# European Pensions

June/July 2016

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Is the insurance industry's solvency requirements affecting bulk annuity pricing?

*Engagement:*

**Employer engagement**

The differing degrees of employer engagement with second-pillar pensions

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# Damage control

As the result of the UK's EU referendum shows, assuming that the 'worst case scenario' will never actually happen simply makes the impact all the more shocking when it does occur.

Despite a 'leave' win not generally being the expected result in the UK (arguably not even expected by the 'leave' campaign officials themselves), leave did indeed win and the impact immediately reverberated throughout the UK, and global, stockmarkets. The pound fell to a 30-year low and the FTSE 100 was down 3.2 per cent as of the day following the result, with France's CAC-40 and Germany's DAX both down over 2 per cent, to name just some examples.

The ramifications from this surprising result will not be fully realised until years to come. Understandably, the pensions industry has questions it would like answered, sooner rather than later, about the impact Brexit will have on the UK's and Europe's regulatory relationship on pensions and investments.

Unfortunately, along with everyone else, the pensions industry will have to wait and see exactly how this will play out. Whatever may occur, I'm confident that the relationship between the UK and Europe's financial industries is sufficiently entwined, and mutually beneficial, to ensure a strong bond remains.

But while we wait, one lesson that can already be taken away is to look for and, where possible, mitigate against upcoming risks. Therefore this issue of *European Pensions* is focused on the current and future challenges facing European pension schemes and how to prepare in order to minimise their impacts.

Our country spotlight on the Netherlands this issue *[pg 17]* is an example of this. Its DB schemes in March recorded a low average funding ratio of 96 per cent, instead of the required 104 per cent. The consensus seems to be that this problem will only remain, and that the current system needs adapting to ensure long-term sustainability. It may not be a quick or easy process, but discussions are already taking place about what needs to be done.

Taking action to prevent or minimise risks before they occur is difficult. It is often easier to maintain the status quo and hope the problems resolve themselves.

But as the UK government and EU officials may now attest to, addressing issues while they are bubbling under the surface can be preferable to managing the clean up when they explode.

**Laura Blows, Editor**

*European Pensions has agreements with several associations to reach their membership. For details contact john.woods@europeanpensions.net*

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# UK votes for Brexit; EU markets begin to tumble

THE UK'S DECISION TO LEAVE THE EUROPEAN UNION HAS RESULTED IN RESIGNATIONS FROM SENIOR POLITICIANS AND MARKET TURMOIL

Written by: Natalie Tuck and Adam Cadle

The United Kingdom has voted to leave the European Union, following a referendum held on Thursday 23 June.

The final result of the vote was leave 51.9 per cent and remain 48.1 per cent with a voter turnout of 72.2 per cent, which is extraordinarily high; voter turnout in the UK for the last General Election in 2015 was 66.1 per cent.

An exclusive ballot of attendees conducted at the European Pensions Awards, held on the same day as the referendum, revealed that 60 per cent voted in favour of the UK remaining in the EU and 40 per cent voted for Brexit.

The referendum result led to market turmoil in the UK and the EU; the pound fell to a 31-year low against the dollar and the FTSE 100 was down 3.2 per cent at the end of the 24 June. In Europe, France's Cac-40 and Germany's Dax were both down over 2 per cent. Post-Brexit fears for the broader EU led to the euro plummeting to a three-month low against the dollar.

Former Mayor of London Boris Johnson and leave supporter said: “In voting to leave the EU it is vital to stress there is no need for haste… nothing will change over the short term, except that work will have to begin on how to give effect to the will of the people and to extricate this country from the supranational system.” He also claimed "people’s pensions are safe, the pound is stable and the markets are stable".

*"Much will depend on the precise nature of our future relationship with the EU, which may mean that some aspects of UK pension provision continue to be influenced by the EU"*

Following the result, the UK's Prime Minister David Cameron announced that he will resign in October.

In addition, the UK’s European Commissioner Lord Hill also announced his resignation following Britain’s decision to leave the EU.

In a resignation statement, Lord Hill said he did not believe it was right for him to carry on with his work as the commissioner in charge for financial services.

In response to the referendum result, the pensions industry has highlighted the uncertainty in the days ahead for UK pension funds. ACA chairman Bob Scott said: "The vote to leave, which confounded bookmakers’ predictions, may make it even harder for policymakers to set a clear pensions strategy. Market volatility and a period of political uncertainty are unlikely to be conducive to setting a coherent long-term strategy for pension provision – it will be important that financial institutions take positive steps to calm markets.”

According to PLSA chief Joanne Segars, “this result is an historic day for the UK and Europe”.

“The ramifications for UK pensions of the UK's decision to leave the European Union will start to become clear over the coming weeks and months,” she stated.

“Much will depend on the precise nature of our future relationship with the EU, which may mean that some aspects of UK pension provision continue to be influenced by the EU. In other areas, UK pension law may need to be disentangled from EU legislation. It is essential that the UK government and policymakers in Brussels now act swiftly and decisively to manage current volatility and announce a clear plan to renegotiate our future relationship with the EU.”

UK DB pension fund deficits hit record lows of £935 billion in the days following the Brexit.

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PENSIONSAge

# IMF advises EU countries to address pensions longevity risk

THE IMF GIVES ADVICE TO COMBAT LONGEVITY RISKS, AS A REPORT REVEALS IT IS THE BIGGEST THREAT TO PENSION FUNDS ACROSS THE GLOBE

Written by: Natalie Tuck and Adam Cadle

The International Monetary Fund has advised countries to take action to beat the longevity risks they face.

For example, it advised Poland that plans to partially reverse the 2013 retirement age increase is a "step in the wrong direction".

In its concluding statement from its mission to the country, the IMF warned the government's plans could "undermine public finances and labour force participation" and therefore, should be reconsidered.

"With a rapidly aging population, preventing the retirement age from increasing gradually as currently envisaged would be a step in the wrong direction," the statement said.

*"Preventing the retirement age from increasing gradually as currently envisaged would be a step in the wrong direction"*

It said that such a move, without offsetting parametric conditions, would reduce the pension replacement rate, increasing the risk of old-age poverty and associated higher reliance on social benefits, with adverse implications for the budget.

In addition, it said that maintaining the retirement age increase envisaged by the 2013 pension reforms would encourage labour force participation from seniors.

In 2012, Poland's President at the time Bronislaw Komorowski signed a bill to increase the retirement age to 67 for both men and women, from 65 and 60, respectively.

However, the Law and Justice (PiS) party, which came to power in November 2015, announced earlier this year its aims to lower the retirement age back down to 60 for women and 65 for men in 2016, unravelling the previous bill.

Germany was also advised by the IMF to link its retirement age to life expectancy and to make the choice to remain in work "actuarially neutral" to retiring.

The IMF predicts that although growth in Germany is expected to remain moderate this year, over the medium term it will decline as the population ages. Therefore it said pension reforms can bring a "double dividend" of increasing employment while reducing old-age poverty.

Currently, the IMF believes that as the old age dependency ratio is expected to rise, the pressures on public finances will intensify.

"Existing automatic adjustment mechanisms to ensure the sustainability of the public pension system will give rise to sustained increases in contribution rates (pushing up the already high tax burden on labour) and declines in pension benefits (reducing old-age incomes)," the report explained.

"By extending working lives, a more adequate level of old-age income can be maintained, without a further rise in pre-retirement savings. To this end, indexing the retirement age to life expectancy and making the choice to remain in the labour force actuarially neutral would be helpful."

The recommendations come as a global survey, commissioned by State Street, found longevity risk is the biggest threat facing pension funds across the globe. The survey of 400 pension professionals who were asked what level of priority they assign to different risk types found that 26 per cent said 'very high' in relation to longevity. This was followed by 25 per cent who said this about investment risk; 22 per cent about liquidity risk and 14 per cent said this when asked about operational risk.

In addition, it found less than a quarter (22 per cent) said they felt the organisation they work for were 'highly effective' in managing issues around longevity.

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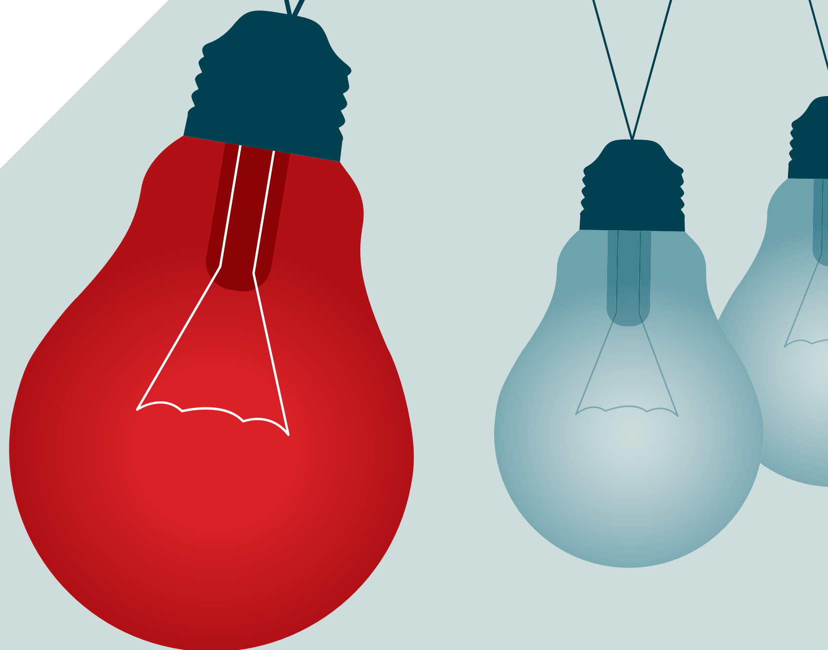

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# Irish campaign group calls for LGBTI pension equality

A CAMPAIGN GROUP CALLING FOR LGBTI PENSIONS EQUALITY IS AWAITING THE EUROPEAN COURT OF JUSTICE'S DECISION ON A CASE THAT COULD SET A PRECEDENT

Written by: Natalie Tuck

Campaigners in Ireland are calling for pension equality for lesbian, gay, bisexual, transgender and intersexed people.

Pension Equality, the group campaigning for change, had its honorary secretary, Fergus Courtney explain that the issue has gained more prominence in light of the case *Parris V Trinity College*, where an Irish pensioner is challenging some of the aspects of his pension treatment before the European Court of Justice.

David Parris, 70, a former lecturer at Trinity College, has argued that he is being discriminated against because Irish law prevents his same-sex partner of over 30 years from accessing a survivor's pension in the event of his death.

Under current rules, Parris would have had to enter into a civil partnership before his 60th birthday, which he did not do. His claim was dismissed by the Equality Tribunal in Ireland and so he took the case to the European Court of Justice in April 2016, and a preliminary decision is expected shortly.

"The European Court of Justice is not expected to give its judgement until September but the Advocate General may issue her opinion very soon. The court very often takes its lead from the Advocate General. The Irish and British governments made strong submissions against Mr. Parris as they clearly see a favourable judgement as incurring liabilities to them," Courtney explained.

"In the UK the Walker case is an example of this, with the British government fighting tooth and nail in the courts to maintain a differential – often substantial in what, for example, the husband of a man would get as opposed to his wife. In the Walker case his husband would get a survivor pension of £500 sterling per year and his wife £41,000."

Courtney explained that the government's defence for not granting these rights comes from a rule that was made in 1984. In 1984 civil and public servants in Ireland were offered an opportunity to leave a pension to a spouse whom they married after retirement, something that was not previously available to them under their pension scheme.

"This scheme was, in effect, a pension scheme for heterosexual people because it contained no benefit of any kind for LGB people. Because the offer was meaningless to LGB people – same sex marriages did not exist – many people declined the offer.

"Following the introduction in 2011 of civil partnership and the voting into the Irish Constitution of the right to same sex marriage in 2015, a number of LGB pensioners have applied to the government to change their pension options from a single person option to a married person option because they can now marry and they want to be able to leave a survivor pension to their new spouse when they die," he explained.

*"A number of LGB pensioners have applied to the government to change their pension options from a single person option to a married person option because they can now marry and they want to be able to leave a survivor pension to their new spouse when they die"*

However, the government has refused to allow this, even though the LGB people concerned have said that they will pay the same pension contributions as heterosexuals, so there will be no financial detriment to the pension scheme.

"The government's defence is remarkable. It says that when LGB employees decided in 1984 that they did not wish to leave a pension to an opposite sex spouse they were in fact deciding that they did not wish to leave a pension to a same sex spouse – 30 years before there was such a thing and while such relationships were still criminalised in Ireland."

# Trustees urged to review processes in light of new EU data regulations

IN LIGHT OF THE THE INCOMING EU DATA REGULATIONS, TRUSTEES MUST MAKE SURE THEY ARE PREPARED TO DEAL WITH THE CHANGES COMING THEIR WAY

Written by: Marek Handzel

Trustees are being urged to review their scheme data management in the light of new EU regulations, which are set to come into force in May 2018.

Law firm Dentons has outlined six areas that scheme trustees need to review to ensure compliance with the General Data Protection Regulation (GDPR) that will completely overhaul the current data protection laws in Europe.

According to the law firm, the GDPR has a greater emphasis on formal compliance processes and imposes substantial new obligations on trustees in the collection and use of personal data.

The six areas are member consent; use of data processors; enhanced data protection rights for members; onerous penalties; data breaches; and the appointment of data protection officers.

Dentons has said that obtaining valid consent from a member will be much harder under the GDPR. Member consent to data processing will need to be "freely given, specific, informed and unambiguous". It has also warned that consent will need to consist of a positive action as it cannot be inferred from silence, pre-ticked boxes or inactivity.

*"Member consent to data processing will need to be freely given, specific, informed and unambiguous"*

Another significant change will be that under the GDPR, data processers will be liable independently for damages caused by their processing activities. Dentons has warned that this will likely lead to the renegotiation of service provider agreements.

It is also urging trustees to appoint a data protection officer, even though they may not be strictly required to do so. It says that the process of appointed one should begin soon, as it is a specialist role.

"We initially we expect there to be a capacity crunch as staff and contractors train up into this role," said the firm in a note to clients.

"Trustees need to consider carefully the duties and responsibilities of the DPO and the skills and experience necessary."

Failure to comply with the GDPR could be costly. Dentons has explained that the new regulations introduce significantly higher penalties for breaching data protection requirements.

Breaching GDPR can lead to fines of up to €20 million – or 4 per cent of global turnover.

## News in brief

■ **PensionsEurope** chair Janwillem Bouma has said that the EU must lessen the capital regulations placed on pensions funds if they are to achieve their full potential as long-term investors in the Capital Markets Union. Bouma said that he hoped to see changes to a number of pieces of EU financial regulation and that the European Market Infrastructure Regulation (EMIR) should allow for "more proportionality".

■ **EIOPA** and the China Insurance Regulatory Commission (CIRC) have signed a Memorandum of Understanding (MoU) to update each other on the developments in the regulatory and supervisory frameworks for private pensions and insurance. The MoU will be the basis for EIOPA and CIRC to build a practical framework to exchange supervisory information, update each other on regulatory and supervisory framework developments for insurance and private pensions.

■ The average Swiss Pensionskassen return has been recorded at 1.13 per cent compared to 7.13 per cent in the preceding year. **Swisscanto** said the economic tensions characterising the 2015 investment year have resulted in higher risk positions in strategic asset allocations. Coverage ratios are also lower compared to the previous year.

■ UCITS registered net outflows of €6 billion during Q1 2016, compared to net inflows of €122 billion in Q4 2015, **EFAMA** revealed. EFAMA said long-term UCITS recorded net outflows of €4 billion, compared to net inflows of €83 billion in Q4 2015.

## News in brief

■ Brazil's state-led oil company **Petrobas** has revealed it has a pension deficit of 22.6 billion reals ($6.8 billion). The company, formally known as Petroleo Brasileiro, said that under Brazilian law the amount it and the fund's beneficiaries must immediately plan to cover is 16.1 billion reals ($4.8 billion). The law makes Petrobras responsible for half of the adjusted shortfall and beneficiaries must cover the rest through higher retirement contributions, it said. The fund, Petros, has more than 75,000 beneficiaries.

■ Pensioners in **Pakistan** will soon be able to receive their pensions through their ATM card. The system will be introduced on 1 August 2016 at all branches of bankAlfalah. Efforts are also being made for the digitalisation of the pension record for enhancing its performance.

■ Taiwanese **President Tsai Ing-wen** has pledged to ensure financial security for every elderly person in Taiwan and to create a sustainable pension system, as the Presidential Office's pension reform committee convened for its first meeting.

