

"Demand has stagnated as the economies have stagnated. There was some fall back, but as economic activity picks up the energy required will pick up correspondingly – it is very much linked to economic outcome and performance," O'Donnell says.

Biasi from Quercus agrees. But concerns have also surrounded the potential for governments to retract incentives and subsidies offered for renewable generation, changing the investment cases of projects.

Biasi says the renewable power sector is entering a new, mature phase, where government incentives will no longer be needed. Projects like wind farms are approaching 'grid parity' where the cost of generating electricity is met by the market price for the output, without extra funds from government or elsewhere.

"I look forward to having a grid parity marketplace," Biasi says. "It's not possible now, all of a sudden, in a very short period, because everything has to follow up smoothly. All the actors in the market need time to properly adapt to the new scenario. But I like the idea that the trend is going to a grid parity environment. I hope we will see that in the next five years or so."

WRITTEN BY MATT RITCHIE

Staying ahead

European Pensions Nordics roundtable

Chair: To set the scene, could you please tell us what your perspectives are about the Nordic pensions market and what you see as the main challenges within it?

Leppälä: I would say that the Nordic market differs from many others. It is more insurance dominated and in some countries even the pension fund framework has more similarities with the insurance framework with its solvency rules. Funding levels are also comparatively high and so it doesn't have the same underfunding issues as, for example, the Irish or the UK funds are at the moment faced with. I think one of the major issues is the volatility of the liabilities and how they're dealing with that. I think there are solutions to that. Looking at the solvency frameworks of different countries, the details are different but basically Nordic countries' solvency situations are better than most. And then that relates to the development at European level with Solvency II and the pension fund IORP Directive and debates about the solvency requirements for pension funds.

Chair: What about from a wider regulatory perspective, what kind of challenges are you seeing in particular Sirkka (*Lindén*)?

Lindén: There is pressure to increase the retirement age and it's just a matter of time when we going there. Each country faces this and it is due to economic issues but in my personal opinion, I feel quite confident that for example here in Finland, even though the debate is quite hard, that it doesn't actually make sense for us to do that. But it will go there absolutely. On the other hand regulatory issues are putting employers in a position where they're trying to think how we could invest in people in a way to attract and perhaps give some additional pension, but that has been quite difficult and of course it always costs lots of money, but that's what we face every day.

Chair: Does that have anything to do with the general agenda of the Nordics (and other countries) to move from DB to DC?

Lindén: For historic reasons and due to the very strong statutory pension system it has been a very long transition from DB to DC. We started with DC in the late 1990s, and other countries have been doing that very much earlier. DC plans is the direction absolutely that we are moving towards, but we still have to take care of all those old DB plans because they are equally important for their owners and beneficiaries.

Leppälä: The change from DB to DC has been strong also in the Nordics. The Finnish employment pensions are still DB from the employees' point of view. But from the employer's point of view, it is a DC plan. So you pay the contributions and you have no other obligations, and as a consequence the volatility in the market does not affect your balance sheet. So that is a hybrid scheme if one looks at it from a wider perspective, but from the beneficiary's point of view it is a DB plan.

Bateman: I think from the investment side it's a different type of pressure. One thing that is absolutely clear is the cost pressure within not just Nordic pension schemes but European pension schemes at the moment. For people like us the pressure to actually deliver is greater than it ever was before. If you're an active manager you absolutely have to be seen to be adding alpha or adding value and the time horizon for not delivering that is growing shorter and shorter. I think the other pressure is actually the cost that European or global pension schemes are paying to people like us. They are increasingly under the microscope and I would suggest they probably won't increase going forward so I think it's a tougher environment for people like us.

Leppälä: That is definitely true. Talking with our members it's a theme that is present for all of them.

Kuncheva: When we discuss costs, we should look into both investment costs and pension administration costs. In general the investment costs in Finland are relatively low. The results of an

Chair: Dorothee Gnaedinger, International Benefit Consultant, Mercer

Dorothee Gnaedinger works for the International Consulting Practice at Mercer and is based in Stockholm. She was recently transferred from London (where she spent over five years in the pension industry). Dorothee's main responsibilities include: managing global benefit projects (GBMs) and audits for Mercer's largest clients in the Nordics; providing local market knowledge and expertise as part of international M&A projects; and consulting on multinational pooling. Her main interest lies in private pension provision in emerging markets. She is also pursuing a PhD at Warwick University on private pension provision, with focus on Latin America and Eastern Europe. Dorothee is a regular speaker at conferences and contributor to the press.

Eric Bateman, European Business Development, Kleinworth Benson Investors

Eric Bateman joined Kleinwort Benson Investors' Dublin based-sales team in June 2013. He has over 20 years' experience in cross border asset management distribution, including lengthy spells at Franklin Templeton Investors (where he led the firm's Dutch and Nordic businesses) and Martin Currie (where he was ultimately head of European sales and client service).

Billyana Kuncheva, Director of Fixed Income for the Nordic region, M&G Investments

Billyana joined M&G Investments in July 2012. She is responsible for institutional business development in the Nordic region, serving clients in Finland and Denmark. Previously, she worked in institutional fixed income and alternatives manager selection, most recently with Aktia Invest in Helsinki. Prior to that, she was an equity sales trader with the Nordic teams of D.Carnegie Ab and Kaupthing Bank. Billyana started her career in the investment industry in 1996. She graduated from the University of Oulu, Finland, with an MSc in Economics and is a CFA charterholder.

Matti Leppälä, Secretary General, CEO, Pensions Europe

Matti is secretary general and CEO of PensionsEurope, based in Brussels. From 2001 - 2011 he was director of the Finnish Pension Alliance TELA. He also achieved an executive MBA, insurance and financial services from the University of Tampere, Finland, in 2007. PensionsEurope represents national associations of pension funds and similar institutions for workplace pensions. It has 22 member associations in most EU-15 member states and other European countries that have significant workplace pensions. Through its members PensionsEurope represents 77 million people and €3.5 trillion of assets.

Sirkka Lindén, Associate, Mercer

Sirkka is an associate in the Employee Health & Benefits business and is involved in complex projects related to pensions and medical insurance as well as life and disability issues including loss of license insurance. Retirement is included within EH&B in Finland and Sirkka also works with pension plan issues such as changes from DB to DC. She joined Mercer in 2002 as an assistant in the retirement business. Before joining Mercer she worked with life insurance company,Mandatum Life (former name Sampo Life), for three years. Sirkka has a vocational qualification in business and administration.

"The relationship between providers and pension funds in the Nordics can be described as a form of partnership – with high expectations for delivery"

independent survey of the Finnish pension system were published in the beginning of 2013. The overall conclusion was that costs are pretty reasonable on the investment side. I think that the administrative costs are one reason why we are seeing a consolidation trend in countries like Finland and Denmark. On the other hand, even though from the outside the Nordics is often thought of as a homogenous market, every country has a different pensions system. For example, Finland's peculiarity is that there is no ceiling for the national pension. This means that these additional pensions and private saving products are not really very common here.

Chair: So what does an additional pension look like here in Finland in comparison to the other Nordic countries, is there a difference?

Leppälä: In Sweden or in Denmark you have a great variety of additional occupational pensions and private savings products, in addition to the long tradition of investing in mutual funds by private persons. It is very different with the Finnish supplementary occupational pensions coverage, which is very low. There was a big increase in the third pillar personal pension products some years ago but then taxation and other rules have been continuously changed and it is very difficult to sell these products at the moment. It seems that the Finnish government thinks that it would undermine the statutory earnings related pension scheme if people were to have additional savings. They are perhaps afraid that people might go to earlier retirement if they have additional savings. In fact there is evidence showing that people who have actually saved more tend to stay longer in working life with that security. This debate has been going on in Finland for many years but at the moment the situation is not very good for the personal pensions.

Chair: That's really interesting. It sounds as if the government is discouraging supplementary pension provision; a measure that's contradictory to pretty much anywhere else in the world.

Leppälä: It is true because at the moment at European level many authorities are really focusing on personal pensions. Many different parts of the European Commission as well as EIOPA, are interested in personal pensions. It seems that from the European level there is an increasing push for a take up in personal pensions and building a European framework for personal pensions but in Finland that is not the case at the moment.

Chair: So, it's an exciting time for personal and occupational pension providers in all of Europe. Eric *(Bateman)*, what is your perspective of the provider market in the Nordics, with particular focus on the fee pressure that you mentioned earlier?