■ The public pension fund for **Boston municipal employees** has filed the first bondholders proposed class action against Volkswagen AG relating to the company's diesel emissions scandal, law firm Labaton Sucharow has said. The lawsuit claims that "false and misleading statements and omissions" by Volkswagen caused its bonds to trade at "artificially inflated prices[...]only to decline after the emissions scandal went public," the law firm said in a statement.

# Japan's govt pension plan sues Toshiba

THE ASSET VALUE OF CORPORATE PENSIONS FALLS FOR THE FIRST TIME IN FIVE YEARS

Written by: Natalie Tuck

Japan's Government Pension Investment Fund is suing Toshiba Corp for losses on its investments after an accounting scandal hit the conglomerate's shares hard.

According to *Bloomberg*, a spokesperson for the pension plan said the $1.3trn fund is seeking damages of around 900 million yen ($8.6 million). The losses relate to shares bought by GPIF's external fund managers in 2009 through a secondary share offering, he said.

"We bought the shares seven years ago and that's how much we've calculated our losses on those holdings to be," a spokesperson told *Bloomberg*. GPIF has previously sued other companies, including Seibu Railway Co. and Livedoor Inc.

Toshiba has been plagued by record losses and executive resignations after unveiling years of padded profits at the conglomerate, which makes everything from computers to nuclear power equipment.

Shares have tumbled more than 40 per cent since April 2015, when it withdrew its earnings forecast and announced an accounting probe that was later expanded.

# Ontario's planned standalone pension fund cost taxpayers CAD$16m

THE SCHEME IS NOW BEING 'WOUND DOWN' DESPITE THE COST

Written by: Natalie Tuck

The planned standalone Ontario Retirement Pension Plan that is being 'wound down' has cost taxpayers CAD$16m, government figures have estimated.

According to the *Canada National Post*, based on the numbers available, the figure could be closer to CAD$20 million. The money was used for research and in setting up the pension fund and the 'administration corporation' that was supposed to run it.

Premier Kathleen Wynne said the programme will be "wound down," but could not estimate how much the ORPP has already cost taxpayers.

Instead, from 2019, all Canadian workers will pay around CAD$7 more a month into the Canada Pension Plan. Had the ORPP gone ahead, Ontarians without a workplace pension plan would have paid at least double that on a sliding scale geared to their income.

As a result, it means the province will save millions in the long run. In the short term, Ontario has already paid CAD$14 million into the plan in fiscal 2015-16, booked CAD$1.7 million in costs for this year and spent almost CAD$2 million on adverts promoting the plan.

# People on the move...

The latest news and moves from people within the European pensions industry

If you have any appointments to announce please contact natalie.tuck@europeanpensions.net

**ALEXANDER CLASSEN**
Bedrock has appointed Alexander Classen as a managing partner. Classen joins Bedrock from Coutts, where he was CEO of its international business. Prior to that, he had a long and distinguished career in the wealth management industry, having worked at Pictet, Goldman Sachs and Morgan Stanley. He will be based in Zurich, where a new Bedrock office and team will be constituted over the next few months.

**ADAM GRAINGER**
State Street Global Advisors has appointed Adam Grainger as chief operating officer of its European DC business. Grainger will be responsible for the overall client experience and the operational oversight and development of the DC business. He brings a wealth of relevant experience, having spent the past six years at J.P. Morgan Asset Management and BlackRock, among others.

**ELENA DELFINO**
Kames Capital has appointed Elena Delfino as business development manager within the firm's European wholesale distribution team. Delfino joins Kames from Neuberger Berman, where she worked within the company's sales team, covering Spain, Portugal and Italy. Prior to Neuberger Berman, Delfino was a sales and account manager at Bloomberg.

**ALAN BURNETT**
Manulife Asset Management has appointed Alan Burnett as head of wholesale sales and relationship management. Burnett's role is to help build relationships with leading fund provider platforms and fund selectors at banks, wealth managers and family offices across the UK. Burnett was with Lyxor, where he was building their alternatives and absolute return multi-asset business in the UK wholesale market.

**RODERICK MUNSTERS**
The Edmond de Rothschild Group has entrusted the management of its Asset Management business to Roderick Munsters. He replaces Laurent Tignard, who leaves the group to pursue new professional opportunities. Munsters was chief executive officer of Robeco Group from 2009 to 2015. He also headed Robeco's subsidiaries RobecoSAM in Zurich and Harbor Capital Advisors in Chicago.

GOVERNANCE

# Knowledge the key to managing global benefits

**Amol Mhatre explains the benefits of good governance within companies' global benefits programmes**

**WRITTEN BY** AMOL MHATRE, SENIOR PARTNER AND GLOBAL SOLUTIONS LEADER, INTERNATIONAL RETIREMENT AND INVESTMENT PRACTICE, AON HEWITT

Multinational companies struggle with the corporate governance of their global benefit programmes in two key areas — having ready access to information to make informed decisions (ie, knowledge management) and in developing an operating infrastructure to execute their strategic decisions on the ground. These are the headline findings of Aon's *2015-16 Global Benefits Governance and Operations* study, conducted in partnership with the American Benefits Institute. In the study of more than 200 multinational companies, responses showed that companies which follow best practices in global benefits governance report significantly higher confidence levels in their ability to manage and reduce benefits costs and risks.

Multinational companies remain concerned about the increasing and unpredictable costs of the benefits they sponsor around the world. Beyond just the financial risks such as volatile cash calls and balance sheet implications of traditional defined benefit (DB) pensions and rising costs of healthcare, companies are increasingly recognising other risks, such as regulatory and administrative non-compliance of their defined contribution (DC) programmes. While most companies have replaced their DB arrangements with DC ones for future hires, they have had little to no corporate oversight of these plans. However as DC plans become the primary vehicles of retirement income for employees, and as the assets in these plans grow, the fiduciary and operational risks can no longer be ignored.

Indeed, benefits design, financial, and operational decisions made at the local levels require oversight and controls for many reasons. Companies want to ensure that the returns on investment they make in employee benefits are in line with the risks such programmes pose. Also, companies can leverage their global scale to reduce financing and operating costs in many countries where local operations simply lack the scale. However, most companies have found that corporate oversight is easier said than done, because of the sheer number of countries they operate in, the number and types of benefits they sponsor on behalf of their employees, and the regulatory frameworks with which they are required to comply.

### Centralisation trend

This year's study shows that boards and senior management of most companies are primarily concerned about adverse financial outcomes due to benefit programmes. Corporate human resource (HR) leaders' worries are more diverse; they include employee appreciation of expenditure, the health and financial wellness of their employees as it affects their engagement and workforce productivity, as well as compliance with increasingly complex and evolving regulatory requirements. All this comes when fiduciary frameworks are becoming more onerous in most mature markets, and when companies are rapidly expanding in geographies with limited resources and local skilled benefits professionals. As such, Aon's study found the drivers of increasing corporate involvement and centralisation are: benefits costs and risks (90%+ of respondents), and regulatory complexities and governance standards (c75%).

In fact, most companies that participated in the Aon study expect over the next three years to manage data more centrally, providing specific corporate guidelines and approval protocols, establishing centres of expertise to address the

lean staffing of their benefits teams, and to establish formal governance protocols with periodic audits.

## Key challenges

Three years ago when Aon conducted the first global benefits governance study, companies expressed the same ambitions to manage their global benefits more centrally. But the 2015-16 study shows that companies have not progressed as far as they would have liked. This is not surprising because companies face two key challenges.

Corporate teams find it challenging to collect and maintain adequate data on their global benefits, and often do not have ready access to information on market norms and trends. In fact, only one in five companies that do not follow best practices in global benefits management reported having reasonable access — with only 2% saying they have ready access — to the information they need. Furthermore, less than a third of the companies generally know the risks posed by their programmes, and only 6% say so with a high degree of confidence. Therefore, knowledge management is in fact the single biggest challenge multinationals face in managing global benefit programmes.

The second challenge multinationals face is lack of formal governance protocols and an operational infrastructure to execute their risk management decisions. The Aon study clearly shows that roughly half the responding companies employ formal governance protocols, with most saying they are effective. In comparison, companies that use informal processes predominantly say their governance is not particularly effective. Fiduciary frameworks often limit risk management decisions, while poor

risk management decisions lead to costs and risks that the companies must bear.

Companies following best practice do in fact successfully execute their risk-management strategies via a strong operational focus that enables information flow, disciplined and collaborative protocols, and a clear delineation of responsibilities for decision-making and taking actions.

## Best practice in global benefits management

This year's Aon study defines best practice in effective global benefits governance using the five measures *[see chart above]*. Only 15% of companies reported following best practice in Aon's 2012-13 study, but in 2015-16 this number was slightly higher at 20%.

The study indicates a strong correlation between companies that report following best practice and their confidence levels in managing costs and risks; as well as alignment of their local benefits with organisational and workforce strategies. Overall, best practice companies — with significantly higher margins — report greater centralisation in managing all benefits across all geographies, formal governance protocols, use of global providers and technology, and global centres of expertise. More importantly, these companies routinely audit their programmes to ensure alignment with their corporate goals and guidelines.

## Managing global benefits

Multinationals face significant challenges when effectively managing their global programmes in an environment of lean staffing models, budget constraints, and rapidly evolving regulations worldwide. Companies want to design benefit programmes that are aligned with organisational, financial and talent strategies, and deliver economic value of scale to employees; minimise the cost of benefits through efficient financing and rewarded risk; reduce operating risks and deliver benefits efficiently to employees.

While some might assert that centralisation in itself drives better governance, the Aon study does not support this. In fact, the study significantly strengthens the 'why' before the 'how' argument of the first study; it is important for companies to understand which risks are important to manage and then to implement appropriate protocols based on where in the organisation they are best managed. There is no easy single solution but with disciplined protocols for making and executing risk management decisions, companies can indeed do a better job of managing their global programmes.

*For a free copy of Aon Hewitt's 2015-16 Global Benefits Governance and Operations Study, or to discuss any of the issues raised in this article, please contact us at talktous@aonhewitt.com.*

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# Pensions and hedge funds as partners

**THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION (AIMA)'S JENNIFER WOOD EXPLORES THE CHANGING RELATIONSHIP BETWEEN PENSION FUNDS AND HEDGE FUND MANAGERS**

**MORE PENSION SCHEMES ARE INVESTING IN HEDGE FUNDS AND THEY ARE GENERALLY INCREASING THEIR ALLOCATIONS AS A SHARE OF THEIR OVERALL PORTFOLIOS**

Since the global financial crisis, the nature of the relationship between hedge fund managers and investors, such as pension funds, has undergone tremendous change. Driven in large part by investors' demand for greater transparency, investors are increasingly forging partnerships with their fund managers.

Investors are calling for relationships with their external investment managers that may include greater knowledge sharing, customised solutions, co-investment opportunities, product seeding and/or equity investing. Forthcoming AIMA research on the alignment of interests between hedge fund managers and their investors underscores the importance of strong communication and enhanced transparency, along with the proliferation of new fee structures and other tools that encourage stronger ties between investment managers and their investors.

Meanwhile, more pension schemes are investing in hedge funds, and they are generally increasing their allocations as a share of their overall portfolios. Currently, roughly 150 UK pensions invest in hedge funds, with the average allocation being 7 per cent among public pensions and 9 per cent among private pensions, according to Preqin. In the US, roughly 20 per cent more pension plans invest in hedge funds today than pre-financial crisis, Preqin has stated.

As a result of these trends, the remit of fund managers' investor relations (IR) teams is evolving along with the hedge fund industry itself. Increased transparency and heightened expectations around communications mean those professionals with client servicing responsibilities now may require additional technical knowledge to respond to investor queries and present regular updates.

Infrastructure and systems are having to accommodate investor reporting in an efficient and secure manner. Fund marketing is moving beyond just the production of pitch books. Branding is gaining currency and when it comes to raising assets, investment managers are increasingly working directly with large institutions such as pension funds, which often entails reviews by investment consultants, deep operational due diligence dives, and a great deal of patience.

For their part, smaller fund managers are considering an array of models, including founders' share classes and seeding arrangements to determine which, if any, will best attract external capital and be the best fit for their businesses. This is all occurring against a backdrop of regulatory change and heightened enforcement scrutiny on marketing compliance.

Amid such transformative change, AIMA has published a *Guide to Sound Practices for Investor Relations*. Among the topics it addresses are the structure and responsibilities of the IR function, investor communications, marketing, fundraising, due diligence, subscriptions and redemptions.

The intention of the guide is to identify a common set of sound practices that will help investment managers build a stable investor base - a key pillar of a sustainable hedge fund business. Given the diversity of hedge fund managers, there is not a single model that will work for all.

Managers must consider their unique business model as they review these principles as the size, nature, regulatory jurisdiction and investment strategy may mean that some or all of the sound practices, as set out in the guide, may be inappropriate.

And just as no two managers are alike, no two investors are alike. Managers must work closely with investors to understand their individual needs. From such strong foundations can a fruitful relationship be built that benefits both managers and investors. ■

*Written by Jennifer Wood, managing director, global head of asset management regulation and sound practices, AIMA*

COUNTRY SPOTLIGHT NETHERLANDS

# A new dawn?

**The Dutch pension system is still highly respected, but lately the financial position of pension funds has been a cause for concern.** Peter Davy **explores why Dutch pension schemes are facing challenges and the solutions being considered**

**WRITTEN BY** PETER DAVY, A FREELANCE JOURNALIST

From bad, to worse: Dutch pension funds, who have barely had time to absorb last year's revision to the ultimate forward rate (UFR) used as the discount rate when calculating liabilities, have seen market turmoil this year further hammer their funding ratios.

By March, the coverage ratio of four of the five biggest Dutch funds had fallen below 90 per cent. Mercer calculates the average funding level across all funds at the end of March was 96 per cent. The minimum level required by the sector's regulator, the Dutch central bank, De Nederlandsche Bank (DNB), is 104 per cent. As the bank noted in its *State of Supervision* report in March, "The financial position of pension funds is a cause for concern."

In fact, such is the concern that DNB president Klaas Knot has urged the country to adopt a new system for its second pillar quickly, telling a seminar in May: "We should not wait too long."

That's supported by Dutch Pensions Federation Pensioenfederatie managing director Gerard Riemen. According to him, the defined benefit (DB) system in the country has had its day. The country needs to rethink the pensions guarantee – or, rather, accept that it doesn't exist.

"For the last eight years it's been obvious that there is no guarantee," he says. "If you really look at it, it might be impossible to give a guarantee through defined benefit schemes."

## What crisis?

That might seem surprising given the country has a system many envy.

"We should still be proud," says Deloitte Benefits & Pension Advisory partner John Smolenaers.

"We have €1.4 trillion in pension funds. Most countries don't have those kind of savings available for the countries future," he points out. Last February, Towers Watson's *Global Pensions Assets* study calculated assets in Dutch pension funds at $1.46 trillion against $3.31 trillion in the UK – a country with almost four times Holland's 17 million people.

It also boasts good coverage. "There are not many employees who don't have a pension scheme. Just about 4-5 per cent," says employers organisation AWVN, head of the pensions advisory team, Leon Mooijman.

It is true that recent years have seen an increasing number of funds having to suspend indexation of their pensions to inflation. Under the financial assessment framework (FTK) governing the sector, indexation can usually only be paid at all when the funding ratio is at least 110 per cent (€110 in funds for every €100 of liabilities) and then at a reduced rate unless the ratio is higher – usually 120-130 per cent, depending on the fund.

Inflation, however, has been minimal – CPI inflation was 1 per cent in 2014 and just 0.6 per cent last year, the lowest since 1987, according to the country's Central Bureau of Statistics.

"It helps that inflation is very low. While it hurts if benefits are being cut what you lose is relatively little," says Mercer actuary and principal Marc Heemskerk.

Even now, with pension schemes' funding levels forcing them to look at actual discounts to payments, these are likely to be modest: estimates by the DNB in a report published in May show about two million members will face cuts in 2017, but these are likely to be 0.5 per cent on average.

So, why the crisis? One word, says Heemskerk: "Trust."

He adds: "10 years ago people thought their benefits were guaranteed and they would get inflation indexation every year. Then there wasn't enough money for indexation. Now benefits are being cut or people are afraid they are going to be. So, 10 years ago people thought they had a guarantee; now they think the system is worthless. The risk was never communicated."

The problem is also going to rapidly become one not simply of perception. In 2021, if nothing is done, the DNB estimates that cuts will be far more widespread and severe, affecting nine million people with cuts to benefits and accrued pension rights of 1.4 per cent for 10 years.

### Time for change

That's why Riemen supports proposals to change the system – broadly in line with the proposals put forward by government advisory body, the Social and Economic Council (SER) in May. Its central proposal is for a system that retains risk sharing for longevity and investment risk, but also decisively breaks with DB schemes that make up the majority in the Netherlands, replacing it with personal pension capital with collective risk sharing of longevity and investment risks.

It simply reflects the reality that DB in Netherlands has long since become unsustainable, he says: "In the recent past that was disguised because we had a young population and only a few pensioners, so any setbacks could be solved by raising premiums. Now we have pensioners living longer and fewer people in work paying the premiums. There's a limit to how much you can raise premiums. It's not fair between the generations."

The DB system doesn't just end up disappointing people, however. It actively works against getting the best outcomes, he adds. While low interest rates continue (and are unlikely to change in the foreseeable future, according to Knott), pensions regulations – and consequently investment policies – remain fixated on protecting the guarantee, limiting funds' flexibility.

"Pension funds are forced to try to fulfil this impossible guarantee and in this low-rate environment are still obliged to invest heavily in fixed income even though they get hardly any return," he says. "It would be better to have the freedom to have a

**THE COUNTRY NEEDS TO RETHINK THE PENSIONS GUARANTEE – OR, RATHER, ACCEPT THAT IT DOESN'T EXIST**

policy that gives members the best possible return. We don't have that right now. Therefore it is essential pension funds have the opportunity to choose alternative pension schemes in addition to those that exist now."

Nevertheless, change will not come overnight.

For a start, consensus only goes so far. Clifford Chance lawyer and University of Utrecht professor of international pensions law Hans van Meerten says: "Everybody more or less agrees the current so-called DB system is not sustainable, and that we should move to a DC arrangement. The question is how collective it should be."

The SER report failed to definitively answer a range of questions, says Van Meerten – particularly how the transition from the old to the new system should be managed. It also, while outlining the benefits of a collective DC arrangement, includes a range of potential options – including even the possibility of a reformed DB arrangement, which unions may favour.

"Really difficult questions are addressed, but they are not answered," he says. With elections due next year, the opportunity to do so without politics intruding has most likely been lost, he adds.

Towers Watson consultant Wichert Hoekert agrees it is unlikely to dramatically change in the next couple of years.

"Given that it probably won't be that easy to form a new government in the current political landscape, that will bring us well into 2018 before any proposals can probably be expected. For those to be brought though both upper and lower house puts us into 2019, big changes in the pension system are probably not feasible until 2020," he says. It could be much longer.

Realistically schemes will be dealing with the system as it is for the foreseeable future.

## Time to talk

For some that will mean continuing to look at their investment policies, but most are limited with what they can do, and even if there were freedom, the current environment does not make it easy to boost returns. About a third of the 180 funds with recovery plans took a one-off opportunity given by the regulator with the revisions to the FTK last year to review and increase their risk profile. For many, though, this has proved unfruitful to date; the DNB's update in May showed those 60 had seen their funding ratios decrease more than average in the first quarter, largely as a result of reducing interest rate hedges while rates have decreased.

There's also likely to be further consolidation – with smaller funds merging or joining one of the new APFs – the general pension fund model that allows multiple plans overseen by a single independent board, with ring-fenced assets.

"We're expecting these to come in by the summer," says Aon Hewitt senior ALM consultant Corine Reedijk.

A survey by insurer Centraal Beheer Achmea published in March found that 16 per cent of employers with their own pension fund and knowledge of the APF vehicle would consider moving to it. Some others may consider moving to an IORP based in Belgium, says Reedijk, as the €1.2 billion Dutch pension fund for BP plans to do later this year.

For many, though, and particularly the larger of the industry-wide schemes that cover the majority of the Dutch workforce, the options are limited. For them, it is primarily a case of expectation management. In May, the Authority for the Financial Markets, responsible for overseeing pensions communications, proposed periodic updates to ensure scheme members have realistic expectations in terms of indexation or potential cuts.

Already, though, Mooijman says employers are increasingly taking it on themselves to reach out to staff about pensions. "Traditionally a lot of employers have discussed issues like pensions only via the labour unions. Now we're seeing employers really wanting to speak to the whole employee population to get their experiences of the pension systems. That is at least one good development." ■

# Structuring reform

PETER DAVY SPEAKS TO SER MEMBER FIEKE VAN DER LECQ ABOUT ITS PROPOSALS TO REFORM THE NETHERLANDS' SECOND PILLAR PENSIONS SYSTEM

Fieke van der Lecq is a part-time professor of pension markets at Vrije Universiteit Amsterdam and a member of the Financial Reporting and Accountancy Committee at AFM. She is also a crown-appointed member of the Sociaal-Economische Raad (SER) – the Social and Economic Council, which advises the Dutch government on social and economic policy. There she has chaired a working group developing a new type of pension scheme and played a key role in the development of the May report on reform of the second pillar pensions system.

**What were the key challenges the SER was seeking to address with its proposals?**
The issues we addressed in our February 2015 report are quite similar to other countries – the demographic transition; financial markets, where returns are low and we are in a low interest environment; and the societal development towards greater individualism. In short, its demography, financial markets and public opinion – those are the three big ones. In the subsequent report of May 2016 we developed a new type of pension plan, as well as a transition path to get there.

**How much of the financial markets issue is simply down to interest rates?**
It's not just interest rates; returns in general are challenging. But the low rates have a particular impact on defined benefit systems where you have to discount liabilities against some sort of interest rate, and these rates are particularly low. That's a huge challenge, and it's very difficult to compensate for the increase in liabilities with any increase in the asset returns.

**But how serious is the funding problem if we're still talking about a funding ratio of 96 per cent on average? It doesn't sound too bad compared to other countries.**
No, but, first, the funding ratios are still declining and, second, the supervisory system here is such that it is not allowed to decline much lower without forcing cuts. We don't operate an underfunded system, unlike other countries that are used to them.

The problem is then that people expect a particular level of pension benefit and when they learn they are not going to get it, it generates a lot of distrust. The system's reputation is at stake. And the pension cuts can be material. We've lost indexation for years, which is a silent way of cutting, and now we face explicit cuts. That makes retirees' future income insecure, and that's a fact, not just a perception. Added to that, participation in the schemes is mandatory, so they feel imprisoned in a system that isn't delivering what they expected.

**How do the SER proposals address these challenges?**
We've developed a mechanism for a plan that can have both individual pension pots and risk sharing, first for investment return risk, and second for macro longevity risk – the population as a whole becoming older than expected.

For the investment risk, we've developed a buffer scheme so that when there are very high investment returns they flow from individual pots to the buffer, and when investment returns are very low the personal pots are funded by the buffer. For the macro longevity risk we've presented two options: a type of swap contract between older and younger generations, so the younger take the longevity risk and are financially compensated for it; or a mechanism by which the longevity risk is spread between different age cohorts in the plan.

The crucial difference, though, is that, first, the new scheme is more explicit in terms of the personal pension pot; people can see it's really their account, which is invested according to their stage in the life cycle, and they get individual statements. Second, there are very explicit, defined rules for how the risk sharing in terms of the buffer works, whereas traditionally risk sharing has been much more implicit and at the discretion of the pension fund board.

**Why have you seen it as important to retain collectivism? Why not just go to a simple individual defined contribution system?**
Because the results are better for nearly all

involved. The ALM studies showed the result of collectivism is to cut some of the extreme results for small groups of members on both the upside and downside, while making results overall much better in terms of the benefits and limiting the risk of pension cuts. It's a bit more difficult to explain, but people understand that sharing risk can be profitable.

**But it would still spell the end of defined benefits in the Netherlands.**
Frankly speaking we don't have much left of defined benefit anyway. We are already making a transition to collective DC that has a fixed contribution for the employer but a DB kind of idea for the employee; it's currently a kind of hybrid.

**The central bank president says we need to move to a new system quickly. Can you explain that urgency?**
The urgency is that the system is not sustainable and if coverage rates are declining year on year that makes it even more difficult to make the transition to the new system.

**Given elections next year, when are we likely to see any substantive changes to the system?**
That's a very difficult one. Opinions vary, but before 2020 would be a miracle – in terms of implementation, at least. Let's hope we can have agreement and legislation by that time so we can start implementing, but even that is still quite ambitious. ■

*Written by Peter Davy*

## Interview - ABP

# Accepting change

**PETER DAVY DISCUSSES WITH ABP'S CHAIRPERSON CORIEN WORTMANN-KOOL THE NEED FOR CHANGE WITHIN THE DUTCH OCCUPATIONAL PENSIONS SYSTEM**

ABP, the scheme for government workers and teachers is the Netherlands' – and Europe's – largest pension fund. With 2.8 million members, about one in six of the population, it had €359 billion in assets as of 31 March 2016.

It is also significantly underfunded. Its latest figures show a coverage ratio of just over 91 per cent, down from 97 per cent at the end of the first quarter and from 101 per cent at the end of the second quarter of last year. Liabilities increased by €36 billion in the first quarter alone as a result of a fall in the interest rate of 0.5 per cent.

Not having provided indexation to inflation since 2010, the fund is now looking at cuts in pensions next year. “We are in the danger zone and that means a reduction in pensions in 2017 is a distinct possibility,” says the scheme's chairperson Corien Wortmann-Kool.

That would be disappointing for the members; there was another cut in 2013, but only for one year, while the new cuts would be longer-term, about €3.50 to €7 a month for the average pensioner income of €700 a month.

It's likely to lead to a lot of criticism, but there's little the fund can do, she adds. It increased premiums from 1 April this year by 1 per cent, but this will not be enough to stave off cuts. It cannot change interest rates or financial markets, says Wortmann-Kool.

In fact, despite the funding problems the scheme's asset allocation remained broadly the same in recent years.

It remains split with about a third in fixed income (split between treasuries and credit, with a small allocation (about 2 per cent) to emerging-market debt; 9 per cent in inflation-linked debt; about 30 per cent in equities (22 per cent in developed markets and 8 per cent EM); and then a little over a quarter of the portfolio in alternative investments, with real estate (10 per cent), hedge funds and private equity (5 per cent each) the biggest allocations.

Last year the portfolio returned 2.7 per cent, while its coverage ratio declined steadily.

The biggest shift over the past couple of years has been to boost its emphasis on sustainable investments, says Wortmann-Kool. ■

*Written by Peter Davy*

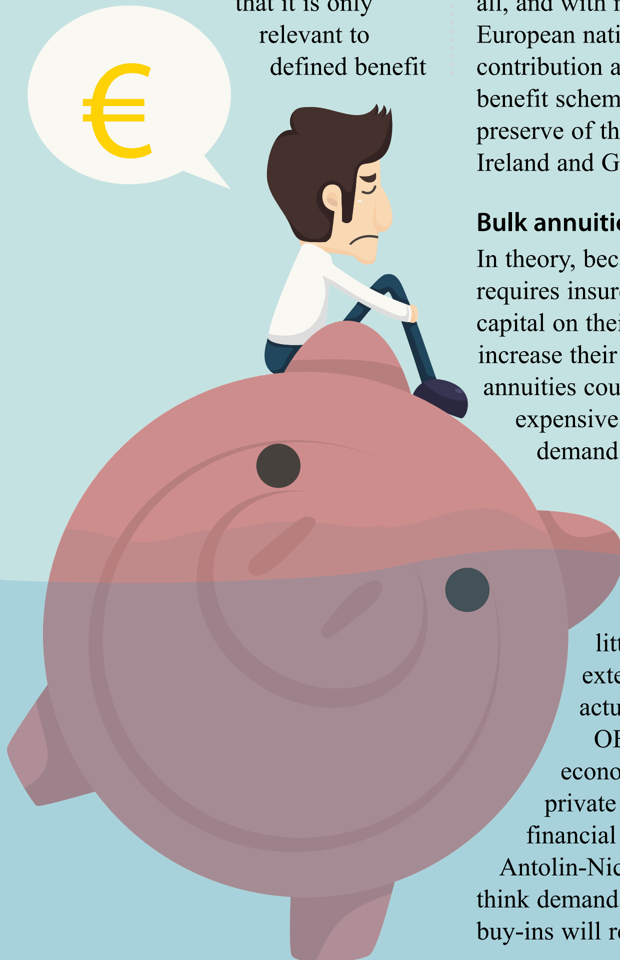
DE-RISKING

# More money, more problems?

**Edmund Tirbutt explores whether the Solvency II Directive is impacting upon the price of bulk annuity deals**

**WRITTEN BY** NICK MARTINDALE, A FREELANCE JOURNALIST

It's still early days, but the impact on European pension funds of the Solvency II Directive, that European insurers have been required to comply with since January 2016, has hardly been earth-shattering. The main limiting factor is that it is only relevant to defined benefit schemes – which may wish to consider insurance-based de-risking solutions like buyouts, buy-ins and longevity hedges.




With countries like France, Italy and Spain having little in the way of private sector pension provision at all, and with many of the emerging European nations using a defined contribution approach, defined benefit schemes are largely the preserve of the UK, the Netherlands, Ireland and Germany.

## Bulk annuities

In theory, because Solvency II requires insurers to hold more capital on their balance sheet if they increase their risk profile, their bulk annuities could become more expensive and this could reduce demand for them from pension schemes. But when experts talk about the defined benefit scheme countries collectively there is little agreement about the extent to which this is actually happening.

OECD principal economist and head of the private pensions unit, financial affairs division Pablo Antolin-Nicolas says: "I don't think demand for buyouts and buy-ins will really slow down that much as pension funds want to get rid of the risk, but on the supply side insurers may be thinking of increasing prices. So it may have an impact but it will take one or two years for the situation to become clear."

Punter Southall head of buyout Alan Wilkes has seen differences in premiums throughout Europe widen this year to around 10 per cent as insurers get to grips with what Solvency II means for their reserving. He reports that the price impact on existing pensioners has been negligible but that there has been an increase of around 5 per cent for non-pensioners because of the importance of getting matching adjustments right – so some pension schemes have decided not to purchase bulk annuities for non-pensioners.

Willis Towers Watson director of global services and solutions David Finn feels that prices have increased by 1 per cent to 2 per cent for pensioners but by up to 10 per cent for non-pensioners. But he stresses that, because demand for non-pensioner bulk annuities has always been comparatively limited, the impact has been minimal.

Independent trustee firm PTL client director Colin Richardson confirms that non-pensioners have been affected more than pensioners but also highlights that there has been a greater impact on buyouts than buy-ins, as the former are harder for insurers to match with assets.

Additionally, many commentators emphasise that it can be hard to distinguish the impact of Solvency II from that of other factors. BNY Mellon pensions and insurance segments leader Paul Traynor observes that Solvency II hasn't altered the general appetite amongst European insurers to offer buyouts and buy-ins and that, whilst some are reluctant to do so, this is mainly for reasons of their own books.

Russell investments head of client

strategy and research EMEA, David Rae reports a drop in demand for bulk annuities during the first quarter of 2016 but feels this has been more the result of market volatility than Solvency II. Mercer European financial strategy group partner John O'Brien feels that Solvency II arguably hasn't yet resulted in any major price changes but that it's hard to distinguish its impact from underlying interest rates and market movements.

### Individual countries

One reason that feedback is so diverse is probably that different commentators are more heavily involved with some countries than others, and it is clear from experts resident in those countries that Solvency II has affected them in different ways.

DLA Piper partner Marco Arteaga explains that because so few pension funds in Germany are funded at all, Solvency II is of little relevance. The total of all occupational pension assets in the country amounts to €538.5 billion but annuities account for only €58.9 billion of these.

He says: "Many of the schemes that are funded don't want to do bulk annuities as they have their own captive insurers or want to continue with the risk. Additionally, even if they wanted to do them, they might not be in a good enough funding position."

Irish Association of Pension Funds (IAPF) CEO Jerry Moriarty says: "There wasn't a huge amount of value in buyouts before Solvency II as Irish pension funds were already required to value their funds according to what would happen if they wound up. The only real advantage of buyouts is to have future pensioner liabilities off the books but there isn't a significant enough cost advantage to create a market, although I think some UK insurers have been looking at the Irish market to see if there are buyout opportunities."

In the Netherlands, which had already had similar regulatory funding provisions to Solvency II for decades, the impact doesn't seem to have been any greater. Although most employees are still theoretically in defined benefit schemes, the risk in these has effectively been transferred from employer to employee.

Robeco executive director European pensions, investment research, Jacqueline Lommen says: "Insurers in the Netherlands have stopped underwriting pensions solutions and they are now doing asset management instead. I think that all countries where the institutions have solvency issues are likely to follow us down this route."