Bateman: It's very difficult to respond to it. I think it's really a pressure on providers to deliver. The period of grace that a provider has is shorter than it was before, I think because the funds are under pressure in terms of what they're paying to people. The results are us being under greater pressure to deliver, so it's not so much a transparency angle that we're coming from, but I know that's been an issue in some of the Nordic markets and indeed in other European markets as well, but I think just in terms of the overall pressure of an active manager. I think you have to be active and really deliver alpha. I think the pressure has never been greater and conversely there's a greater pressure on fees than there was even two or three years ago. I think it actually means doing what you say you're going to do. The phrase creating alpha tends to be linked with sensationally strong performance but I think what managers are being asked to do now is what they say they will do. So if you are in a particular space don't drift from your style but also deliver what you say you're going to deliver.

Kuncheva: I think it's more to investment manager relationships than investment performance expectations. The matter of trust, predictability and transparency, in addition to performance, is also very important. In addition, institutional investors including pension funds are increasingly looking for sparring partners to discuss ideas with. Unlike in some other countries, in the Nordic region the decision-making organisations are very professional, they are not too dependent on intermediaries and consultants and are usually very much aware of new investment ideas and trends. They are very well serviced by the sell-side community, so managers need to offer market insights and new solutions. And that's in addition to delivering investment performance, that's another service that they expect in return for the fees.

Leppälä: And one peculiarity about the Finnish system is it is still a legal requirement in the Finnish pension system that the majority of the investments in pension insurance companies have to be done in-house. That is why you cannot outsource to the same extent as many do in some other countries. This legal requirement has enabled the pension insurance companies to build in-house teams who actually do have expertise.

Chair: So, the relationship between providers and pension funds in the Nordics can be described as a form of partnership – with high expectations for delivery. Does that also mean investors are willing to take a bit more risks in order to achieve these relatively high expected returns and performance? Do they look at alternative options? Where do you find new ideas?

Kuncheva: Meeting a certain level of return in the current economic environment – for example 4 per cent annual return over the long term – these days is getting harder and harder without taking unwarranted risks. So you need to work harder for your returns and that puts demands on both internal organisations and external counterparts.

Leppälä: But the big difference is how the liabilities are discounted in Finland. There is an administrative discount rate of 4 per cent and because within the same scheme you have both the funded part and the pay-as-you-go part you don't have to be as rigorous mark-to-market liabilities as they are e.g. in Sweden or in Denmark. These kind of differences make comparisons between countries very difficult. But as a result you don't deal with the same kind of solvency volatility issues in Finland as you do e.g. in Sweden because in Finland only assets are marked-to-market, but not liabilities.

Chair: Have you seen different investment strategies that have been of interest or that clients have been asking for?

Bateman: I think where we are seeing demand is on the equity side. Dividend-based strategies are still proving quite popular. Environmental strategies also remain of interest to

investors in this part of the world. We have also started to see real interest in emerging markets again and going back 20 odd years when I first started doing this, emerging markets was a fairly revolutionary story. It felt like they've really become out of favour and there was a lot of cynicism about emerging markets but it feels like people are now looking and maybe seeing them as an entry point to revisit again.

Kuncheva: That corresponds to our observations as well. Yield, whether it is in dividend form or coupon paying instruments, is really a driving force. But we need to remember that while everybody is running after the yield, the value in some yielding assets is already becoming a bit questionable. So I think the larger institutions are beginning to be aware of the risks becoming asymmetrical with very little upside. It is good that investors are becoming more value aware, price aware and are looking for ideas where there is still adequate return for the risk taken. We found them mostly in markets, where there are assets that are under-researched or hated or complex or illiquid. For the investors that can afford illiquidity and that can afford and feel comfortable with the complexity, these themes are of interest. Of course the mainstream large allocations remain as they were, but not so much in government bonds but in corporate credit. We haven't seen this great rotation that everybody is talking about from equities to fixed income. I think its more on headline level than on practical level, people are still comfortable with relative safety in terms of volatility that corporate bonds offer. In the big picture, tactical asset allocation bets are becoming more common, especially in Finland. Other pension investors have taken a different route and have invested in illiquid and alternative assets to escape market volatility. These paths are quite different so it's interesting to see which would pay out better in the long term.

Chair: What about multi asset credit?

Kuncheva: That has been a big topic for us. We're lucky to have a strategy that has been proven to deliver over the credit cycle and has attracted a lot of interest. So for investors who do not have the resources to take a tactical view in credit or within that to analyse specialist credits that requires a lot of intensive research, we have seen a lot of interest in giving us the mandate to do that for them – even if it is only an overlay or a diversifier to their existing credit exposure.

Chair: Nordic pension schemes are quite well known in the world for their environmental, social, governance (ESG) agenda when investing. Eric *(Bateman)* you mentioned this before. Would you like to elaborate on this point?

Bateman: I think its becoming increasingly important, not just here in this part of the world where its always been important but across Europe it demonstrates a really clear logical, transparent and repeatable ESG process for a lot of clients. Some of what we do and some of our environmental products are by definition ESG compliant using any kind of measurement. So for example we have a water mandate and that universe is pretty much ESG compliant using any measurement. However, even in the rest of our business it's something which we're seeing lots more interest in, not just in the pension fund and institutional market but increasingly in the sub-advisory distribution market as well. So I think it's only going to grow but it's very important to be able to demonstrate that you do what you say you're going to do with that and actually have a process in place, particularly for the smaller funds.

Kuncheva: In the Nordics it's probably a theme that is more current than in the rest of Europe. I think once again we're ahead of the curve on that particular front. The interesting thing is that there are still different interpretations on how to implement ESG or SRI factors. So what we tend to do is work with individual clients to meet their particular requests. On the investment side, we have found that this is definitely a factor that needs to be taken into consideration when we're establishing the fundamental investment proposition. This is not a consideration that should be superimposed, but something that you incorporate already at credit analysis level. For us that's an integral part of the investment decision-making process.

Chair: So do you think there is a

trend in large Nordic pension funds to stimulate and direct the ESG trend?

Kuncheva: Different investors have different demands, so we need to respect the particular methodology clients are employing to implement change in the company they are investing in, be it as a bond investor or as an equity investor.

Leppälä: One of the features which is Nordic is the fact that the Swedish service providers who screen the investments are also used by some of the biggest Finnish pension institutions.

Chair: Do you think there's a link between ESG investment and possibly de-risking?

Kuncheva: In this part of the world we have a lot of allocation to real estate where there are obvious benefits of owning a property with low electricity, heat and water consumption. Then we have the very active approach – the investments in infrastructure assets, in renewable energy that some of the larger Nordic pension funds have made, which is also another way of actively implementing ESG principles.

Chair: Are multinational employers looking more towards a streamlined approach to pension provision – for example from a governance perspective – with the aim to reduce investment risks?

Bateman: One of the obvious trends I have seen over the last few years, not just from Nordic institutional investors or pension funds, is the focus on long investments' counterparty risk. With people like ourselves, if we went to a pension fund due diligence meeting, an onsite meeting five/six years ago, they tended to be 75 per cent focused on investment and maybe 25 per cent maximum focused on operational due diligence and that ratio has moved dramatically. I think things like operational risk within asset managers, investment risk management generally, is much more heavily focused on by pension funds than they were a few years ago, so it's a different perspective.

Kuncheva: I do agree that after a few spectacular investment manager blow-ups, there is increased awareness of operational risk factors. I think investors are aware that little things like what are they doing with the collateral on securities lending, who owns it, who manages it, and administrative issues in terms of asset valuation, mark-to-market, who provides the pricing and so on and so forth. The quality of the counterparty is becoming an important investment criterion. In terms of investment risks, the trend is towards increased levels of transparency of the investment decision-making process and the underlying investment instruments.

Chair: What are the concerns that employers have when they come to you and ask for advice, do they come to discuss the new or old schemes?

Lindén: They mostly discuss old schemes and they are asking for advice about how to change their old schemes to DC plans and how to get to grips with the new DC plans they have. They are always very long projects because there are a lot of issues around it and lots of

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negotiations and its very slow work but always interesting.

Chair: Now perhaps we can make our final statements, summarise any kind of key message that you wanted to put to this table today.

Leppälä: A key message from my point of view is that the regulatory frameworks should enable pension funds to take risk and to manage that risk. That they are not too short-termistic, that the time horizon is not too short because of the volatility and because of this marked-to-market of assets and liabilities. The liabilities have a long duration, on average decades, but a solvency framework that just looks at e.g. one year makes often impossible to hold assets with more risk. That doesn't make any sense and that is the major issue for DB pensions in Europe. This is not confronting Nordic countries as severely as some other countries but still it is an issue and we should deal with this also going forward in a very sensible way. In addition are the costs resulting from new regulation. New regulations and good supervision are important, as the financial crisis has been real and pension funds in the Nordic region also lost a lot, but there has to be a right balance of regulation and the costs.

Kuncheva: If I can sum it up in a couple of sentences, the Nordic pension systems are among the best in the world, run with a high level of professionalism. The internal investment teams are pretty good at meeting the challenges that financial markets throw at them. However, they also have to deal with the uncertainty of evolving regulation. This is not a challenge or a risk that can be analysed or hedged in any sensible manner. So I hope that the authorities are aware of the real impact new rules will have on the future pensions.

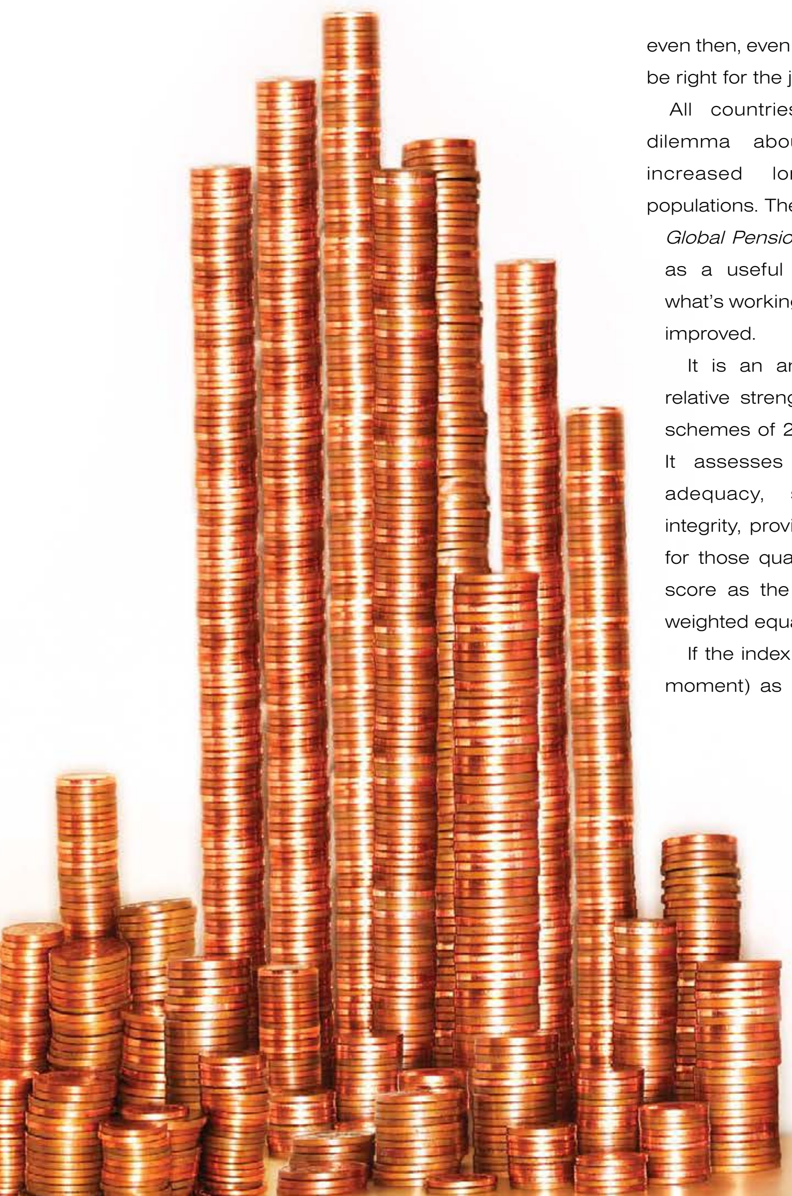
Bateman: I think looking back over the last 20 years from the investment perspective, Nordic pension funds have been real innovators, they've been very early into different asset classes, and they are dealing with the pressures that they are under in terms of their investment and manager selection. I hope that they can continue to maintain this innovation over the next 20 years because if they can then the prospects for the members of the underlying scheme should be pretty good.

Measuring up

In global surveys of the best pension systems in the world, certain countries always come out on top while others lag behind. Pádraig Floyd looks at what makes a winner and how European pension systems stack up against their international counterparts

It is said the UK pension system was the envy of the world. However, decades of neglect, particularly in the areas of state pension and defined contribution (DC), and over-regulation of defined benefit (DB) schemes, had resulted in a system in dire need of root and branch reform.

Policymakers looked abroad for inspiration and were particularly taken with the Australian and, to some extent, the US system as both structures offer mature DC systems. But assessing the relative merits of a pensions system is like measuring the proverbial piece of string. And even then, even if long enough, will it be right for the job?



All countries face the same dilemma about how to fund increased longevity in their populations. The *Melbourne Mercer Global Pension Index* is designed as a useful yardstick to show what's working and what might be improved.

It is an annual study of the relative strengths of the pension schemes of 20 world economies. It assesses each system for adequacy, sustainability and integrity, providing relative scores for those qualities and an overall score as the categories are not weighted equally.

If the index is considered (for a moment) as a competitive table, the first country outside the medal positions and leading the UK's section with a B grade, is Switzerland.

OECD data uses a weighted asset to GDP ratio to indicate how important pension savings are to the economy of those countries. The higher the ratio, the better able those investments will be to provide high benefits to individual savers, with the highest ratios being achieved by the Netherlands (160.2 per cent), Iceland (141 per cent) and Switzerland (113.6 per cent).

The next tranche of countries is led by the UK (95.7 per cent) and Australia (91.7 per cent), way ahead of the OECD average of 77 per cent and demonstrating that pension saving is an essential component to the economy.

In the Melbourne Mercer index, though the UK's score improved from 2012 – largely the result of the current reforms to the basic state pension, extension of retirement age and of course, auto-enrolment – there is still room for improvement.

What makes a good system?

Coverage is the first consideration, with the better countries having most of the working population covered in a private pension plan, says Mercer senior partner and author of the index David Knox. The next is contribution levels.

"Not only do you have a funded scheme where money is being invested for the long-term future, but you have more and more people who are in those schemes," he says. More people in schemes leads to more contributions and more assets being built up.

The three top countries also have contribution rates of at least 9 per cent of earnings, another important consideration, adds Knox. "If you've only got 3 per cent or 4 per cent going in, it's not going to make a lot of difference and you're still going to rely very heavily on social security."

Those countries Knox is referring to are Denmark (A), the Netherlands (B+) and Australia (B+).

Land of the free

The US doesn't make the grade for that group. In fact, it comes below Germany, with a similar C grade and an overall score considerably lower than the UK's 65.4 per cent.

Though famous for its 401k private sector DC plans, the US has a history of dysfunctional DB, so there's a problem with perceived integrity, much like the UK.

But its DC has problems in measuring up to the index, with 401k coverage being patchy and acting for many like a savings plan to be plundered in times of need with no requirement to covert savings into a retirement income.

A land down under

Pensions are important to the economy in Australia, with high levels of assets accumulated since the introduction of compulsion. But there are other characteristics of the system that align it more closely to its counterparts in the Netherlands and Denmark.

All three nations have applied their arrangements across the whole labour market, through agreement with employers and workers' representatives, such as trade unions.

Their systems are mandatory and employ large scale industry-wide schemes run by professionals to manage the assets in the members' interests.

For a successful pensions system, you need a well-regulated system that works in the members' interests, says UNPRI managing director Fiona Reynolds, an expert on Australian super and former CEO of the Australian Institute of Superannuation Trustees.

"In the main, we have industry-wide schemes, so if you work in the construction industry, you will be in the fund for construction workers.

"The member has to come first," adds Reynolds, "which all comes back to making sure you've got very good governance."

Dutch courage

The Dutch system – like the Danish – has been in place since the 1950s and has time to fine tune the structure and amass huge schemes, says APG director of institutional business development Alwin Oerlemans.

"There is broad public support for

the coverage and auto-enrolment," says Oerlemans.

The state pension offers only around €15,000 per annum, which sounds good in comparison to the UK's state pension, but is a long way short of replacing even 50 per cent of average career earnings. This is important and explains the 85 per cent to 90 per cent coverage of the system.

Coverage goes further in both the Netherlands and Denmark, as the self-employed are included in the legislation and some groups have organised to produce schemes for themselves and take advantage of economies of scale.

The exclusion of self-employed from the system in Australia combined with the cash fund approach is "a weakness" says Knox.

The inclusion of the self-employed as a metric of good provision is a major target for the Melbourne Mercer Index, he says, as entrepreneurs should not – and cannot – rely on their business alone to provide a retirement fund.

Hitting the Denmark

So why does the Danish system come out tops? The Dutch have been consolidating pension funds in recent years, but the Danish system has only around 15 funds in total, allowing for far greater economies of scale.