In the UK, where the impact of Solvency II has been greatest, feedback is mixed. Lincoln Pensions managing director Alex Hutton-Mills observes that it seems to have been "business as usual" amongst the main bulk annuity providers during the first quarter of this year. Standard Life investment director for insurance solutions Bruce Porteous feels that the UK could arrive at a situation in which schemes close to being fully funded could still afford the more expensive buyouts and buy-ins resulting from Solvency II but those with big deficits will not be able to afford them – and could simply run out of money.

### Other areas affected

Solvency II has also indirectly affected many European pension schemes by making insurers invest more heavily in assets like infrastructure and corporate bonds, making them more expensive for pension schemes to invest in.

AXA Investment Managers head of solutions research LDI Shajahan Alam says: "Insurers using international corporate bonds have to hedge currency risk to comply with Solvency II matching adjustment requirements. If it becomes more onerous for them to hold these they will look to local markets instead. This will raise the price of domestic corporate bonds for pension schemes, which may therefore diversify into international corporate bonds as they don't have to comply with Solvency II requirements."

There is also a significant knock-on effect from Solvency II to European reinsurers as a result of insurers wanting to lay off longevity risk, which is particularly capital intensive under the new regime.

Aon Hewitt head of risk settlement and senior partner Martin Bird says: "There is a drive by European pension funds to transfer longevity risk to insurers via hedging mechanisms as alternatives to buyouts and buy-ins, and insurers are feeling it makes sense to hedge the risk in the reinsurance market rather than keep it on the balance sheet.

"Pension funds and insurers across Europe are chasing the same reinsurance capacity, so when either go to market they need a thoughtful and well-prepared approach to check they get the right capacity and price."

Reinsurers are coming up with innovative solutions to help with this increased demand, which should result in keener pricing. Innovation from insurers, however, is currently less evident but could emerge further down the line. One particular area to watch involves work being done on pooling smaller schemes so that they can obtain similar terms to bigger schemes for buyouts and buy-ins.

Punter Southall's Alan Wilkes concludes: "It's going to be interesting to see how this market develops. The smaller schemes may have different funding levels and levels of security provided by the sponsor, so there are real challenges to be overcome." ■

ENGAGEMENT

# Time to engage

**David Adams explores the differing degrees of employer engagement with second pillar pensions**

WRITTEN BY DAVID ADAMS, A FREELANCE JOURNALIST

If future generations of Europeans are to have a decent income in retirement, occupational pensions will need to play a bigger role – in some countries a much bigger role – than they do today. That places a great responsibility on employers. Second pillar pensions require support from employers, even if it goes no further than a minimal employer's contribution.

Across the different countries of Europe, the extent to which employers are actively engaged in supporting their employees' efforts to save for retirement varies hugely, by country, by industry, by organisation or scheme size, or culture. But although this makes generalisations both difficult and potentially misleading, some themes are visible almost everywhere.

## Low interest rates

Arguably the most important is the low interest-rate environment, which has helped to make sponsoring a DB scheme unaffordable for many employers across Europe. "This is the main reason why in countries like the UK almost all DB schemes have closed, or have closed to new accrual," says Pensions Europe secretary-general and CEO Matti Leppälä. "Employers cannot continue to have these liabilities on their balance sheets."

This has led to one near universal trend in countries where the second pillar is well developed. "Everywhere there is a shift from DB to DC," says director of the European Association of Paritarian Institutions (AEIP), Francesco Briganti. "All the new schemes are DC. Even in a country like the Netherlands, which was a paradise for DB schemes, employers do not want to put more money into that system."

It is not always true to say that a DC pension is inferior to a DB pension, but it is often the case that contributions made by both employers and employees to DC schemes are lower than those seen in DB schemes. While some employers may regard this as someone else's problem, others are concerned by the possible implications, in particular the reputational damage they could sustain if it looks as if they have neglected their employees. There is also the potential issue of the modest size of some employees' pension pots driving them to continue working beyond what would otherwise have been the point of retirement.

"That's a problem for many employers, because they need more of a turnover in the workforce," says Mercer senior associate Anne Bennett. In other cases, employers may want to provide better pensions for older workers as part of benefits and working conditions that persuade them to continue to work for the organisation in some way beyond retirement age – perhaps because they have specific skills that are difficult to replace. "Either way pension provision is a part of addressing those issues," says Bennett.

Willis Towers Watson global services and solutions group director Nigel Bateman suggests that a growing number of employers across Europe, particularly multinational companies, now recognise that a DC scheme needs to do more than provide the bare minimum. "If you help employees get the best out of the scheme you are helping to protect the business," he says. Many employers across Europe are redefining the pensions offers they make to employees within broader benefit packages being used to attract and retain staff.

## Local factors

The extent to which employers are prepared to engage with pensions may vary because of local factors. In the UK, Switzerland and Denmark employers must offer

employees some pension provision; as must employers in the Netherlands, through collective DC schemes; and in France, through collective schemes offering DB arrangements. In the Netherlands and Denmark many occupational pension schemes are based on collective agreements often influenced by trade unions – which can influence the nature of pension provision in any country where unionisation is widespread, such as the Nordic countries and the Netherlands.

Employer engagement in pensions may also be increasing in countries where the first pillar has traditionally been the predominant source of retirement income, like Italy or Portugal; and in some eastern European countries where occupational pensions barely existed until very recently. In the former group of countries the state is often drawing back from previous commitments to provide retirement income, driving employers and pension providers to fill the gap.

However, in some countries the odds are stacked against strong growth of the second pillar. In Italy, the existence of very high contributions for the state system (employer contributions of 20 per cent plus another 10 per cent from the employee); and Italy's unique Trattamento di fine Rapporto (TFR – a severance pay fund to which all employers have to contribute, paid out as a lump sum at retirement) mean that, as Briganti puts it, "there is not a big margin to develop occupational pensions". But he believes this could change in Italy and elsewhere as first pillar systems become less generous, and more employers start to use pensions and other benefits to attract employees.

Some multinationals are also competing for employees by offering attractive benefits packages in eastern European countries, as they expand into new markets and/or relocate business functions to those countries. As yet, says Briganti, not many local employers in those countries appear to be following their lead, but he thinks that at some stage a combination of market forces and the decline of first pillar provision may persuade more of them to do so.

### Auto-enrolment

Sometimes employer engagement is mandated by the state. Auto-enrolment has undoubtedly been a success in the UK to date, with around six million extra pension savers having been enrolled in schemes and opt-out rates remaining lower than had been predicted since employers began to join the system in 2012. But whether this will continue to be the case as the smallest employers auto-enrol employees over the next two years remains to be seen. At least some small employers will regard auto-enrolment as a cost rather than a benefit, while some low-earning employees will feel they can't afford to save from their salaries. There are also concerns that opt-out rates will increase as contributions are increased over the next few years.

Even so, policymakers in countries where second pillar provision is currently at a low level, including Ireland, Germany and Italy are considering the introduction of some form of auto-enrolment. In Ireland second pillar coverage remains below 40 per cent. "It's very difficult to close that gap by continuing with a voluntary system, so we need to consider some form of mandatory or semi-mandatory system," Irish Association of Pension Funds (IAPF) CEO Jerry Moriarty says.

He would be happy to see auto-enrolment introduced in Ireland and suggests that if opt outs increased over time in industries where salaries are often low or where employees tend to move between employers frequently, then creating industry-wide collective schemes might help to counter those factors.

Tax incentives are, of course, a key factor in determining the degree of employer (and employee) engagement with pensions – but some changes to tax rules could end up having negative effects. Bateman suggests that reductions in annual and lifetime allowances for pension savings in the UK may be colouring decision makers' attitudes to the scheme used by their colleagues. "These people are often decision makers, so there is a possibility that if those changes lead to them being disengaged with the pension scheme you may see a shift in the organisation's treatment of the scheme overall," he says.

It does not look as if the EU will be a particularly helpful source of encouragement for employer engagement in the near future: Moriarty is critical of the actions of EU legislators and regulators in relation to pensions – noting a contradiction between the European Commission's pledge to close the pensions gap and EIOPA's drive to introduce tougher regulatory measures that could make supporting pension schemes more difficult for employers.

But whatever the means used, it is clear that most countries in Europe need to improve second pillar provision and that means greater employer engagement. Bateman sees reasons to be optimistic. "More organisations are remembering that the point of these programmes is not to give actuaries jobs but to provide something for employees," he says. "The most thoughtful employers will recognise that this offers an opportunity to engage with employees, to try to get the best out of them and do the best for them – and for the employer." ■

LONGEVITY

# The number conundrum

**Peter Carvill explores the challenges politicians face when attempting to link state pension age with changing longevity stats**

**WRITTEN BY** PETER CARVILL, A FREELANCE JOURNALIST

The European pensions landscape is challenged, compounded by a lack of pension savings from a decreasing youth population and a growing retiree population. In November, the European Commission said that the population aged 60 and over was growing by two million people each year across Europe, a rate double that of the late 1990s and early 2000s. A separate report — *European Union Pension Systems: Adequate and Sustainable?* — outlines that even today, a quarter of citizens in the European Union rely on their pension income. More chillingly, the life expectancy of people—and the amount of time they will spend in retirement — has not only increased but is expected to further grow: in the 28 countries of the European Union (still including the UK), remaining life expectancy after the age of 65 is set to climb from 17.6 and 21 years for men and women respectively in 2013, to 22.4 and 25.6 years in 2060. Other statistics predict that the EU will move from having four people of working age for every person over the age of 65 to having just two by 2060.

There is, then a clear and present need for reform: in fact, the authors of *European Union Pension Systems: Adequate and Sustainable?* state, "There is the risk that inadequate pensions may, through public pressure, lead to ad hoc increases in pensions or other support, jeopardising sustainability. Similarly unaffordable pension systems that are not reformed will ultimately collapse under the weight of ageing populations, and so prove inadequate." Or, according to *European Semester Thematic Fiche: Adequacy and Sustainability of Pensions*, "to be sustainable in the long run, public pension schemes must be able to absorb the impact of population ageing without destabilising public finances".

## Resolutions

There have been moves across the continent to address the problem: 27 of the current 28 European countries have plans to increase their retirement ages, these raises usually coming in increments of one to two years. Such increases are also global, with Canada, Iceland, Japan, Norway, Switzerland, and the US planning to extend the working lives of their populations. But not all the increases across Europe have been linked to longevity—while Denmark, Greece, Italy, the Netherlands, Portugal and Slovakia have linked their retirement ages to expected life expectancy, other countries such as the UK have only taken longevity as one factor in their calculation.

However, not all countries are moving in this direction: Luxembourg seems to be maintaining its pension age at 65, and Poland bumped its retirement age from 65 for men and sixty for women to 67 for both, before then deciding to reverse this change.

Poland's move and counter-move drew the criticism of the International Monetary Fund (IMF). That body

said in a statement: "With a rapidly ageing population, preventing the retirement age from increasing gradually as currently envisaged would be a step in the wrong direction." The IMF has also been forthright in advising Germany to link its retirement age to life expectancy, saying that such a move would be ultimately actuarially neutral for those deciding on whether to remain in work or retire.

The simplest, most base answer as to how to solve this crisis, Spencer & Partners director Hugh Nolan says, is for people to save more. "If you want a 30-year pension rather than a 25-year one, you need to pay more," he says. "The average life expectancy is about 87 years now so you're looking at 22 or 23 years of retirement. If someone only joins a pension scheme in their mid-forties, that means they're paying in for 20 years and then getting a payout for 20 years. You only get out what you put in. So if you only put in 10 per cent, that's not a great situation."

### Developments

The pegging of retirement age to longevity is a recent development. When state pensions were first introduced, the assumption was that those collecting them would survive no more than a few years past their retirement, with the pension visualised as more of a top-up to personal savings.

"State pensions in the UK," says The Pensions Management Institute technical consultant Tim Middleton "were fixed in 1940 when life expectancy was far less than it is now. The first change to that was the Barber Judgement, which pushed women's retirements ages to the same levels as men. But it had nothing to do with longevity. It was about inequality instead. So there ended up being over half a century in the UK where longevity improved but there was no development alongside that. It's been catch up ever since."

The report *European Semester Thematic Fiche: Adequacy and Sustainability of Pensions* elucidates this point: "Yet most Member States that have raised and linked the pensionable age to life expectancy and significantly reduced access to early retirement have room for further and more comprehensive measures to underpin these reforms with changes in employment policies and workplace and labour market practices to enable people to continue in employment as pensionable ages go up. Absent these conditions, there is an increasing risk that pressures on other benefits such as unemployment, sickness and social assistance benefits will mount as people are unable to work to higher pensionable ages."

There are difficulties with approaching the pensions gap solely from the direction of longevity. To begin with, longevity is a prediction and anecdotal evidence suggests that in three of the last four years, life expectancy has either fallen or remained static. A blanket, state-wide retirement age based on average lifespan also fails to recognise that that value shifts geographically and across the social spectrum: those living in the south of England tend to live longer than their northern counterparts, and those with white collars tend to outlive those with blue.

"If you set a policy where the state retirement age is dictated by longevity," says UK independent trustee firm PTL managing director Richard Butcher, "everyone will lose out to an extent. There are still some areas of the population in larger cities where life expectancy is below 70 years. That means there will be some people that won't live long enough to collect their state pension. Such a thing is a blunt instrument and glosses over many of these issues."

Taking a forthright role in tackling the pensions problem could be political suicide—most governments around Europe are elected every four to five years, while those paying into a national pension system now will only see the benefits of that two, three, and even four decades from today. And those about to retire soon are also the ones most likely to vote. Any move from any government to increase working life or reduce retirement entitlement may see one party shoved out of office to make way for another.

The elephant in the room is however that many civil service pension schemes — paid for by central and local taxes —are themselves unsustainable. "If you've got a public service pension scheme," says Middleton, "that's usually a defined benefits scheme. There's very little provision of that in the private sector. Historically, there's always been an understanding that people in the public sector might not have been well-paid but they had better pension benefits. That's an idea that's been challenged by those saying they weren't well paid before they retired. And it's a problem with the larger public sector pension schemes because there's a strain on public finances."

The focus has been on longevity increasing. However, as mentioned earlier, there has only been a significant increase in one year of the last four. "The last thing to consider," Middleton states, "is the question of what would a government do if, in linking the retirement age to longevity, that that number would peak. How about a generation with a bad diet and doesn't exercise? What if those numbers declined? Would governments then consider reducing the retirement age?" ■

SECURITY

# Defence mechanisms

**Nick Martindale examines how cybercrime is affecting pension funds across Europe and the tactics that trustees need to put in place to combat this growing problem**

WRITTEN BY NICK MARTINDALE, A FREELANCE JOURNALIST

It is a sad fact of life that wherever there are large volumes of money – or data that could lead to funds – criminal activity is not far behind. It's why banks have traditionally used vaults to protect physical cash, and also why there is so much attention focused on the danger from cyberattacks today. According to Jupiter Research, the cost of cybercrime quadrupled between 2013 and 2015, and is expected to do so again by 2019, by which time it will cost as much as $2.1 trillion a year.

### Vulnerability

Along with other parts of the financial services sector, pension funds are an inevitable target for such activity. "The scale of technology adoption, coupled with the role of pension funds as custodians of high-value financial and personal data, has made the industry a prime target for cybercriminals," Stroz Friedberg director of cyber resilience Simon Viney says.

There are a number of ways in which funds could be vulnerable. Perhaps most obvious is the kind of hacking attack that affected telecoms giant TalkTalk in 2015, which saw 157,000 customer details stolen at a cost to the business of £35 million, or the attack on the Japanese Pension Service, which resulted in unauthorised access to more than one million records.

"Pensions data is extremely valuable – it's people's identities, whereabouts and financial circumstance," Blue Goose managing director Chris Barrington comments. "Pension funds have a responsibility to completely safeguard customers from scammers and fraudsters and must ensure that they have robust technical and operational defences but, equally importantly, that their employees are equipped to be aware, alert and able to deal with the threats."

Radware's Northern EMEA region regional director Adrian Crawley says the financial services sector is particularly vulnerable to so-called distributed denial of service attacks, which can then be used as a prelude to accessing sensitive data. "Smokescreen attacks are more common in financial services than any other industry after government, especially now that attackers are using automation and robots to run attacks," he says. "'Cyberbots' are a big problem because they can be left to run unattended for days, even months, and cause untold damage."

Organisations tend not to focus on the data risk, he adds, instead seeing such attacks as a way of causing inconvenience.

### Technology

The growing use of cloud technology, partly as a solution to more onerous data protection rules, has also made pension funds more vulnerable to attacks, Veratta information officer Rosin McKeever contends. "By using these services for elements such as the management of pension funds, companies can store near limitless volumes of data at a considerably reduced cost," she says.

"However, these solutions also bring their own risks. Decision makers and trustees responsible for evaluating potential pension fund solutions must ensure that their service provider has resilient control mechanisms and strong working practices, which guarantee the safety of their members' data and are compliant with all relevant legislation, depending on geographical location."

The recent decision by the German pension insurer Deutsche Rentenversicherung Bund (German Federal Pension Insurance) to increase its use of open source software is another example of the direction in which firms are now moving. The logic here in terms of lower costs and speed of application development is sound, Black Duck director of strategic communications

Brian Carter states, but it could also leave funds exposed to incidents.

"In commercial applications, open source software often makes up 50 per cent or more of the code," he says. "While many organisations recognise the importance of running automated inventory and tracking processes of their open source code to find and remediate known open source vulnerabilities, many need to do better." A study by Black Duck of open source security audits on 200 commercial applications found that nearly 70 per cent contained known open source vulnerabilities, and that 35 per cent of those vulnerabilities were rated severe, he adds.

Indeed, third-party partners can pose just as big a risk to organisations as their own internal weaknesses. "The recent public cyberattacks in relation to one of the key global payment systems has provided a timely reminder of the potential vulnerabilities facing the wider financial services ecosystem, well beyond one particular institution," Viney points out.

Consumers can also be targets, and the UK is particularly vulnerable as a result of the pensions freedom reforms, which have opened up pensions to direct access by consumers, Deloitte cyber risk services director Andrew Johnson says. "Pensions are becoming much more like current accounts and, with funds more accessible, this causes greater concern for pension funds," he says. "Online platforms to access and manage pensions are evolving quickly as part of a broader push to digital business models within the pensions sector. This creates new vulnerabilities that pension funds need to control. Online customer registration and validation, for example, are key areas that need to be managed well."

This is less likely to be an issue in other European countries, Mercer partner and professional lead Deborah Cooper adds. "I can't think of any country in Europe where individuals can access their savings," she says. "In France it's largely state provided; in Germany and the Netherlands pretty much all employer-sponsored funding is done through a scheme that is administered by a standalone administrator, and in Denmark and other Scandinavian countries, although there are funds and members do choose where they're invested, they can't access them directly."

Yet, despite the threat, the issue of cybercrime does not get the attention it warrants, particularly from employers, Trafalgar House business operations manager Phil Claridge believes. "In our experience, data protection and security is something covered as part of a tender process but is rarely, if ever, subject to review or testing on an ongoing basis," he says. "Trustees should regularly review their own processes and procedures and those of their providers. They should not be afraid to ask difficult questions of their providers to ensure they are satisfied with the solutions in place and that the risks are understood."

### Counter initiatives

There are plenty of steps funds can take to make themselves less likely to fall victim to cybercriminals. Altus Consulting head of technical architecture Michael James says internal fraud measures should include training employees around the dangers and running background checks on employees and business partners, while external steps include encrypting data and the use of firewalls and passwords, as well as controlling access to that information.

"This means the use of external data to validate people and the context of the transaction, just as credit card and banking transactions are validated," he advises. "Credit reference agencies often provide identity verification services on behalf of firms." This is even more important for pension providers, he adds, as they tend not to have frequent interactions with customers, making it harder to identify suspicious behaviour or unusual trends.

New rules are also coming in that will force organisations to pay greater scrutiny to this issue, says McKeever, including the EU General Data Protection Regulation coming into force in May 2018 and the EU-US Privacy Shield governing the handling of data concerning EU citizens.

Pension funds and employers should also draw up plans that would enable them to respond should they be affected by a breach. "Many organisations are increasingly accepting that a cyberattack is inevitable," Burges Salmon partner Clive Pugh emphasises. "A response plan should not only deal with remedying the breach, and addressing flaws in the trustee's operations, but also managing the effects of the breach through communicating with stakeholders and, where necessary, self reporting to regulators."

The challenge for the industry going forward is two fold: to ensure it understands the danger it faces today from cybercrime and, secondly, to keep up with new threats in a rapidly changing environment. "Cyber attacks have risen significantly in the past year and are expected to continue to increase in the years ahead," says Viney. "Pension funds need to ensure they are positioned to appropriately and proportionally manage these threats, factoring in the security of the organisation, as well as protecting the security of its customers." ■

# Currency risk management roundtable:
## AN EYE ON THE FUTURE

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**Key Points:**

- *The growing consensus is that it is inappropriate for pension funds to regard currency as an asset class.*
- *There is no such thing as a universally applicable optimal hedge ratio. Each fund needs to evaluate which ratio is appropriate based on its asset allocation strategy as well as its risk tolerance and asset-liability management model.*
- *Inertia is not an option for pension funds under increasing regulatory pressure to minimise the costs of managing their FX exposure and achieving best execution in the currency market.*
- *Rather than insourcing FX risk management or outsourcing it to multiple managers or custodians, pension schemes could generate substantial cost savings by outsourcing the process to a single service provider.*

**NOBBY CLARK**

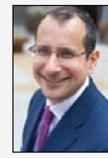
**MD Client Solutions Group, HSBC Global Banking & Markets**

Nobby Clarke joined HSBC in 1989, focusing on UK interest rate swaps and options trading sales and has held various roles since. Nobby founded the pension solutions team in 2004 with the objective of deepening HSBC's relationship with its customer base by bringing holistic solutions to their complex pensions issues. Nobby also was tasked by senior management with providing solutions for managing HSBC's own pension risk.

**KATE WRIGHT**

**Director - Institutional FX Sales, HSBC Global Banking & Markets**

Kate Wright is director, head of EMEA FX Fund Solution Sales and Global Co-Ordinator of FX Overlay at HSBC Global Banking and Markets. Kate has 20 years of experience in foreign exchange and has always worked in institutional sales with a focus on real money and hedge fund accounts. Kate joined HSBC in 2005 as head of the UK real money FX sales team. She was appointed to her current role in early 2014.



**SIMON COHEN**

**CIO of Dalriada Trustees**

Simon Cohen is an experienced pensions investment actuary and is the CIO at Dalriada. He deals with a range of pension scheme clients on investment matters, including asset strategy and manager selection. Simon joined Dalriada in 2015. He entered the pensions industry in 1994 and became a fellow of the UK's Institute and Faculty of Actuaries in 2000. He has worked for three major investment consultancies holding senior roles in consulting and management positions.

**LUCINDA DOWNING**
**Asset Allocation Researcher, Aon Hewitt**
Lucinda Downing develops asset class views within Aon Hewitt's global asset allocation team for investment advisory and delegated consulting clients. She was previously director of balanced funds at Russell Investments where she structured and managed multi-asset, multi-manager funds. Before then, she was a portfolio manager at State Street Global Advisors, where she managed bond and currency portfolios and created forecasting models.

**CLIVE GILCHRIST**
**Deputy Chairman, BESTrustees**
Clive Gilchrist has over 40 years' experience of the pensions and investment industries and was, until 2010, managing director of BESTrustees plc since its inception in 1992. His early career was in stock broking and investment management, including 10 years as investment manager/director at the Post Office S.S.F./PosTel (now Hermes). He was a member of the Pensions and Lifetime Savings Association Council and Investment Committee for many years.

**CHRIS PARROTT**
**Head of Pensions, Heathrow Airport Holdings Ltd**
Chris Parrott is responsible for the operation of all group pension arrangements and insured benefits at Heathrow Airport Holdings. He has been working in occupational pensions since 1982 and is a fellow of the UK's Pensions Management Institute; a member of the Advisory Council for the European arm of the Association of Investment Managers Sales Executives (AIMSE Europe); and of the Pensions Committee of the 100 Group.

**NEIL MCPHERSON**
**Managing Director, Capital Cranfield Trustees**
Neil McPherson joined Capital Cranfield in August 2014 as managing director and a member of the company's board. Neil is responsible for Capital Cranfield's commercial, operational and business development activities. Neil has extensive commercial and fiduciary experience working with pension funds over a 30 year career. At Citigroup, he established Citigroup Asset Management's European retirement services business and was a trustee of the UK pension scheme.

**Clark**: What is the general sentiment among pension funds with respect to currency risk management?

» **McPherson**: I surveyed my client directors – we have 38 trustees around the country – and I asked for their views on currency across the piste, both as an investment opportunity and a risk to be managed, and the over whelming opinion was to hedge it out completely. There were a few dissenters, but otherwise it was regarded as an unrewarded risk and that you should get rid of it.

» **Cohen**: I am of a similar opinion. There is a negative view about investing in currency as an asset class to provide a return – looking around at historical performance of currency, it doesn't seem to have performed particularly well.

» **Gilchrist**: I would agree, although most of our clients probably aren't hedged completely, rather they are hedged to a significant percentage as that is a more efficient way of doing it – there is no point paying for the last few per cent.

» **Parrott**: I would agree with everything that has been said. As an asset class I don't think it comes to the table very often. Certainly with schemes I have managed we have had our fingers burnt with currency so it would take an awful lot to persuade me that it is something to get back into. That said, I am with Neil *[McPherson]* around hedging as much as you possibly can, particularly if you are moving towards the end of a de-risking path. For those still seeking return, the places you have to go to will inevitably be more global, so you have to think about the currency risk that goes with that. My final comment would be that currency risk is as big a risk as any other risk you have got to consider. It is something to take seriously.

» **Downing**: I have a bit of a different view – it depends on the asset class. With global bonds, the conventional view is to fully hedge, because currency provides a lot of volatility and bonds are supposed to provide stability. On the equity side, however, the objective should be to minimise portfolio volatility, so the answer isn't to 100 per cent hedge, but a 50-70 per cent hedge on equities is what we would typically advise our UK clients.

I am surprised that some of the views around the table are to have a 100 per cent hedge, because that means you are have to potentially write a cheque for a huge amount if the currency goes against you.

There has been a growth of passive funds offering a hedged sleeve and I think this is going to be an increasing trend for more actively managed funds because it just removes the pain of writing cheques and the task of raising cash to fund losses.

» **Gilchrist**: What some schemes do is use the passive funds that are hedged 100 per cent and then match that with some others that aren't, so they end up with something that is for example 50 per cent/70 per cent hedged overall, but do it simply and cheaply.

» **Clark**: Can I try and draw a level of agreement from where there was apparent disagreement? I thought it

was interesting hearing the concept that, if you have got a risk, hedge it – which is valid, although sometimes quite a simplistic approach. If you think you have a risk and there is an opportunity to hedge it, then a natural response from a risk averse trustee might be, indeed hedge it 100 per cent, but I actually think that the point Lucinda *[Downing]* is making delves into the fact that the risk you are trying to hedge is not stationary, so the idea that you are trying to hedge something that will move very easily, and you can put a hedge on and it will perform exactly as expected, is a simplification.

» **Gilchrist**: I think the difficulty is (as the distinction made between equities and bonds demonstrates perfectly), if you have an overseas bond portfolio you can hedge that because you know what your risk is. If you have an equity portfolio, you don't know what the underlying investments are doing, you don't know precisely where they are trading and the extent to which they are hedging, but you know that they hedge some of it because they tell you that. For example, if you hedged 100 per cent of your equities, some of those companies will also curry currency hedges, so you will be over hedged.

» **Clark**: To characterise your argument there, if you have a multi-national company whose shares are in sterling, actually a lot of their performance may be driven by dollar receipts for example. Therefore, understanding the underlying components is key.

» **Downing**: But the 50-70 per cent we suggest, and studies on currency have also come to similar conclusions, is based on historical return simulations that take into account this impact from overseas revenues or company hedging activity on equity returns.

» **Clark**: The mathematics of performance in the past would exactly give you something from which in the past you would have been able to construct an appropriate hedge ratio through time given the data as it was. I was talking to some consultants recently who were pointing back to some of the work they were doing in the early 1990s, around what the long-term hedge ratio should be, and there it was borne out of this long-term analysis of correlations of foreign currency and the asset performance.

» **Gilchrist**: Are those relationships stable?

» **Clark**: No and that's exactly the point.

» **Gilchrist**: I am just thinking of the difference between the early 1990s and today – today we are in an environment where almost universally interest rates are low but, more significantly, they are at a similar level to each other; in the early 90s they were much higher, but more significantly they were different to each other.

» **Clark**: Absolutely, that is significant. I think one of the ways in which we're seeing an attitude to currency change is that historically a lot of the analysis has been done over a 30-40 year time horizon, on the basis that pension schemes are looking at things from a long-term perspective; but actually the time horizon over which material things have to be addressed, like funding negotiations, performance numbers, is much shorter now. So even if the correlation and the volatilities would support a hedge ratio of 70 per cent for example in the very long-term, over the short term you can see correlations go from positive to negative in six months. It's that change of market behaviour that we think is not necessarily picked up in a static hedge ratio over a long term.

» **Downing**: I think it comes back to the fact that strategic currency hedging is a very tricky topic, it's a bit of a hot potato and it's because the optimal hedge ratio does vary over time. So the ideal situation would be to have a strategic hedge ratio that varies over time.

» **Gilchrist**: I'd be interested in other people's views but I actually think that trustees pay less attention to currency now than they did 10, 15 years ago. When they're investing they decide to buy the hedged sleeve, or the unhedged sleeve, and then from time to time they remind themselves how much hedging they've got, but that's about it.

» **Clark**: I would concur with that.

» **Downing**: And historically people have tackled that with a strategic hedge and then they would employ a currency overlay manager to adjust currency exposures from that starting point. Unfortunately, currency overlay managers haven't had the best performance.

» **McPherson**: But the focus generally for your average trustee has changed since the mid-90s when everyone was taking pension holidays and investing in emerging markets - that's all changed. Today the sponsor is saying: "Take the risk off the table now because for the last decade I've been pouring money into this scheme and, with the best will in the world from our investment managers and our consultants, the situation's got worse – so get me out of this." So it's got to be a pretty compelling argument, I think, to convince the average UK investor to take an aggressive view on their currency risk position when, as we touched on earlier, their main preoccupation at the moment is managing inflation risk and interest-rate risk.

It may be different for a PGGM, an OMERS or one of the large Scandinavian funds, or even one of the large self-managed funds in the UK, but not for most mainstream UK funds that have got a funding

deficit and an intractably low gilt rate. All the talk at the moment on the growth side is about getting rid of the liquidity premium, because you don't need it and de-risking via LDI on the other side. I don't know where taking an active view on your currency fits into that general scenario.

» **Clark**: I'd flip that argument the other way around. It depends what you consider to be an aggressive position – a simple position would be either to not hedge at all or to hedge 100 per cent. I don't necessarily think that it is the same as aggressive or non-aggressive. I'd say either of those positions, as far as an overseas equities book's concerned, is an aggressive position. The challenge is agreeing what the appropriate measure of risk is for the scheme and then trying to construct a hedging strategy that minimises risk on that basis wherever possible.

The problem is, although that may sound straightforward, as soon as you start to say: "OK, what do I need to do that?" you enter a level of complexity because you're going to have to create a hedge ratio today; but when you look backwards, how far are you going to look? Are you going to look back 20 years and use that data – because actually, through that period, we've gone through completely different market environments – so what's a really good segment of data to use that's a good predictor of a hedge ratio right now? It could be six months, it could be three years.

» **Downing**: That's assuming that you can predict a better hedge ratio.

» **Clark**: Absolutely.

» **McPherson**: Why are you looking back; why aren't you looking forward?

» **Clark**: The benefit of looking back is to try and generate a methodology that creates a hedge ratio that you can back test in many different ways and ask: "How did it perform?" It's not guaranteed that it's going to work in the future but you can say, for example, if

the market downturns, or if we have a global financial crisis, does my FX hedging strategy put me in a better position than just a static one?

» **Gilchrist**: Can you define what you mean by "put you in a better position" – better than what? Because when we think about the risk of all the currencies, actually our biggest risk is that we are starting with our home currency. There are arguably two or three big other areas of risk there, but your biggest risk is your own currency. So if you decide to hedge and you come up with an efficient ratio of, say, 70 per cent or whatever the number might turn out to be, you can, after the event, measure what happened; and actually your biggest factor in that is whether your own currency went up or down. So what do we mean by better, do we mean reducing volatility, do we mean increasing returns?

» **Clark**: Whenever you set out a strategy, it may change slightly from scheme to scheme.