"These large entities are professionally run and have achieved very low costs as they are less dependent on advice from institutions," says Affiliated Managers Group director of business development for the Nordic region Michael Moth-Greve. This has had a profound effect upon charges, with Denmark consistently achieving the lowest cost provision of around 10bps over all with consistent investment outperformance, according to OECD.

This self-reliance – replicated in both the Netherlands and Australia to a large degree – is the key reason for Denmark's top position.

"Denmark is particularly unique, because pensions are separate from corporate entities, so the pension savers are not reliant upon the company's balance sheet," says Moth-Greve.

There is an argument that these three nations have it easier because they have relatively small populations and that can be the trouble with statistics. However, data from the OECD shows just how much has been achieved by the Danish system.

Though its autonomous pension funds – those dedicated to pension provision alone – show an asset to GDP ratio of just 50.1 per cent or half its GDP, the total private pension assets it held in absolute terms in 2012 was $636 billion. That is a mere drop in the ocean compared to the US, which in 2012 had the greatest amount of private pension assets at $19,391 billion. However, that amount is around twice the level of GDP in that year.

In the end...

We know the best way to save a meaningful sum for retirement is to start early and pay in as much as possible throughout. It is no different for national schemes – where coverage and contribution are the key determinants.

The UK has a long way to go, but unlike the US or Australia, it preserves pension savings for retirement and has an annuity industry in place to deliver secure retirement income.

The Melbourne Mercer index included post-retirement as a chapter for the first time this year, as it is an unresolved problem for many countries' systems; how to deliver the income from savings.

Knox won't be drawn on a structure, but suggests "a pooled solution, a bit like going back to the future with defined benefit pensions" might be an option considered, where risks are shared between stakeholders.

Knox says: "Annuities are not a very attractive proposition for most retirees at the moment and there are certain longevity risks, so there needs to be a solution in the DC world post-retirement."

WRITTEN BY PÁDRAIG FLOYD,
A FREELANCE JOURNALIST

Environmental investing focus: Sustainable growth

Water: An abundant opportunity in a scarce resource

Steven A. Falci explains the value of investing in water equities

The search for consistent alpha generation across global equity allocations is an ongoing challenge. If you were presented with the opportunity to invest in a strategy that could provide a new source of alpha and has delivered nearly 5 per cent excess returns per annum over 12 years while adding value above global equities in 10 of the 12 years, my guess is your interest would be piqued. Equally, I'm sure you would want to know what drove these strong, consistent returns and is this performance repeatable.

The Kleinwort Benson Investors Water Strategy has delivered these returns, and through the continued application of specialist active management to a universe of stocks supported by long term sources of growth, we believe we will be able to continue to have the opportunity to outperform consistently.

Investing in water equities is a multi-year opportunity sustained by multiple persistent drivers that should sustain returns in water for decades. A portfolio of water stocks provides access to a number of persistent global growth themes that investors are keen to access including;

- Natural resource scarcity
- Emerging market growth
- Infrastructure investment

While water investing is sustained by these long term secular drivers, there is opportunity to generate returns consistently through stock selection and portfolio positioning. The opportunity set of stocks providing water solutions have diverse return characteristics - representing companies with diverse business models selling into a variety of end markets and geographic regions. Specialist active management can identify which companies are best positioned across the cycle to generate superior returns across market environments.

The case for an allocation to water equities

The long term case for water has been well documented - water is a finite resource for which there is no substitute and demand for this precious resource continues to grow significantly faster than population. Less than 1 per cent of the world's water is available for use and this limited supply is increasingly threatened by pollution, particularly in emerging market countries as they grow and industrialise. Historically, water demand has grown at twice the rate of population and is expected to grow by 41 per cent by 2030.[1] Water is essential to sustaining life and critical to global economic well-being as an essential input across many industries. Today nearly 800 million people do not have access to clean drinking water and 2.5 billion people lack access to basic sanitation.[2] It has been estimated that unless water provision is adequately addressed, 45 per cent of projected 2050 global GDP (approximately $63 trillion) could be at risk.[3]

In order to address the challenges of water scarcity, an estimated $22 trillion investment will be required from 2005 to 2030, which will be the largest component of global infrastructure spending over that time period - more than roads, railroads, seaports, and power combined.[4] As a specialist manager focused on water equities we see a tremendous opportunity to identify how this capital will be deployed and which companies will provide the winning solutions.

Investing in water

Kleinwort Benson Investors defines water as all manufacturers, service providers and operators across the water cycle. The water cycle describes the flow of water:

- from its origin
- through collection and treatment
- to delivery to end users across residences, industry and agriculture
- through wastewater treatment and remediation back into the environment

We segment companies working across the water cycle into three water sectors:

- Water and Wastewater Utilities
- Water Infrastructure
- Water Technology

Companies across our three water sectors have diverse return characteristics, providing the opportunity for specialist active management to add value across different market environments.

Water utilities are the linchpin for providing water for residential and commercial use and treating waste water for reuse or remediation back into the environment. As such, they are managers of water infrastructure and the users of technology to filter, treat and measure water use. Regulated utilities are the dominant component of this sector, providing a stable, low-beta safe haven during periods of market turbulence. The sector can also provide the opportunity to participate in growth through non–regulated utilities with more cyclical businesses and emerging market utilities that are facilitating and participating in growth in developing countries.

Water infrastructure companies include manufacturers of pipes, pumps, valves, fluid control systems and irrigation equipment. They also encompass engineering and consulting firms and construction companies that are involved in the design and implementation of large scale projects. It is a high beta, long-term growth sector, and will be volatile due to exposure to cyclical variables related to the economic cycle and capital spending. The need for new infrastructure in the developing world and the replacement of aged infrastructure in the developed world will drive growth in this sector for many years to come.

Water technology consists of a broad array of niche companies providing both established and ground breaking products and services to meet a variety of needs across the water cycle, including filtration, disinfection, metering and testing. While in aggregate the sector has a beta in line with the market, there are a variety of opportunities to earn extraordinary returns in high growth, smaller cap stocks. These returns can be earned through companies that grow organically or through others that are acquired by larger companies looking for leading niche technologies to complement other capabilities.

There are times when valuation disparities between sectors provide the opportunity to add value. This is very much bottom-up driven, and specialist active management can identify clusters of companies within each sector that have become under or over valued and identify the fundamental reasons for the valuation disparity. For example, during the European economic crisis in the summer of 2011, many water infrastructure stocks were sold off well beyond their intrinsic value. The more defensive regulated utilities outperformed in this sell off, and many were viewed as fairly valued, providing the opportunity to reduce exposure to utilities and access outstanding opportunities in many undervalued infrastructure companies. This shift proved beneficial to the performance of the water strategy, as infrastructure stocks significantly outperformed in 2012.

Conclusion

Water equities provide exposure to long term sources of growth and unique sources of alpha that are not prevalent in many global equity allocations. While the long term drivers of water largely provide the beta of the theme, specialist active management can exploit inefficiencies through stock selection and position the portfolio to deliver consistent returns across the investment cycle. Opportunities for strong, consistent returns are hard to find. Have a closer look - we think you will want to find a place in your global equity allocation for water.

[1] McKinsey Global Institute, Resource Revolution: meeting the world's energy, materials, food, and water needs, November 2011

[2] WHO and UNICEF, "Progress on Drinking Water and Sanitation," 2012

[3] Bank of America Merrill Lynch, A Blue Revolution – Global Water, December 2012

[4] Jacobs Securities, Global Water Primer, April 2011, referencing Booz Allen Hamilton

WRITTEN BY STEVEN A. FALCI,
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For the greater good

Andrew Williams discusses the case for environmental investing and how this can benefit pension funds' portfolios

In recent years, an increasing amount of pension funds have become involved in environmental investing - in several areas, including wind energy, solar power and water resources - and are beginning to discover they may not just be 'good' from an SRI perspective, but also for the benefits they can provide in terms of returns.

Specialist management

Pension funds can access environmental investing in many ways - with the most appropriate strategy likely to depend on a number of factors. According to UK Sustainable Investment and Finance Association (UKSIF) chief executive Simon Howard, the best route for any particular pension fund will depend on its size. In his view, large schemes should consider finding a specialist manager and investing in a portfolio of direct investments.

"Such a scheme's size means it should have the governance resources to manage a new manager in an emerging asset class, and it should have sufficient insight into the scheme cashflows to be able to manage the relatively long building process and the even longer life and exit process," he says.

"These assets are not readily realisable. Smaller schemes should not take the direct approach. They should try to find a suitable pooled fund and access the diversification and liquidity benefits available through that route," he adds.

Historically, a lot of pension fund money has been invested on a private basis, with the fund acting as a 'limited partner' via an investment management team. As Greencoat Investing principal Connie Lee explains, such funds tend to use leverage to boost their returns into double digits, are committed for a period of 5-10 years, and could be invested in a wide range of assets under the environmental banner.

"Investment in these funds has usually come from the alternatives allocation," says Lee.

"At Greencoat Capital, the publicly listed wind infrastructure fund that we manage is slightly different in that it doesn't use leverage in the same way and is designed to produce a steady 6 per cent dividend that will increase in line with RPI inflation and protect capital on a real basis," she adds.

The fund, known as Greencoat UK Wind, was the first renewable energy listed infrastructure fund of its kind, with a business model that mirrors other listed infrastructure funds, such as HICL, that Lee points out have "proven their structures over the last several years".

In addition to wind energy, pension funds also have the opportunity to invest across other renewable energy sectors, as well as energy efficiency, water and agriculture projects, through both private and public market vehicles.

Another company with substantial experience in the area is Kleinwort Benson Investors (KBI), which has built up expertise in publicly-traded equities. As KBI head of strategy development sustainable investments Steve Falci points out, this involves investing in companies providing "scale-solutions to society's biggest resource and environmental challenges" across water, energy and food.

"We believe specialist active management is best placed to understand the companies providing the solutions, as well as the drivers and end-markets for solutions. One example is infrastructure, [which] will be essential to meeting needs for water, food and energy," he says.

Doing something positive

For Howard, one "obvious" advantage of environmental investing is that the scheme, sponsor and beneficiaries are doing "something positive" to mitigate global warming, something that he believes is important in terms of reflecting sponsor and member attitudes, as well as their recognition of the "stewardship responsibilities" of asset owners.

"We also think UK pension fund trustees probably have a fiduciary duty to consider systemic and long-term threats to their portfolios from factors such as climate change and this should move them to consider assets of this type," he says.

"In more narrow terms, schemes that invest in this way will be positioned to benefit from growing demand for alternative energy, and, if the scheme funds investment by reducing assets in 'conventional' energy, the scheme will have reduced its exposure to falling asset values if and when societal pressures result in carbon taxes or carbon use limits that really bite," he adds.

Meanwhile, Lee highlights the fact that renewable energy projects have "long asset lives", with a newly-built wind farm having a typical project life of around 25 years, a "similar time span to the liabilities that pension funds are looking to cover".

"The returns are inflation-linked, and the underlying projects are highly cash-generative, enabling fund managers to offer a stable dividend yield. There is low correlation with GDP and the broader stock market, and it is an ideal investment for portfolio managers looking to diversify their portfolios in a stable investment class. There is also potential upside as power prices are projected to rise over time," she says.

Falci agrees that pension funds are by definition long-term investors, and he believes that investing in companies meeting the needs for water, food and low-carbon energy provides pension funds with access to "long-term growth themes that will drive returns for decades".

"Investing in environmental equities can provide a new and diversifying source of alpha to pension funds, as there will be little overlap with existing holdings and the correlation of excess returns above the market is generally very low with other areas they have looked for growth," he says.

However, Lee also stresses that, in order to fully realise such benefits, funds should be aware that environmental investment presents its own set of management challenges, calling for "specialised expertise, operational strength and understanding of the local market and support regimes for renewable technologies".

Returns

From a practical, financial perspective, Lee explains that environmental investing can be 'very beneficial' in terms of financial returns, especially in markets like the UK, where the Renewables Obligation Certificate (ROC) regime is well established, offering inflation-linked returns with power-price upside.

"A successful example of this is UKW, which successfully completed an oversubscribed IPO earlier this year. The assets have performed in line with management expectations since listing, further acquisitions of wind projects have been made and the fund is currently in the market for a £135 million follow-on equity raising," she adds.

Meanwhile, Falci points out that environmental investing provides the opportunity to access "strong long-term returns by investing in companies providing solutions to our biggest sustainability challenges". As such, he says it is a very distinctive example of the ability to generate returns while also having a "positive impact on our global society".

"The KBI Water strategy has delivered nearly 5 per cent per annum above the MSCI World since inception, while outperforming it in 10 of 12 calendar years."

Looking ahead, Howard thinks it's too early to predict which technology will show the best returns in the long-run, and he points out that other technologies "will probably emerge", with energy storage linked to renewables being an "obvious case" that would attract "enormous demand".

"A lot of money needs to be invested in transmission and distribution systems too and they should show predictable, bond-like returns as well. Schemes should probably focus on getting exposure to a wide range of end-technologies and techniques, another reason for looking for a specialist manager," he says.

WRITTEN BY ANDREW WILLIAMS,
A FREELANCE JOURNALIST

Continuing the search for yield

Amidst the ECB rate cut and the Fed's hinting at tapering, the search for yield in fixed income portfolios continues unabated, Lynn Strongin Dodds finds

The European Central Bank's (ECB) recent decision to cut its benchmark interest rate to 0.25 per cent, a historical low, may have surprised markets but it did not move the needle on the fixed income investment compass. Institutional investors are staying on the unconstrained course, looking across the credit and duration spectrums with some also heading into real asset terrain.

"The impact of the ECB rate cut is pretty limited because rates were so low anyway but it has a symbolic impact because it shows that the central banks will do anything to stimulate growth," says J.P. Morgan Asset Management international CIO of fixed income Nick Gartside. "Investors are now more comfortable to take risk because they see the ECB being proactive."

Few market participants though expected to see the central bank move so aggressively. "The timing was surprising," says Henderson Global Investors director of fixed income Kevin Adams. "On the face of it, the economic data in the eurozone looked a bit stronger but the ECB has concerns over falling inflation and they wanted to avoid a Japan-like situation."

According to ECB president Mario Draghi, the recent interest-rate cut was aimed at providing a "safety margin" to keep inflation from falling too close to zero. It is currently running at 0.7 per cent, well below the targeted rate of 2 per cent and if it continues to hover around this level or drop, some market participants believe that interest rates could slip into negative territory.

The eurozone's economic woes are not the only problems hanging over fixed income markets. The mixed messages from the US are also taking their toll. In its latest financial stability report, the ECB said that the risks to the region's financial system from outside the currency bloc had grown since May on the back of the Federal Reserve's talk of tapering its $85 billion-worth of monthly bond purchases. This caused a major re-pricing in global bond markets as participants geared up for the reduction.

In the end, the Fed unexpectedly pulled the plug on the idea but the general consensus is that it is only a matter of time before tapering is back on the table. "Central banks are walking a tight rope with their forward guidance," says Threadneedle Investments client portfolio manager, fixed income James Waters. "They want to provide more guidance and hence help reduce the uncertainty premium, but if they step away from that guidance it can seem like empty rhetoric."

Despite the talk and the divergence in central bank policy in the US and Europe, the search for yield remains unabated. As Waters puts it on the beta front, investors have three options: "to go out on the curve, down the credit structure or take more illiquidity premium. The other choice is to focus more on adding more alpha and absolute return strategies although they have received mixed press over the last few years. This is why investors need to look for managers who have been successful at generating additional value."

State Street Global Advisors head of investments, EMEA, Bill Street says: "Manager selection is always important but if you are in an absolute framework, there is no hiding place. The alternative is to be tied to a benchmark and exposed to market risk. I think given the record low yield environment, it is an ideal time to look for opportunities in an absolute return framework. Investors will however need to do the right due diligence."

Gartside also sees pension funds migrating away from benchmarks to take advantage of a larger opportunity set. "They are looking at absolute return funds which promise to deliver consistent returns regardless of market conditions as well as total return funds which take a more strategic view and try to make the journey smoother although there is an acceptance that things may go wrong at times."

There are of course different flavours within these strategies. For example, in the absolute return arena, some funds adopt a macro-based approach that expresses top-down views on interest rate, currency, country and sector exposures while others follow a more concentrated path. This involves investing across the broad fixed income market or specialising in a single sectors region. There is also the hybrid fund which encompasses both methodology and looks at the full range of global fixed income sectors, rate markets, and currencies.

According to Neuberger Berman fund manager Jon Jonsson, the firm uses what it calls a 'state-space analysis' framework to help shape the asset allocation within its global absolute return fund. This incorporates what current market expectations are for the return for a given fixed income sector, what each sector team expects the return to be, and what confidence they have in that expectation, which is a key component of the teams fundamental asset allocation strategy. A range of fundamental variables are factored in and the probability of these scenarios materialising.