» **Wright**: That's the important point, what you mean needs to be defined by the scheme itself. It's about risk minimisation, it's about reducing the overall portfolio volatility but the starting point is to determine precisely what risk you're trying to control.

» **Parrott**: I think the starting point we are missing is are we talking about currency as an asset class itself or are we just talking about currency as it forms part of volatility or whatever term you want to give to it within the portfolio?

» **Clark**: One of our colleagues expressed this much better than I did so I wrote it down – he said that an asset class is either something with an expected positive return and in that context currency/FX doesn't fall within that. He defined FX as a tactical instrument where to generate incremental returns you need some signal or recommendation to buy or sell; whereas a buy and hold strategy is an accepted strategy for a lot of asset classes. That's why in my simple view I don't think of currency as an asset class.

Within something that's an asset class you'd expect a long-term performance/expect a return by just holding it, whereas with a currency it's a tactical instrument.

The challenge on a simplistic basis then, if you conclude that it's not an asset class, is how would you go about reducing risk? Risk can be defined in a number of different ways. There's portfolio value but some of the clients I've been talking to recently describe risk in terms of cashflow risk as well. One of the things that they were concerned about was there might be a big drawdown on the currency hedge and they'd have to fund that in some way. So the funding component of the hedging strategy becomes another part of the metric by which they were concerned about what to do.

» **Wright**: Which comes back to the point about the sleeve versus the non-sleeve and a combination thereof because to be fully hedged exposes you to that cashflow risk and that is, from some of our clients' perspective, a huge problem. However, I think from a trustee's perspective to buy the sleeve or not, someone's still doing the hedge so the questions around that are: How is it done? What are the costs of it? Questions we'll come on to later in terms of the implementation. So it gets rid of some of the problem in that someone else is managing that cashflow, but it doesn't necessarily deal with the implementation risk of the strategy, which I think trustees will still need to take account of.

» **Clark**: Can I go back to a point made earlier about the starting point of sterling because I think that is very important. One of the things that we've been looking at is in analysing the hedge ratio across a portfolio of overseas assets. What we've done is scrutinised not just an overall hedge ratio but actually the fact that you should probably look at your dollar portfolio and have a hedge ratio there, your euro portfolio, your yen portfolio because each currency and the correlations between that and the asset class that you're hedging vary – they're not all the same.

» **Gilchrist**: I was actually looking at this recently for one of our larger clients.

» **Clark**: To give a stylised example, if the dollar strengthens in a crisis, then you may prefer as part of an overall risk management strategy to under-hedge your dollar component because of its tail risk properties. That's where you'd need to think about what the overall objective of your currency hedging strategy is, because by tweaking it slightly you may introduce an element of, "actually I think that if we do have another financial crisis the dollar will strengthen, my dollar portfolio will perform better in sterling terms, so I don't necessarily want to go up to my optimal hedge in the current market conditions".

One question also worth asking is who is responsible for which risks? At the very senior level, you could say a trustee is responsible for meeting the liabilities and developing an asset allocation but, from then, every single decision should have some accountability around what you are trying to achieve, how you are going to measure it and how it is implemented. I think that sometimes FX can fall through the cracks – we made the comment earlier that trustees may periodically look at how much they're hedging but they won't give FX the scrutiny that some of the other risks get and yet it's a very important risk component in the overall portfolio.

» **Downing**: We're in a difficult position at the moment because we may generally agree that strategic currency hedging should have the objective of minimising volatility, but we all know that currency can move a lot and we want to ideally benefit from these currency moves. That would be particularly helpful now as other asset classes don't have a high return outlook at the moment. But then, on the other hand, currency overlay managers are out of fashion at the moment and so therefore, on an active basis, there is a danger that currency can be left unmanaged.

» **McPherson**: That's an interesting point – currency overlay was flavour of the month at one point but then a lot of people got burnt; securitised debt was flavour of the month, then that got burnt; there's a taint because of various things that have happened. FX is not immune to that taint and trustees are generally a conservative cynical lot.

» **Parrott**: I cannot recall the last time there was a discussion around asset allocation where currency came forward as a class to go into, I just simply can't think of it.

» **Gilchrist**: And it's largely because of what I said earlier - there is no interest rate carry, all the interest rates are pretty much the same.

» **Parrott**: Absolutely, yes.

» **Wright**: But to your point, Lucinda *[Downing]*, currency is very occasionally extremely volatile and we've seen that with the Swiss move; those were very, very substantial moves. We've talked at some length about currencies probably not being an asset class – and I don't think it is in its own right – but having worked in FX for 20 years, I know it is definitely a risk that could cost you a lot of money at some point if not managed correctly. So the conclusion is yes, you should have a strategic hedge ratio but on top of that allocating a risk budget to better minimise that downsize risk probably, as a happy outcome, puts you in a positon where you can also benefit. So I think it's two sides of the same coin. Whereas if you are trying to dynamically manage some portion of your hedge ratio you will probably benefit from

those tactical and short-term volatilities in the market. The solutions we offer are non-discretionary, there are other discretionary managers out there, but certainly it's something that the trustees have to look at.

» **McPherson**: But let's look at the dynamics of the market – if we look back a while, the flow came from transaction flow either from pension funds or fund managers, for example through portfolio transitions or through capital market activity, new issues etc.

» **Wright**: It's interesting how the dynamics of FX have changed over time. Both technology and regulation have had a great impact. For instance, the way in which we operate is much more transparent; technology helps us to demonstrate how, what and with whom we are trading. However, in very volatile conditions you could end up with moves that extend beyond what would have happened historically.

» **Clark**: I'd just like to add my thoughts on regulation and the challenges that face not just banks and counterparties to this market but pension schemes and other users of FX. Some of the challenges I see going forward is that the implementation of MiFID II and the requirements for greater understanding and disclosure around execution has its positives and negatives.

It is all, in one sense, a positive for the end client because there is going to be greater clarity around how things were done, when they were done and what costs were incurred in the execution of trades.

What we're trying to do in some of the propositions we're taking to our clients is to turn an element of the FX market from banks providing a risk-taking service to a service proposition.

» **McPherson**: Well we heard all that in relation to the credit markets – it was all going to be regulated and more transparent – and the unintended consequence was that liquidity has all but dried up.

» **Clark**: Absolutely, and one of the consequences might be that you may get spikes in FX markets.

» **Gilchrist**: But if the banks aren't taking the principal position, if they're acting as agents to the client, who is taking the principal position?

» **Clark**: Well the marketplace itself is becoming increasingly automated. One of the propositions that we're working on is to say if we have a group of clients that are happy with a set of rules, can we enable them to actually offset each other before the residual component can be traded in the market? We have an LGPS platform where several clients' orders are taken together, they're amalgamated and looked at for the offset and then it's only the residual that is executed on risk.

» **McPherson**: Do you mean netting?

» **Clark**:Yes.

» **Gilchrist**: So a sort of crossing facility?

» **Wright**: Yes.

» **Clark**: So normally with this proposition as a client you may say, "If you've got four managers, we'll take orders from your four managers, we'll net those". Then we'll say, "Well actually, within those, we're going to net that scheme with this scheme." So we're going to have a pool of schemes that will all join together.

» **Wright**: We've been through an intense period of regulatory change and it will carry on with the onset of MiFID II as it has already been highlighted. What that means is that we are much better at demonstrating how we've executed and where we've executed and it's true of transactional foreign exchange as it is of outsourcing of currency risk management. When outsourcing, you necessarily outsource the service but you also retain a responsibility to ensure that your provider has done what they said they've done. For pension funds, the next leg of development of foreign exchange represents quite a huge opportunity to really be able to get your arms around what FX is costing you, what you're being charged, how it's being executed on your behalf and to really put yourself in a position where you can drive those costs down. In terms of the challenge of foreign exchange, particularly in a low yield, low return environment, getting your arms around your costs is probably the minimum requirement, even before you've considered, "What should I be hedging?"

» **Downing**: Can I ask – custodians once had a bad reputation of offering forward pricing for currency transactions – can you confirm they have made it more transparent and with tighter pricing already?

» **Wright**: Yes, each of the large global custodians has dealt with that and it's quite straightforward to deliver in G10s, it's more problematic in restricted currencies.

Following on from that, we need to delve into the commercial aspects of these arrangements and really try and understand what's a fee or a margin that pension funds should be paying; what should the investment manager be paying, so on and so forth and I still think there's a lot to be done in that area – we're not finished yet by a long way.

» **Clark**: Quite often the biggest component of cost is the spread that you trade at.

» **McPherson**: But the biggest benefit for the bank is knowing what the client's position is. You know where the flows are coming from therefore you can position against it.

» **Clark**: Absolutely not. I can categorically say that in the world we're dealing with now, what we're trying to set up with some of the algorithmic trading is that it's away

from human intervention and appropriately ring fenced.

Let's look at our algorithmic trading team, they have algorithms that may be liquidity seeking; what they'll do is try and identify the pockets of liquidity that satisfy the order that's been put through.

» **Parrott**: How far has this been stress tested?

» **Clark**: That's a valid question, one of the cornerstones of any of this risk management process that we're advocating is to understand what it is, measure the way it's executed and be clear about what you're paying for.

» **Wright**: To go back to what Lucinda *[Downing]* was saying about the global custody proposition, those issues have been addressed but the problem that we still have is that, if you have more than one custodian, they'll all be doing things differently. So while they'll likely offer you transparency, they'll be trading at different points during the day, each custodian will have its own policy; there's no coherent methodology, which means that you're still not in a position where you have leveraged your control and equally you haven't got netting.

For example, you may have an equity fund manager who's buying euro sterling in the morning and another one that's selling it in the afternoon which seems irrational, so having a sense of how your FX is done, who's doing it, how much they are charging and whether there are ways in which you can work with banks to leverage and optimise your FX execution are all important considerations. So there is very much an opportunity here for pension funds going forward and, within that, to also make sure that if you are going to use a hedging, whether it's 100/50/70 per cent, whether it's in-house or external, that your hedging requirements are included in that so you're netting wherever possible.

» **Gilchrist**: Is that a series of questions that we as trustees should be paying really close attention to or are they ones that we should be discussing with our custodian and making sure that they, or indeed the investment managers, are paying attention to?

» **Clark**: If you make a decision to hedge, you should have clarity all the way down and understand who is doing it, what are the different ways in which you could do it and which one best fulfils your requirements? For example, if one of your managers thinks that they're using currency to outperform, maybe they shouldn't be included in netting because they're doing something active and you're happy with that. If for all the other managers the currency is a second thought and it's not what's really driving their performance, then you need to consider perhaps how the totality of that FX is brought together – who's bringing it together, what is being netted, what are the terms of that netting, what residual risk is there left over, who's hedging it, how are they hedging it and what are you paying for?

I'd like to also go back to a point made earlier about banks having flow. In this environment, we think the asset owners own the flow. It's your flow. From that position, you determine the way that this thing is done. Banks have a multitude of different ways of executing FX and if you don't like some of them, don't do it that way.

The first point that we're trying to make is, if you own something then make the decisions on how you're going to implement things. And what you can do is say: "We, as a group can net off flows and we will agree to do this at 10:00am, at 11:00am etc."

» **McPherson**: I agree but for most of our clients, bar the largest that are dealing directly, our conversation is with the fund manager who invariably will have their own dealing desks and you hope would be netting off anyway.

» **Wright**: That's the very important point. Whether you are working with fund managers that have a specific approach in terms of their execution through their own dealing desk and technology or, whether you work with fund managers where FX is a middle office or a back office function, we encourage you to ask the right questions.

» **McPherson**: And it's for us as end investors to demand best execution.

» **Wright**: Yes – and what we're doing is trying to position ourselves to anticipate our clients asking us those questions.

» **Parrott**: But the level of leverage that a small scheme, who's in a multimillion pound pooled fund, can impose on that manager is limited – it is a relatively small voice.

» **Clark**: On that manager, correct, but the flow that comes out of it and how it's managed and if you have the opportunity to invest in a dollar class or sterling class they're all decisions that you can potentially make based on the leverage you have, your knowledge of what's currently being done, your ability to influence maybe not at the dollar share class but the sterling share class might be amalgamated with something else. It's really just around the clarity of what am I trying to achieve, how much leverage do I have, is it being executed appropriately and do I understand exactly and measure what the cost is?

» **Parrott**: But isn't that down to the manager research?

» **Clark**: Well you may say: "I think that there's a manager proposition here, a custodial

proposition here and a bank proposition. Our proposition is that we can potentially amalgamate all the managers, or all the custodians and we have operational underwriting which means once we've got it, we've got the balance sheet to support the execution composition, and within your own scheme we can net with your managers. We can net across custodians. We can net across other schemes. We have a multifaceted approach that enables us to underwrite the execution of a very large pool of FX using multiple levels of netting with a pre-agreed execution methodology, which is determined by the client. As I said earlier, they own the flow so if they want to execute against a fix or use an algorithm, we can do that. It's around a clarity of owning the flow and deciding how it's going to be implemented and how it's going to be measured post-execution in keeping with the way in which that proposition has been presented.

One of the things we think is driving our ability to deliver some of this is that we're responding to our own regulation requirements but asset owners and certainly asset managers are going to face increased regulation themselves. Some of it is symmetrical, it's not necessarily identical to what we have to do, but having developed the technology to respond to our own regulatory requirements enables us to provide a service to our clients to help them. Regulators want to see that we're delivering value to our clients and clients want to see that they're getting a good service. There's an opportunity here to be very clear about who's providing your FX service, what you're paying for and that the measurement and monitoring after the event validates that.

» **Cohen**: For a small to medium-sized pension scheme, I can't see them coping from a governance perspective with all that you've described. There's enough going on that they can't cope with hence they go the fiduciary route, for example, so for them to have to address all those questions you raised there I think is probably a step too far.

» **Wright**: I would agree with you it's not for everyone, yet; it's not a level playing field in terms of being able to manage that process. But I do think for the larger schemes that perhaps do have some resource to devote to this it's not a bad time to start.

» **Downing**: What's the advantage of the extra netting you propose?

» **Wright**: Well, we did some work with some external transaction costs analysis (TCA) providers and we took the year's transactions for a large scheme which was multi-custodial and had a number of external managers, above 10, and we asked that TCA provider to look specifically at where they could net their transactions. We wanted to validate our own assumptions, and it turns out that particularly in the main currencies for that particular piece of work they could actually reduce their overall volumes in those currencies by 20 per cent.

This suggests that there's something there – particularly in a very low return environment.

» **Clark**: What was also interesting with this analysis was that there were multiple levels of discovery for us. The quality of the data, as a first point, wasn't first rate, so they had to clean the data. Also, the hedging strategy that was adopted by the different managers wasn't uniform. Some of the performance was dreadful, a fairly small component to be fair but it was a long way off acceptable levels. Then the rest of the analysis pointed to the fact that there was this opportunity for netting that wasn't being captured and our overall perception was that they were probably paying more than needed in terms of spread costs that they should have been.

» **Gilchrist**: Clearly there would be a benefit in looking at it and investigating it, seeing if there were small areas that are really inefficient. However, given the transaction charges that are sort of relatively low compared to some other asset classes, if you can save 20 per cent in the way you've described but you've had to put in effort in order to do that, is it cost effective? Is the saving worthwhile, given the resource that has to be put into it?

» **Wright**: All this suggests that it's worth finding creative ways to work with your global custodian, with your banks, with your fund managers to optimise what you're trying to achieve both from the currency risk management perspective and the implementation because currency risk is very important, it needs to be managed effectively.

» **Clark**: The benefit that I see in the future is that there's going to be a situation where asset owners can decide who does different parts of the strategy. There's an opportunity to get excellent service in these different elements of seeking your strategy. You own the flow; you can dictate the way that you want strategies to be implemented. There is some real power back in the hands of the asset owners about how things are done and a real opportunity to make the most of that. ■

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INTERVIEW

# Healthy investing

**Adam Cadle speaks to Irish Funds Industry Association chief executive Pat Lardner about the body's ambitions and the current state of the investment market, both in Ireland and in Europe**

WRITTEN BY ADAM CADLE

**What are the objectives of the Irish Funds Industry Association?**

As the representative body for the international investment funds industry in Ireland our role is to be the voice for, and of, the industry at home and around the world in the areas of advocacy, promotion and development. We represent our 112 member firms (who come from every facet of the funds industry) in discussions with policy makers and regulators in Ireland, the EU and globally. Our objective is to support the development of the industry by optimising the environment in which funds management and servicing occur.

A significant part of what we do is promote the industry in Ireland around the world and engage with the 800-plus global fund managers who have already chosen Ireland as a location to domicile or service investment funds and those who are looking to do so.

**What is the total amount of assets under administration that the Irish Funds Industry Association holds and how are these assets divided up?**

As of Q1 2016 the total assets administered in Ireland amounted to €3,663 billion, with that total being equally split between funds domiciled in Ireland and those serviced from Ireland. Ireland represents a home for 17.5 per cent of all UCITS assets as well as being a leading player for alternative investment funds. There is full coverage across investment strategy and asset class as illustrated by the following: over 50 per cent of all European ETFs are domiciled in Ireland, Ireland is a globally recognised centre of excellence for money market funds, we service some 40 per cent of the world's alternative funds and other than 2008, the industry has grown in each of the last 25 years.

For pension funds, Ireland established its highly efficient pooling vehicle, the Common Contractual Fund (CCF), back in 2003. The key characteristic of a CCF is its transparency in Ireland both from a legal and tax perspective (it is tax transparent from an income and capital gains perspective), resulting in its recognition as tax transparent in over 20 global markets to date.

**Can you explain the work that you conduct around risk, asset management regulation and the Capital Markets Union (CMU)?**

We are currently active across a range of regulatory and technical areas, through the association's staff and our 38 working groups, which comprise over 500 participants from 80-plus member firms. This gives us significant firepower across a range of areas and we have specific working groups for each of risk, asset management regulation and CMU. Our work on Money Market Fund Reform, AIFMD and UCITS V implementation has been significant and continues. As well as being active locally in Ireland, we advocate directly with the Commission, the European Supervisory Authorities and the European Parliament.

**The ICAV has attracted €8.4 billion in the first 12 months of existence. A total of 157 new funds have joined the investment vehicle. How has this improved efficiency and accessibility for new Irish investment funds?**

The ICAV has been hugely successful since its implementation, and is fast becoming the vehicle of choice for funds looking to register here. It has improved efficiency, and negated a range of barriers for international funds. Notably, it has removed the 'check the box' requirement for funds looking to operate in the US, which has simplified the process considerably. The ICAV also streamlines company law requirements, which has again increased efficiency.

**What are the biggest challenges that the association faces over the coming years ?**

We'll be looking to continue our work over the past two and a half decades, and further develop the industry here in Ireland. Having put Ireland on the map as a global centre of excellence for investment funds, one with serious capability and scale we now look to push that further to meet regulatory and market challenges as well as the opportunities that inevitably come from product and service innovation. ■

INVESTMENT

# Riding the risk wave

**Lynn Strongin Dodds explains the many different risks facing pension fund investments and how they can be tackled**

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

European pension funds' investments have always grappled with a long list of risks, most notably liquidity, event, market, concentration and currency. They vary in importance during an investment cycle but since the financial crisis they seem to be weighing institutions down. There is an array of tools and strategies to mitigate any dangers but innovation and dynamism will also help leverage the opportunities presented.

"There is a rising belief that volatility and therefore risks are increasing, although I am not sure that is true," J.P. Morgan Asset Management head of EMEA pensions solutions and advisory Sorca Kelly-Scholte states.

"I think what has happened is that they are getting harder to tolerate because pension funds across Europe are becoming more mature and there is less time to deal with them. There is sometimes a lot of noise that distorts the truth and pension funds have to assess how real the risks are."

### Political risks

This is particularly true with political risks, which have dominated the headlines since the beginning of the year. All asset classes took a battering in January due to a slowing Chinese economy and tumbling oil prices but they also opened the door to some attractive buying prospects. However, just as markets were regaining their equilibrium, the UK's 'Brexit' referendum result to leave the EU, as well as the US elections in November, have rattled investors. In fact, according to the recent Mercer *Pensions Risk Survey,* the uncertainty has contributed to FTSE 350 defined benefit plans hitting record accounting deficits on the back of falling corporate bond yields.

"Uncertainty is pretty much on the doorsteps all the time," says Allianz Global Investors head of UK & Ireland Solutions team Iain Cowell. "In the past, structural change was far enough away to get diluted before it happened but now we have instantaneous media gratification and things can change very quickly."

The other political or economic threat is the depressed interest rate environment, which has been fuelled by central banks' quantitative easing. The situation is unlikely to change in the near or medium term as the European Central Bank is still pumping money into the system and keeping rates low, while the Bank of England is thought to be mulling over another base rate cut below its current 0.5 per cent. One response has been to invest in higher-returning riskier assets but there is a fear that it could then leave institutions exposed to future negative shocks, such as a liquidity crunch.

Piecemeal solutions though are not the answer.

"In the past pension funds tended to look at

everything in isolation and everything was model driven," Mercer financial strategy group principal Le Roy van Zyl says. "Today, there is a greater emphasis on scenario planning, which looks at if 'x' happens what will happen to sponsor contributions, investments and funding levels. Based on that, pension funds can determine what actions should be taken. This should help lessen the downside exposure if market conditions subsequently worsen."

In the UK, this is called an integrated risk management framework and is recommended practice by The Pensions Regulator. However, European pension schemes are also adopting a more dynamic and holistic approach. "The difference between the two is that continental pension funds are typically larger and open while the majority of the UK schemes are closed," says Cowell. "Our dynamic risk management solutions are extremely popular in Germany and France and in more recent years has taken off in the UK, as risk has risen up the agenda. Most risks are represented as volatility in the market and the aim is to match the performance of the market and protect the downside."

The asset allocation approach will differ depending on the country, its national regulations and the size of the scheme. For example, the UK, which is home to around 6,000 schemes, typically prefers packaged or pooled solutions except for the largest schemes, while the Netherlands has consolidated its pension fund industry to around 365, the majority of whom have the clout to invest in the more complex and illiquid strategies directly.

### Diversification

Despite the differences, diversification is a common theme. Multi-asset credit, diversified growth funds, real assets, smart beta strategies and multi asset funds in general are all slotted into this bucket to mitigate concentration, liquidity risks and unexpected turbulence. "One of the most important things is to spread the risk more effectively and be nimble enough so that you can move away from positions that might hurt you," Aviva Investors head of investment strategy, global investment solutions, John Dewey states. "Correlations are not static and can change significantly and if portfolios are not diversified then the risks you are running will be much higher."

**[INVESTMENT RISKS] ARE GETTING HARDER TO TOLERATE BECAUSE PENSION FUNDS ACROSS EUROPE ARE BECOMING MORE MATURE AND THERE IS LESS TIME TO DEAL WITH THEM**

SEI managing director EMEA advice team David Hickey advises that pension funds should not just look at divergence across asset classes but also within them. "For example, in equities, investors need to look at developed as well as emerging markets," he adds. "Diversification also means investing in different managers and investment styles such as growth and value as well as a range of currencies."

Aon Hewitt principal Colin Cartwright also warns that "diversification is a risk management strategy at its heart but it is not a panacea and has not worked well since the global financial crisis where everything sold off".

"If you look at US equities and UK bonds, they have been the best performing asset classes over the past few years so investors have not been rewarded. Pension funds need to have structures in place where they can accept, minimise and reject the risks as part of the investment process."

The same applies to liability - driven investing (LDI), which is also gathering a following on the continent, albeit gradually. "The UK and the Netherlands are the frontrunner with the large majority of all schemes having adopted an LDI framework because it is extremely well suited to manage risks," Candriam head of financial engineering Kristof Woutters comments.

"We are also seeing an increase in Germany and Belgium, as well as France where the industry is mainly run by insurance companies. They are going straight into the second generation, which splits the portfolio into liability matching and return seeking assets."

BlackRock head of

UK strategic clients Andy Tunningley adds: "LDI is specific to each country but we are seeing a general move with pension funds aligning their assets to better meet their liabilities into what I call the middle ground. These are more complex and illiquid assets, such as private credit and infrastructure, that schemes did not invest in before. As a result, they need to develop the right governance structures to understand the risks and exposures."

## Investment risks

**Liquidity risks**

Funding liquidity risk - the risk that pension funds cannot meet their financial obligations when they fall due, at all or without incurring significant unexpected costs.

Market liquidity risk - the inability to easily exit a position. For example, since Basel III has been implemented, banks have withdrawn from certain segments of the fixed income and lending markets, causing illiquidity.

**Currency risk**

Pension funds that invest overseas carry the risk that the currency will move against their assets. This is particularly true in fixed income, where it has been estimated that as much as 85 per cent of the performance of a global bond portfolio can be attributed to currency volatility, compared with just 25 per cent for a similarly internationally diversified equity portfolio, according to research from ECU Group, global macro research, advisory, and investment firm specialising in currency risk management firm.

**Concentration risk**

For instance, in a bull market, stocks may represent a significantly greater percentage of a portfolio than before since they gained more value than the bond holdings.

**Correlation risk**

Investments within the same industry, geographic region or security type tend to be highly correlated. Concentration in illiquid investments can pose a risk because they are difficult to sell.

**Political risk**

The volatility and disruption to markets due to political changes or instability in a country. Current examples include the fallout of the 'leave' vote succeeding in the UK's EU referendum and the US elections and the possibility of Donald Trump becoming President.

### Research and beta analysis

Market participants also urge pension funds to be much more analytical in their allocation. According to Loomis, Sayles & Company managing director, EMEA institutional services, Chris Yiannakou, all schemes will benefit from a rigorous, fundamental top-down and bottom-up research. In the fixed-income world, for example, this means a greater understanding where individual countries and industries sit on the credit cycle in order to mitigate risks but also uncover investment opportunities.

"In other words, are they in the 'late' or 'downturn' phase of the cycle, which is generally not good for bond holders, where default risk is potentially at its highest," he adds. "Alternatively have they entered the 'credit repair' or 'recovery' phases that can provide significant investment opportunities for bond managers? Should you take broad market exposure or seek out individual/idiosyncratic opportunities?"

Yiannakou also recommends beta analysis tools that measure the sensitivity of a portfolio to changes in yield curves, spreads, currencies etc, as well as scenario analysis tools which examine hypothetical impacts to the portfolio using a variety of historical scenarios such as 9/11 and the credit crunch. ■

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# Smart beta focus:
# REDEFINING INVESTMENT

**The rise of factor investing**

Peter Gunthorp discusses the increasing popularity of factor investing within Europe and examines how differing methodologies lead to differing outcomes, when attempting to combine factors within an index

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**New pathways**

Sandra Haurant explains why factor-based investing could soon become mainstream

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INVESTMENT

# The rise of factor investing

Peter Gunthorp **discusses the increasing popularity of factor investing within Europe and examines how differing methodologies lead to differing outcomes, when attempting to combine factors within an index**

**WRITTEN BY** PETER GUNTHORP, MANAGING DIRECTOR, RESEARCH AND ANALYTICS, FTSE RUSSELL

A factor is a common driver of stock returns. The component of stocks' returns that is driven by factor exposure (i.e. from exposure to systematic risk) is seen as distinct from the stock-specific (non-systematic) component.

In the Capital Asset Pricing Model (CAPM)[1], which was introduced in the 1960s, a single market factor explains stocks' returns. This market factor carries an associated risk premium, called the equity risk premium.

However, empirical evidence has emerged indicating that other characteristics, such as stocks' valuation and size, also help explain their performance over time. For example, stocks with lower price-to-earnings ratios (value stocks) have shown a tendency to outperform those with higher price-to-earnings ratios over the long term. And smaller-capitalisation stocks have outperformed the shares of larger companies over the long term.[2]

Empirical evidence of other equity factors has been identified and achieved wide acceptance amongst investment practitioners. In parallel, a burgeoning literature that attempts to rationalise the existence of such factors has evolved. Such explanations range from compensation for bearing risk, the existence of structural market rigidities and behavioural explanations. FTSE Russell's global factor indexes cover the following equity market factors: value, size, momentum, volatility, quality and yield.

A factor index is designed to capture the return premia associated with exposure to a set of factors in a transparent, rules-based and replicable format. Factor indexes can be used both as benchmarks for the performance of actively managed funds and as the reference or benchmark index for an index-replicating product.

## Investors' interest is rising

In early 2016 FTSE Russell conducted its third annual survey of global institutional investors' use of smart beta, including factors.

This year's survey provided evidence of the rapidly growing interest in this area, and a couple of things stood out in the results.

First, European investors are leading the way in adopting smart beta. By 2016, 52% of the European asset owners surveyed had adopted smart beta, compared to 28% in North America and 38% in APAC.

Second, the most popular type of smart beta strategy amongst survey respondents was multi-factor combinations. Investors are increasingly looking at how to combine factors, rather than examining individual factors or other smart beta strategies in isolation.

Factor combinations are often sought, since the behaviour of individual factors is variable and they display relatively low correlations with one another. For example, the global size factor within the Russell® 1000 Index had a positive year in 2009, with the prices of smaller-capitalisation stocks rebounding from the depths of the financial crisis. Momentum and (low) volatility factors did less well that year, however. More recently, (low) volatility and quality factors have done well worldwide, while value has underperformed.[3]

## Challenges in combining factors

A simple approach is to average the stock weights across a number of single factor indexes. An alternative is to use an average or composite of

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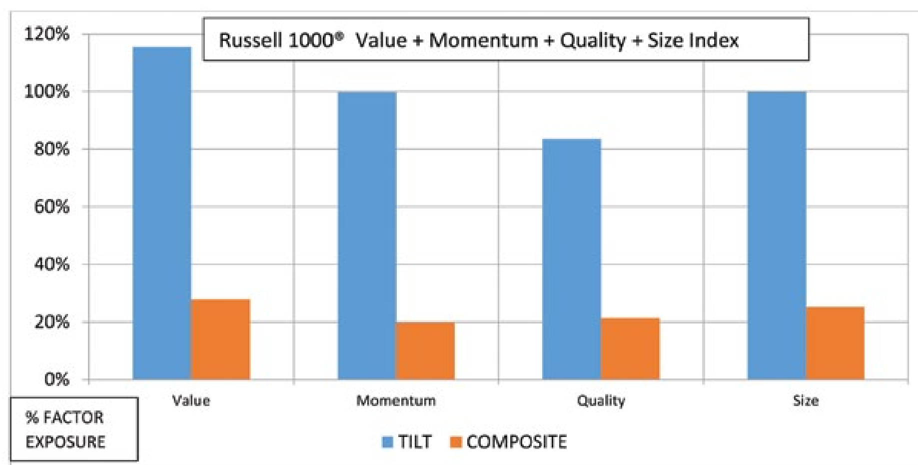
1 *The CAPM was introduced by Jack Treynor (1961, 1962),[4] William F. Sharpe (1964), John Lintner (1965a,b) and Jan Mossin (1966)*
2 *^Fama, E. F.; French, K. R. (2012). "Size, value, and momentum in international stock returns". Journal of Financial Economics*
3 *Source: FTSE Russell. Russell 1000 data from 29 June, 2001 to 30 September 2015.*
4 *"Value and Momentum Everywhere" (Asness, Moskowitz and Pedersen, 2012)*




Source: FTSE Russell, June 2001 – September 2015. Past performance is no guarantee of future results. Returns shown may reflect hypothetical historical performance. Please see the end for important legal disclosures

the factors of interest to create a single composite factor index.

Such approaches result in diluted or muted exposure to the desired factors, when assessed relative to the factor exposure of the equivalent single factor index. This is exacerbated as more factors are combined and the factors are negatively correlated. Value, for example, has shown a negative historical correlation with both quality and momentum.[4]

An alternative approach is to "tilt" a starting index repeatedly; each time towards one of the desired factors. In other words, index weights are first tilted towards the first factor of interest, then towards a second factor of interest, and so on. Tilting sequentially results in exposure to all the desired factors.

**Combining four factors via composite and tilt approaches**

The chart above illustrates the difference between an averaging/composite approach and the multiple tilt (tilt-tilt) approach for a four factor combination consisting of, value, momentum, quality and size using the Russell 1000® Index. Each bar shows the factor exposure within the multi-factor index as a percentage of the single factor index's exposure to the same factor.

A composite approach to combining the four factors dilutes the value and size factor exposures to around 25-30% of their magnitude in the single factor indexes, while the momentum and quality factor exposures are reduced even further, to around 20%.

However, the tilt – tilt approach retains over 80% of the starting exposures to all four factors, with the size and value exposures completely undiluted.

There are trade-offs involved in the different approaches to combining factors. A composite (averaging) approach is likely to result in lower levels of active share, tracking error and turnover than the multiple tilt approach. Relatively high levels of factor exposure in the tilt-tilt version are likely to result in a greater divergence in performance against the benchmark capitalisation-weighted index. If the chosen factors are important determinants of risk and return outcomes, then higher levels of exposure will generate a greater disparity in index returns.