New strategies are also being formulated on the credit pitch with the return of the multi asset credit or MAC fund with the majority seeking to combine exposures to high-yield bonds, leveraged loans, mortgage and asset-backed debt securities, emerging markets debt and distressed debt. "We are definitely seeing more investors looking to outsource their credit allocation," says Blair Reid, institutional portfolio manager for BlueBay Asset Management's asset allocation products. "One of the main benefits of these funds is that they allow managers to change allocations in a timely manner because they are not benchmark driven. We can rotate in and out of different asset classes plus we have the ability to move into cash if we need to."

Adams has also noticed greater allocations to multi credit strategies. "High yield, asset-backed securities and loans are in the sweet spot because they are floating rate notes which not only generate a decent return but also are not particularly sensitive to interest rates."

High yield in particular has caught the imagination because it is negatively correlated with government bond markets and more in tune with equity markets. This is why the asset class rebounded quickly after volatility sent bond markets across the board spiralling after the Federal Reserve hinted at tapering. Returns to date have been around 5.5 per cent to 6 per cent, approximately twice the return from equity dividends and fund managers are optimistic about next year's prospects due to the ongoing improvement in high yield issuers' balance sheet quality, and the market's abundant liquidity.

Atlanticomnium (UK) CEO and manager of the GAM Star Credit Opportunities Jeremy Smouha believes investors should not ignore companies higher on the ladder. "The search for yield can take investors to risky countries and companies in the high yield and emerging market debt space. Our strategy is to invest in the junior or subordinated issues of investment grade companies. We conduct detailed analysis and identify strong companies with a very low probability of default. This enables us to go lower down the capital structure and generate higher returns regardless of market conditions."

While fixed income and credit are proving to be fertile ground, investors are also venturing into real assets which are attractive for their potential to garner equity like performance but with greater downside protection. "I think real assets can be a substitute for fixed income," says Dexion Capital founder Robin Bowie. "The positive is that they are not correlated with equity markets and can hedge some types of inflation risk, while the negatives are that sourcing these assets requires specialist skills."

Legal & General Investment Management head of fixed income product specialists Shelly Moledina adds: "Assets such as real estate or infrastructure debt are not as liquid as bonds and do not have a natural benchmark. However, they are strategically important and can generate income as part of a diversified portfolio."

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

Challenging times

European Pensions currency roundtable

Chair: On the face of it the current variability of economic environment should be great for currency managers. When there are differences in the phasing of economic cycles, then that would tend to create opportunity amongst the currencies that could be exploited. So given that environment, what do you see as having been the main challenges faced by currency managers over the past 12 months?

Siragusano: From my point of view the last 12 months could go as the last 24 months, with currency markets driven by political decisions. Then what we were seeing was more demand for emerging markets (EM) currency programmes. After the eurocrisis a lot of investors, especially institutional investors, tried to diversify their currency holdings by investing abroad. Especially for example in Germany where normally they were quite heavily invested in the euro, but now they try to diversify and now they get a little bit of the negative side of diversification. They bear some additional risk, like currency risk.

Klopfenstein: One of the interesting things, about a year ago now, was a move away from the risk-on risk-off world that we had seen prior to that. I think we're out of the pure risk aversion paradigm, we're more into one where currencies are being revalued according to some of their fundamental drivers, which I think is a good thing. Offsetting that is the overall pressure that we see from monetary policy keeping volatility down, and this doesn't create the broader opportunities going forward. When that pressure is lifted, there should be quite a bit of market movement.

Adaya: We have seen over the last 12 to 24 months a certain need for managers to adapt quite fast to changing market conditions. After the crisis, most central banks engaged in accommodative monetary policies, which brought interest rates and interest rate differentials across economies to very low levels. As a result, currency managers were less able to rely on carry-type of strategies to generate returns and focused more on trend-following and other momentum strategies. The importance of being able to adapt to changing market conditions was further emphasised by the fact that a few specialist currency managers disappeared from the market place, while a number of asset management houses closed down their FX business or limited the risk budget allocated to FX within their portfolios.

Paesler: The active currency management aspect of it has been a very strong challenge, especially with the interest rate differentials in developed markets being very small. We've seen a lot more requests for information on the passive side rather than on the active side. And then the question that remains is: what hedge ratio should be used? We have had a lot of discussions recently with clients about wanting to take all of the currency risk off the table and go for a 100 per cent hedge.

Koriath: For the industry it has been particularly difficult. Political risk has been material, particular interventions, so very hard to time, very hard to get right if you're in the active space - if not impossible to get right. I think that the interest rate based systematic carry strategy has been absolutely destroyed, people have been waking up to that. Overall I think the industry is moving towards a more passive approach.

Dale: I'm certainly echoing the move towards passive. Diversification can actually dampen a significant amount of volatility that really does pull of the carry trade from time to time, especially with leverage on it. I think this is an evolution for currency managers that can adopt passive and active strategies and move in and out of these strategies.

Determining the hedge ratio

Chair: Going back to Klaus' [*Paesler*] point, adjusting the hedge ratio is an open issue for lots of people. There are two question marks: one is when should you hedge, since ideally it would be when your base currency is extremely undervalued but delaying the decision incurs

Chair: Malcolm Leigh, principal, Mercer

Malcolm is a senior consultant in the manager research team of Mercer's Investment Consulting business, with expertise in advising currency, commodity and global macro investment managers. Malcolm has 25 years experience within the fund management industry.

Alex Koriath, Director, Head of Manager Research, Investment Advisory, KPMG

Alex is a senior client consultant and head of research at KPMG Investment Advisory. He is also a member of KPMG's Investment Research Committee that sets the strategic direction of the team's research and client advice. Alex advises a range of pension fund clients on investment strategy, asset allocation, risk management and manager selections.

Bill Dale, Chairman and CEO, Cürex Group

Bill has over 20 years' experience in innovating, building and managing financial services companies, products and technologies. He co-founded Cürex Group in 2007 and is creator and inventor of Cürex foundational, proprietary intellectual property and market eco-system architecture. Previously, Bill was partner and officer of RBC Dominion Securities, where he also chaired the National Advisory Board.

Gary Klopfenstein, CIO, Mesirow Financial

Gary's executive responsibilities include the oversight of all direct alternative investments including currency, commodities and real assets. He is responsible for developing the currency management group's proprietary trading and risk management programs, overall responsibility for the investment management processes, and conceptualisation and initiation of new research projects and investment products.

Klaus Paesler, Head of Currency & Overlay Strategy, Russell Investments EMEA

Klaus' responsibilities are to design, implement, and manage portfolios for Russell's overlay services group. He also engages in speaking assignments on exposure management and foreign exchange strategies. Prior to joining Russell, Klaus was a portfolio manager with Mellon Capital Management in San Francisco. At Mellon, Klaus was responsible for managing institutional index funds with a variety of strategies.

Roubesh Adaya, Senior Associate, bfinance

Roubesh joined bfinance in 2013, after more than six years of experience within fixed income. He joined from BNP Paribas Asset Management where he covered core fixed income. Prior to that, he was a global fixed income investment specialist at Fisher Frances Trees & Watts for three years.

Tindaro Siragusano, Head of Private Banking & Asset Management, Berenberg Bank

Tindaro joined Berenberg in 2006 and has headed the Asset Management business unit since February 2009. He is responsible for the development of innovative overlay and investment solutions for institutional investors. In October 2011 he additionally assumed overall responsibility for the management of institutional and private assets. Tindaro has more than 15 years experience in the asset management industry.

risk and so depends on your risk appetite, and the second is how to decide how much of it to hedge.

Klopfenstein: There are a few things that really point towards a need to make an active decision around the hedge ratio. One of them is you have to have a significant exposure to currency. What we tend to see on a global basis, those currencies that are near extremes tend to be where you see a shift from passive to active risk management. We're not talking about going out and generating alpha, I'm talking about working through the portfolio, and asking what are the exposures in there, and do we want to be more hedged or less hedged? We're starting to see the trend of having specialist managers make the tactical call once that strategic point of neutrality has been established, which is in my mind the definition of outsourced currency risk management.

Siragusano: Many of our clients have the 50 per cent hedge benchmark. It is the optimum, but what is the reason for that? After lots of discussions I think it's 50 per cent because you really don't know what the optimal hedge ratio is. With 50 per cent you perhaps have the feeling that you're not doing something wrong. We challenge this 50 per cent hedge ratio which a lot of passive mandates have in place. Perhaps it is a good starting point as a benchmark for active management and then to deviate the hedge ratio depending on market movements. More and more investors demand this time of dynamic currency management focusing more on the risk side. So our goal is to always have the optimal hedge ratio in place and not necessarily to generate a market neutral alpha performance. This is the big shift away from alpha to more risk management side.

Koriath: What do your clients end up in then? Do you move them away from the 50 per cent? How do you determine that?

Siragusano: We determine this with our quantitative model framework that generates signals for each currency pair and the starting point is 50 per cent. The clients have the flexibility to restrict the overlay by giving us a maximum or minimum hedge ratio, e.g. 25 to 75 per cent or leave the overlay unrestricted between 0-100 per cent. And then it's changed depending on the market movements. A purely trend-following strategy.

Paesler: I agree that 50 per cent tends to be the standard and it's really down to regret risk. As you say, it's one extreme or the other: 100 to zero. Go 50 per cent and then you reduce your regret risk. However, you mentioned a lot about benchmark and I think that's an interesting thing that's happening a lot with currency. We've done a lot of research on what should drive a currency benchmark and for most of what we've seen, it's carry, trend and momentum, but how do you weigh those drivers? So in essence what we're saying is, don't necessarily have your currency weights driven by your equity weights. Rather look at what's driving the currency market and that should be your passive benchmark, rather than focusing specifically on the hedge ratio.

Klopfenstein: We tend to have a little bit of a different view on that. Generally we find there's a couple of different ways our clients look at it. One is on an asset class by asset class basis, so they pick a different hedge ratio for each asset class. So it's almost a waterfall effect by asset class, and then by total currency view. At the end of it, it's what's your residual currency risk that is important, because you could end up with a very different outcome than what you would expect if you take a strictly asset class view. But the point Tindaro [*Siragusano*] was getting to is that, whatever you start with, you can then actively position to be more or less hedged. I like your concept, and clients think about this the same way. Many times the currency component of your investment is a by-product of your asset allocation decision as opposed to the intended currency exposure.

Dale: We talk a lot about hedging, always getting out of foreign currencies and coming back to your local, but what about your local currency? We've seen interest in a very passive strategy, in the sense of just an equal weighting of currencies, as an absolute beta comparison against which all of these decisions can be measured. Going back to what our clients' objectives are, we have portions of our capital there for capital preservation, we have some that are there for inflation protection. One of the by-products of currency management that we shouldn't lose sight of is the fact that when you're moving out of your local currency, you're in many ways creating inflation protection for yourself in case of a local currency. And it can create a really interesting manner in which you can actually create coincident inflation hedges in your portfolio with the use of active currency management as opposed to just looking for tips or other sorts of currency-linked investments.

Siragusano: A further question to this is if you have active equity managers and they start to change countries, what should your currency programme work on, on which allocation? The benchmark allocation of your equity investment or on the real exposure allocated by your equity managers? It's a question on the approach of the active equity manager, is he also looking at currency performance and against which benchmark is he performing?

Is the currency investment itself the main driver of investments, like emerging markets, or is it just a by-product, like with hedge fund investment or private equity investment.

Paesler: The overlays we put in place, we look at it manager by manager to make that determination: do we hedge the benchmark or do you hedge out the actual currency exposures? It really comes down to what the individual managers are doing their research on. So you really have to dig in to the managers themselves and see what goes into their research and their stock picking.

Siragusano: That's the reason why every overlay management is very individual. There is no standard solution for currency overlay, because you have to take everything into consideration. The asset allocation process of the client, the manager's selection criteria and is your manager benchmarked against S&P500 or benchmarked against in sterling denominated MSCI North America, where you have to take consideration of the US dollar-sterling development.

Chair: Do you agree that when we advise clients, we should be looking at currency exposure in a more general perspective, taking account of the broader portfolio and objectives?

Adaya: It raises some interesting questions, especially on where currency management should sit within the investment framework of each client. If each manager selected by the client performs active currency management, and has currency exposure that varies significantly from their benchmark, it is not simple for the client to include a currency overlay in their programme. Furthermore, I would like to stress that unlike other asset classes, currencies are pretty much a zero-sum game. A currency will always gain or lose relative to another currency. As a result, the long-term appreciation of the 'asset class' is pretty much zero. It is important to make sure that you are actively positioned to not only achieve good performance, but to be able to attain a reduction in volatility compared to the client's unhedged portfolio. As portfolios become more customised, currency overlays become more difficult to implement. This raises the question: is it worth having an interest rate overlay programme across the broad structure of the client's assets, or is it better to actually leave diversification to play, and allow selected managers within that asset allocation programme to run their own active currency exposure?

Dale: I think it's a choice. I think it comes down to how you want to view currency. I think there's an appreciation of the isolation of currency, what it can add in terms of portfolio advantages. For many passive investors and even active investors, currency sits there as a passive component of the portfolio. And I think there's a choice of whether one wants to remove that currency and capture some of the carry that is inherent. What we find quite interesting is when you equally weigh across a very broad section of currencies, it dampens volatility tremendously. But you have to capture carry, because you construct to pick up the yield in currencies you wouldn't normally have exposure to or wouldn't certainly overweigh on any sort of a market cap basis. So currency I've always felt is this amazing pick up in beta, it's just additional pennies far away from the steam roller, because it's an additional yield that you can start to add into these asset classes but it does take an approach and it does take a decision.

Koriath: It's probably intellectually very sound. But I think what happens in practice is much more blunt. In practice there is often a 50 per cent hedge ratio used or some other crude hedge ratio. And very often EM exposures in particular aren't hedged. They aren't hedged because A) it's costly, no one offers it as a reasonable price, and B) there's the prospect of or the hope that EM currency goes up. It hasn't worked for the last couple of years, but maybe it will.

Klopfenstein: We see very specific hedge ratio discussions based on what is in the underlying asset mix. We do that on the passive portfolios all the time. I think it depends on the client's objective. Understanding the details of the underlying assets is less important as active returns will overwhelm the nuanced variation of portfolios. On the active risk management you have to understand governance, and where your returns are going to come from. Active performance tends to dominate those decisions, in the sense that returns are generated by the active deviation from the benchmark as opposed to the selection of the benchmark itself. That being said, the benchmark selection should correctly and exactly reflect the client's view of risk neutrality. The client needs to understand where their starting point is.

Dale: It's a starting place from which you can add alpha and when we have these we can start to employ very common programmes of these and equities which is short the benchmark, long the active manager and finding ways to actually reduce volatility but present some of these types of returns. I think it opens up a whole new sphere of ways the market can embrace the 'asset class'. And I call that asset class with parentheses, because I have this view that currencies attribute to all asset classes, so we have something to offer everyone, but at the same time when we get into these types of discussions we end up having very asset class-like discussions and I think that we have a lot to bring to this discussion around, taken from that point of view.

Active vs passive

Klopfenstein: I think there is a shift to managing risk in portfolios whether it is the active or passive portion and away from pure alpha.

Chair: I totally agree. But in some ways, managing risk by changing the hedge ratio is already what every active currency manager is doing, albeit usually in currencies individually rather than across the board.

Klopfenstein: The question there is, is it a strategic change, because we think that should reside with the client. If they want to change strategically what they're doing, typically that decision is maybe once every year or two or three. Our job is to be active around that.

Chair: That raises a number of questions. How is the success of those tactical decisions going to be measured? Should it be performance against the strategic benchmark or are there other objectives such as volatility reduction or cash flow management? How do you make these decisions? Most ways of determining the strategic long-term currency exposure is based on variance or some other measure of risk or liquidity or growth views. But for the tactical rebalancing, the key thing for me is defining its objective. We've mentioned here, on occasion in the same breath,

reducing volatility and adding alpha. Reducing risk and adding value do not normally go together. Do you really believe that this is the case, that you can both reduce risk and increase returns as well?

Paesler: Yes, you can do it passively, but you can also get in essence active returns out of it, just like you would by using smart beta strategies in equities.

Koriath: I don't buy it unfortunately. I don't buy it at all. I think it is very difficult to achieve two objectives of adding alpha and reducing risk at the same time. And a couple of strategies that sound quite similar to what you've just described have performed horribly over the last six years. There were a number of these strategies that were popular with UK pension funds that performed very poorly, and a couple were semi-passive strategies that didn't work very well. I think to evaluate these, it comes back to this: how long does it work with small gains? I think you have to look at this over a long period of time, and see whether they are really robust, because strategies can work quite well for quite a number of years and then go sensationally wrong. I think it's very dangerous to just give a very short history and people can make the mistake of looking at a too short history of strategies that look en vogue and quite nice now, for the last two, three years or for the last four years, but haven't been tested through several cycles. Some strategies in this space were not hedging at all anymore, they were actually risk increasing, tremendously increasing risk on the downside through a skew with many small positive returns but some huge negative returns.

Siragusano: Yes, and that's why it is really important to look at how the strategy behaves and what the investment strategy itself is doing. On the risk side against a 50 per cent hedge benchmark I'm extremely confident that even a simply structured currency overlay programme will reduce risk.

Adaya: As an active manager, you should predominantly look at reducing the risk of an unhedged portfolio. That's principally what you're looking to achieve. We do believe that any incremental performance you get on top is a bonus.

Dale: It's a very good point. When we look at this as an asset class in isolation, the drawdowns I agree can be dramatic. But what we need to remember is that FX, I've never met anyone in my career that has 100 per cent FX in their portfolio. The drawdowns that are happening in currency are also in the equity portfolio, are also in the bond portfolio. So the question is, are you creating some diversification, some dampening, and I think that speaks to, again a layer of diversification which in itself is a very passive strategy to have, but requires a lot of action to actually keep you diversified. You end up undiversified pretty quick if you don't do anything. I think it's a very interesting point: can you add alpha with a reduced risk and add return? I think you have to answer that question in the context of your entire portfolio.

Klopfenstein: That's the whole point of currency overlay. All our clients we're talking about have equities. We manage the inherent risk of currency that is imbedded in global equities, that's what we do.

Dale: Exactly, and that's a conversation that needs to expand more broadly. But it's inherent. I think we have to keep that in focus more.

Klopfenstein: If you have currencies imbedded in your equity portfolio or bond portfolio or

> "We challenge this 50 per cent hedge ratio which a lot of passive mandates have in place"

whatever it happens to be, you're taking risk, because currency is risk to that, without any expected return. So as a rational investor why would you do that? And if you're able to successfully and actively manage that, you should be able to reduce risk at the same time. As a by-product of that, there will be some alpha that comes through.

Chair: I tend to be sceptical about the ability to reduce risk and add alpha. I think if you have a benchmark, it's simpler, if you define risk by tracking error, to reduce risk completely. You go a benchmark and stay there, because every time you step away from the benchmark, you're taking an active risk.

Klopfenstein: It depends on what your benchmark is. We've been talking about your benchmark with unhedged currency. What's does risk reduction look like versus a 50 per cent hedge? I would find it generally difficult to reduce volatility of returns to currency against a 50 per cent benchmark actively. I think you can reduce the downside risk, but that's different than what you're talking about doing. You're adding an active decision process to a benchmark, when you do that, you increase active risk.

Chair: Would you say that that's an indication that the benchmark is not well constructed? A correlation between the currency and the underlying assets, which you're dealing with on a tactical basic, should instead be dealt with on a strategic basis.

Paesler: I think the big question is what is a passive currency mandate, what is a currency benchmark? We're not suggesting someone should either be in currencies or should not be in currencies, but if you're going to be in currencies do it deliberately and invest in those currencies that describe the currency market. I think you were saying, one of the things that's critical is the manager's expertise, not only in investing in currencies as part of their research, as part of their chosen securities, but how they invest in currencies.

Siragusano: That's a very good point, because we've got two goals as a currency manager. Not only determining the best current hedge ratio, but also to ensure a best execution process to reduce transaction costs.

Adaya: Currency has been slammed for contributing little in terms of performance for a number of clients. However, I believe there is room to add value through currency management. When you look at fixed income managers for example, currency is often used as a source of alpha and allocated a risk budget in most of their portfolios. What I do not agree with is the constant use of carry strategies to which high risk budgets are allocated, irrespective of the market condition. Scaling up your risk to take advantage of lesser opportunities within carry strategies, for instance, is not a wise choice. Some trades are likely to work better in some economic environment and other trades are likely to perform better on a risk-adjusted basis in other instances. In the last few years for instance, the risk-on risk-off environment was a good example; if the manager focused more on trend-following strategies than on carry strategies, he would either be long the USD or to EM currencies, rather than just being overweight to countries/currencies with positive interest rate differentials. Adopting the right strategy, or using the right models, at the right time and according to specific market conditions has been key to how successful a manager has been. At the moment, we are seeing investors coming back to carry strategies. Forward guidance by central banks as well as a possible decoupling of monetary policies across countries has meant that the correlation between the expected interest rate differential and the valuation of a currency pair has increased, rendering carry strategies attractive again. From an investor's perspective, this brings up the question of how to add value with a currency overlay programme, especially if the underlying managers of the client's overall portfolio are taking active positions on the currency markets? How do you actually monitor all of this, and try to add value without significant ongoing knowledge of the client's underlying currency exposure?

"What I do not agree with is the constant use of carry strategies to which high risk budgets are allocated, irrespective of the market condition"

Dale: I think you always have to look at those types of comments in the context of the time horizon of your investment. The reality is that there's very few of us that are going to be zero-sum game over our lifetime. We're either going to be positive or negative effects by currency, that's something you have to pay attention to.

Koriath: A lot of our clients are in the pension fund space and they are long-term investors. For pension funds it's more about avoiding permanent loss or permanent impairment of capital. The interim volatility in theory you can ride out, if you are a 30-40 year investor, you should be investing for the long term. Are you not then just paying commissions, trading costs, investing fees to overlay managers?

Paesler: I would agree. I wish more of the industry would look at it that way, but in fact, you have to report to the trustees quarterly, annually, etc. And if they see a 5 per cent drop in the value of the assets due to currency movements, they're going to have a lot of explaining to do. Whether in the end that's going to revert itself in the next year or two, unfortunately those that are going to see the reports are going to take issue with that.

Emerging markets

Dale: I think you tapped on something I believe strongly in as well, and that is a look to the emerging markets. Even in some cases frontier markets. Not necessarily what's in everyone's portfolio but when you have a very long-term time horizon, you can ride out significant volatility. I think there is some fundamental about capital being injected into economies where they don't have the monetary policy to handle the infusion of capital that net results are an appreciation of a currency, it's obviously difficult for those countries to deal with those appreciations in currencies but they have them nonetheless.

Chair: How would you all recommend playing the emerging markets?

Paesler: Generally, how we see people do it is you hedge developed and you leave the emerging markets unhedged. In that sense practically it's still better to do that portion unhedged. If you want to have some currency exposure and you don't just want to remove 100 per cent of all currency risk, it is probably at least operationally easier to leave the EM unhedged because of the costs, the spreads, the operational difficulties around that. That said, that is changing. For example, in China it's becoming a bit easier to trade now.

Siragusano: Of course our recommendation is benchmark with EM of course unhedged. Because the benchmark decision determines the sensitivity of the currency overlay programme. With an unhedged benchmark, our currency overlay programme is more fat-tail protection instead of continuous dynamic hedging starting at 50 per cent. So at the very end, the other alternative is to be long EM and to buy a put option on the EM. But we all know it's quite expensive, implied volatilities are quite high and if there's a better solution to have this asymmetric fat tail or shortfall event hedging style and dynamic hedging instead of buying a put option then this is something that is quite interesting and perhaps delivers the possibility to let investors participate in the appreciation of the EM.

Adaya: Leaving your exposure to emerging markets unhedged, without active monitoring, is a risk. Quantitative models have not tended to work so well in emerging markets historically. We believe the exposure to EM currencies should be left to a manager who is able to take judgmental positions based on the fundamentals of such countries. Often, managers in emerging market debt or equity may take an active position through both a bond/ equity trade and a currency trade, with one leg acting as a hedge for instance. With the assumption that the manager has had experience managing EM currency, we tend to believe that the management of EM FX should best be left to the manager of the underlying asset class, be it EM bonds or EM equity.

Klopfenstein: A couple of years ago, five or seven years ago for sure, very few people would even consider actively managing EM currency risk. Today we see a lot more hedging of emerging market currency risk, so it's becoming more common place.

Koriath: Do you see costs coming down for EM currency trading?

Dale: In the long term I think we're going to go through a transition. The market is going to learn to adapt to a new world. There are very few true liquidity providers in non-deliverable markets who had to take real risk. These aren't guys who can lay off the risks in five seconds, they hold the position for weeks. You actually have relatively few real liquidity providers. There's a lot of decisions that need to be made and people are going to make mistakes, they're going to learn about the new market place that they're moving into. Ultimately that will lead to more transparency, but what will have to happen is, we're going to have to see in combination of an evolution of that market place, an evolution of the countries under which they are linking themselves to learn ways in which they can actually increase liquidity. Because ultimately this is an unsustainable path, it is a stepping stone in emerging markets' evolution to an open and more mature monetary policy and these countries are growing so quickly now and they require the tools that are a bit more sophisticated. I think they'll come quicker than they have in generations past. We live in a world where information is shared much more openly and where technology is much more freely available and where many of these countries are willing to trade, they're willing to bring in new trading systems, new platforms that will create more transparency. I think there's a great amount of hesitation and apprehension but also at the same time there's a big stick behind them in terms of domestic inflation and a requirement to move into the new environment. I think the push towards electronic trading will eventually move this to more deliverable currencies.

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