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INVESTMENT

# New pathways

## Sandra Haurant **explains why factor-based investing could soon become mainstream**

**WRITTEN BY** SANDRA HAURANT, A FREELANCE JOURNALIST

In a nicely diversified portfolio, different assets are meant to behave, well, differently. In simple terms, when equities are having a bad time, bonds should have a ball. When bond yields go south, real estate should pick up the slack. Correlation between different asset classes should be minimal, so some parts of a portfolio do well even when others are underperforming.

In the financial crisis of 2007/08, though, quite the opposite happened. Equities, bonds, even alternative asset classes such as hedge funds, went downhill. And then, when the recovery set in, broadly speaking, they went back up again, correlating again in just the way they shouldn't.

### A different approach

If all the asset classes in a portfolio move in the same direction, then diversification is no longer doing its job. Which is why the investment world is always looking to reduce correlation and give itself a better chance to beat the markets with strategies that remove those risks.

One approach that is growing in popularity is factor-based investing, also known as smart beta or style investing. Instead of looking at asset classes separately, or even looking at individual securities, the idea is to look at the underlying factors that affect their performance and to invest according to those. Those factors refer to objectives in investment style, such as quality, value and low volatility.

Born out of an interest in this approach, the FTSE Global Diversified Factor Index Series was launched in 2014 to "capture a more even distribution of uncompensated sources of risk across regions and industries," according to FTSE Russell. "Additionally, the indexes screen for stocks exhibiting attractive relative valuation, positive price momentum, low volatility, high quality and lower market capitalisation relative to traditional market capitalisation weighted indexes," the group said.

It's an approach that is gathering momentum, although it has been something of a slow burner. As FTSE Russell senior index research director Gareth Parker said in December last year: "Investors have long recognised that underlying factors such as quality, size, value, volatility, liquidity, yield and momentum help influence equity market performance. However, in recent years they have been able to take a more nuanced approach to understanding the influence of these factors through smart beta indexes."

A popular way to illustrate the factor-based approach is one provided by BlackRock managing director and head of factor investing strategies Andrew Ang. He says that when you choose to eat healthily, you need different nutrients that come from a variety of different foods. One type of nutrient might be found in different foods; it doesn't matter what those individual foods are, it's the nutrient itself we are interested in. And in factor investing, it doesn't matter what the label on the asset says it is, it's the factors within that we are interested in.

"I think we can look at factors as key drivers of risk and return," FTSE Russell managing director, research analytics Peter Gunthorp states. "Rather than thinking of stocks individually, there are a finite set of factors that affect all of them."

It is an approach that has something of a global appeal. AQR Capital principal Christopher Palazzolo says: "Investors across Europe have shown strong interest in these types of strategies, perhaps more so historically in northern Europe than in southern Europe and in UK, but we see this trend changing recently."

Gunthorp agrees: "We thought that it would be asset owners and pension funds who were interested in this, and that was initially true in certain sectors – particularly in more knowledgeable markets like Scandinavia and Benelux, and there were noticeable first movers in Holland. But there has also been more recent interest in the UK and Asia." While Goldman Sachs Asset Management managing director looking after quantitative strategies in EMEA Javier Rodriguez-Alarcon adds: "Appetite is growing in the Nordics, UK, Germany, Australia and the US. It's a global trend."

Indeed, says Rodriguez-Alarcon, interest in the strategy is growing: "It is difficult to generalise, but on the equity side pretty much everyone is either implementing something in this area already, evaluating the

framework or just starting to think of it." And it's not just equities. "There are comparable elements within other asset classes," says Gunthorp. "Rather than think of an asset class I think about them in terms of factors – value, carry, low volatility and so on. It might be a more effective way to invest."

Factor investing may not be quite mainstream yet, but it's getting there. PwC has predicted a tripling of assets under management by 2020, with factor investing playing a key part in this trend. In its report entitled *Asset management 2020: a brave new world*, PwC said: "Factor investing represents a genuine 'third way' between active and passive, which will continue to grow in popularity. Factor investing will 'cross over' from the realm of active managers, through highly sophisticated institutional passive investors, and into the mass-market retail space."

### Active or passive?

Whether factor investing is active at all is a matter for debate, and one that has been running for some time. Palazzolo maintains that factor strategies sit neither in one camp nor the other: "Previously faced with the choice of low-fee passive strategies that benefit most if markets are efficient, or paying high fees for the chance to select a manager with an informational advantage which cannot only lead to gross outperformance but, also net outperformance after fees, many investors felt this was a difficult and often costly choice to make," he says. "Factor investing operates at the intersection of both theories, and perhaps at least mitigates part of the conundrum. Factor, smart beta, style investing (it has many names), means using known, academically-tested and rigorously-applied tilts away from pure passive market capitalisation weights, but not at traditional active fees."

Royal Bank of Canada Global Asset Management senior portfolio manager Dag Wetterwald says it is a matter of definition: "People are unable to agree on what passive actually means. For me it is something you don't do anything with, and the only way of doing that is if you have market cap-weighted indexes or funds where the market caps take care of themselves. It will always be linked to the market cap and how a stock performs.

"Then you have degrees of passive: very simple additional rules where you don't really have to do anything, maybe that is passive as opposed to active? But a much better way to think about it is how cheaply can you implement the strategy? There are degrees of cheapness, rather than degrees of active or passive. There is a continuum, they are not discrete, and at the end of the day it comes down to how cheaply one can implement something."

And that fees question is a key one, of course. "There is no secret that pensions funds are looking to reduce the fees they are paying," says Rodriguez-Alarcon. "I would say this is a very interesting benefit."

### Cost

The rise of factor investing allows investors to take a long hard look at the returns more expensive active managers are producing and ask some important questions. Wetterwald says: "What I think is happening, and we have seen proof of this, is that investors are getting more and more concerned about the kind of returns the manager is delivering." After all, if a manager claims to be stock picking but actually returns simply benefit from underlying factors, perhaps a straightforward factor-based ETF would be a more cost-effective.

Wetterwald adds: "I think the trend we are seeing is going to continue. The reason is simple: factor investing is cheap. You can deliver the investment stream very cheaply to your client. At the end of the day it is just programming a computer to do something, and a little bit of oversight."

Factor investing is certainly gaining ground, and low costs are a strong driving force. But some consultants are warning that this may be something of a bandwagon investment, and are cautioning investors to be wary before jumping aboard.

Noenetheless, says Palazzolo: "There is much to come in the exciting area of factor investing, as we at AQR and across the industry come out with new research on existing or new factors and continue to enhance our delivery of them. Generally, clients should see lower fees across their portfolios as a result of the industry competition. We believe this is a healthy and welcome development for investors." ■

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# Fixed income roundtable:
## THE DASH FOR YIELD

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*Chair:*

**KATE HOLLIS**

**Senior Investment Consultant, Willis Towers Watson**

Kate joined the credit research team at Willis Towers Watson in 2015 and specialises in fixed income alternatives research and smart beta innovation. She has over 30 years of industry experience, having previously spent 10 years at S&P Capital IQ as global head of fixed income/alternatives fund research. Prior to that she spent five years working for various funds of hedge funds and 15 years in fixed income sales and trading.

*Panel:*

**LENNOX HARTMAN**

**Global Head of Fixed Income Strategies, Aon Hewitt**

Lennox is global head of fixed income manager research at Aon Hewitt. The team's remit covers traditional and unconstrained fixed income strategies as well as liability driven investment (LDI) approaches. He is also a member of the firm's Global Investment Committee, which sets policies on investment matters for its clients. Since joining Aon Hewitt in 2000, he has also been a part of the client consulting team.

**PETER THOMPSON**

**Trustee Executive, BESTrustees**

Peter Thompson is an actuary with over 30 years' pensions experience. He joined BESTrustees in April 2005, having worked at a leading actuarial consultancy for nearly 25 years. Peter has worked in London, Leeds and Manchester and has dealt with pension schemes of many different sizes and in many different industries. Peter's BESTrustees clients include J Sainsbury, LV= and Scottish Power pension schemes.

**STEPHEN COHEN**
**Managing Director, Global Head of Fixed Income Beta, BlackRock**

Stephen is responsible for overseeing the beta fixed income investment group and the fixed income iShares business. Prior to his current role, Stephen was the chief investment strategist for BlackRock International Fixed Income and Global iShares. In addition he is a frequent contributor to financial news media and appears regularly on Bloomberg TV and CNBC. Stephen joined BlackRock in 2011 from Nomura.

**XAVIER BARATON**
**Global Chief Investment Officer of Fixed Income, HSBC Global Asset Management**

Xavier Baraton is global chief investment officer of fixed income. He joined HSBC in September 2002 to head the Paris-based credit research team and became global head of credit research in January 2004. From 2006, Xavier managed euro credit strategies before being appointed as head of European fixed income in 2008 and as global CIO, fixed income, in 2010.

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**ANDRES SANCHEZ BALCAZAR**
**Co-Head of Global & Regional Bonds, Pictet Asset Management**

Andres joined Pictet Asset Management's fixed income team in 2011 as co-head of global & regional bonds. Before joining Pictet, he was a senior portfolio manager for Western Asset Management Company for six years. During his tenure he was responsible for global, European and absolute return fixed income portfolios. Previously, he worked for five years as a global and European portfolio manager.

**Chair:** Let's kick off with an overview of the market. Andres *[Sanchez Balcazar]*, how are people looking at fixed income at the moment?

» **Sanchez Balcazar**: I think there is a substantial amount of unease about holding yields at the current levels, be it corporate or government yields, and therefore people are trying to find alternatives to that. We have seen a substantial amount of demand for unconstrained or absolute return fixed income solutions as a way to circumvent the issue. There is no free lunch. If you are going to sacrifice duration and replace it with spread you are also increasing the level of illiquidity in your portfolio. If you are going to add on other markets or other derivatives, there is also a cost to that. A lot of the work we are doing at the moment is making our clients aware of those other risks and trying to find in many cases customised solutions for what they want to achieve. I think it is reasonable to say that fixed income benchmarks are no longer the panacea and are on the way out.

» **Hartman**: There are three main things to comment on here. One, clients have increased their liability hedges, so in this very high risk/low yield environment they are wanting to get rid of as much of this unwanted risk as possible. In terms of return seeking, there is not a lot of return to seek and I think people are getting used to that. You must think about liquidity here because there will be pockets of opportunity at some point in time and then you must think about the liquidity premium. We are telling pension fund trustees to construct their portfolio appropriately, to choose the right fixed income manager and then take advantage of the liquidity premium – think about direct lending and real estate debt for example.

» **Chair**: In the Eurozone, a number of pension funds have to provide a minimum level of return, how are they coping with this?

» **Baraton**: It is increasingly challenging. As we speak, close to 25 per cent of the global bond market is now yielding sub-zero yields. At the other end of the spectrum, about the same percentage of US high yield is trading at distressed prices. For conventional long-term asset owners, it is a slowly but surely narrowing space to play with. It takes a lot more volatility or risk allocation to get the same returns as in the past. If you want to mitigate this trend you need to work on volatility and look into solutions where managers try to control the downside. You need to look at alternative credit and increase allocations into EMD and high yield where we see pension funds increasing their allocations to.

» **Chair**: How much do you think it is necessary for pension fund investors to relight their return assumptions and also their discount rates in this type of environment? Are you seeing people doing that?

» **Thompson**: We have to reflect the environment we are operating in. As a pension scheme trustee, what we are trying to do is meet a pattern

of liability cashflows, most of which are related in some way to an inflation index. That is the starting point, then you are looking at the funding position of the scheme and the strength of the employer covenant. What we have got used to in the last few years is first of all that yields will be low for a long time and we are finding from consultants and asset managers a much wider range of fixed interest products, far wider than a few years ago. It is not just gilts and corporate bonds but a range with a greater or lesser degree of risk, a greater or lesser degree of risk of duration and of course of liquidity. It also depends on the duration of these illiquid products. If I am going to lock up my money for, say, 20 years, I would want a bigger illiquidity premium than if it is only five years. We are also mindful of mark-to-market volatility.

» **Chair**: One of the things that concerns us the most about mark-to-market risk is not that our clients should be worried about it per se, but when you are investing in funds that have a very mixed institutional and retail ownership, our clients, if there is a mad rush for the door, are likely to be the ones turning out the light. A lot of products at the moment are offering liquidity at a cost that is far below the cost available in the market. We are concerned about daily dealing funds. If we invest in them they should charge people the correct amount for liquidity.

» **Baraton**: Liquidity is shrinking and there are no signs of a turnaround any time soon. In our funds, we have put in place a series of measures to mitigate liquidity: semi-swinging factors but also managing with more cash and using derivatives more actively. These measures have also played a role in educating on the fact that we cannot offer in funds liquidity that does not exist in markets, but also educating on the other fact that if you are a long-term asset owner you should not subsidise the most active investors that get in and get out.

» **Sanchez Balcazar**: With regards to unconstrained fixed income, I would say that with today's liquidity situation, any fund bigger than $10 billion in size will start to become for the whole strategy quite cumbersome to manage. At the end of the day your investment process and investment style needs to adapt to conditions. We are living in a world where the disintermediation of credit provision is happening and the role of the asset management industry to an extent is to provide that liquidity to the market, which used to be provided by other people. In a way that affects your investment process as well. We are supposed to be the longer-term investors, we need to be able to be in that position and therefore be buyers into weakness and sellers into strength. But if you are too momentum driven you will end up paying a very high liquidity premium for your fund.

*"Liquidity is shrinking and there are no signs of a turnaround any time soon"*

» **Chair**: Institutional investment in ETFs has been picking up. Can you comment on this issue?

» **Sanchez Balcazar**: In our portfolios we don't invest in ETFs, we prefer to invest directly in the sectors where we have actual expertise. I think the ETF pricing could be a challenge for certain sectors. I think it is an overstated challenge in a way, because at the end of the day these funds are entirely transparent to the market. So you know that flows are coming, that is good but in the situation where we were before, where this was not transparent at all, it was probably worse. I don't think that ETFs are the foe that everybody makes them out to be but it is an additional element of the market that you need to be aware of.

» **Cohen**: When we look at the markets over the last five years, we have a situation where structurally the fixed income market is undergoing the biggest change in decades. The reality is that the traditional providers of liquidity are not there, they are not coming back. The banks are struggling to define what their business models will be, and the regulators will not let up on the banks and allow them to have big balance sheets. In that world, I think you see a shift in liquidity provision and transfer. The asset management industry is becoming a liquidity provider and within that, as a liquidity provider, what are the tools that people need to be able to transfer that liquidity around? Traditionally it would be a bank sitting there with a big balance sheet and bonds going in and out. We see ETFs as becoming one of those vehicles to provide that transfer. US high yield is a great example. When you see signs for stress in the underlying market, you see the volume of the ETF go up. Typically it is new people coming to the ETF, particularly institutions to make that risk transfer. We talk a lot about the concept of blending, active and

*"When we look at the markets over the last five years, we have a situation where structurally the fixed income market is undergoing the biggest change in decades"*

passive, but there is also a blending of ETFs with individual bond portfolios. ETFs can sit as a tool alongside the individual bonds they are using and credit derivatives or futures they are using, depending on the market, to be able to manage in what has become a very illiquid environment.

» **Chair**: It is my impression that US institutions use ETFs more than European institutions and I wonder if part of that is due to the attitude towards derivatives and I also wonder if that is possibly going to change as EMIR bites and the cost of clearing and trading derivatives pick up?

» **Cohen**: That is part of the reason but another reason to consider is that the maturity of the European ETF market is behind where it is in the US. The absolute size of the ETFs in the US are bigger, they have been around longer and US investors are more comfortable with using ETFs. There is an element of being further down the track as it were. We see Europe coming along very quickly however. If you look at our European high yield fund it is now at $5 billion. These funds are getting to the point where they are sizeable. The one challenge here in Europe as we know and ahead of MiFID II, is that transparency is not what it is in the US. In the US you can look at any ETF and you can see the liquidity on the exchange, we are not at that point in Europe. Regulatory change will help to change the visibility and transparency element in Europe however.

» **Chair**: Lennox *[Hartman]* can you see your institutional investors and asset owners ever using ETFs?

» **Hartman**: My institutional investors do use ETFs. They are used mostly during transitions when you are trying to get exposure quickly and some of the larger schemes will use them when they have in house teams. Multi-asset funds also use ETFs in our client base.

» **Chair**: Looking at EMIR, we have been doing a lot of work around that not only with respect to a swaps clearing but also with respect for forward foreign exchange. Do you see the new rules changing the way which you use interest rate derivatives, credit default swaps or forward foreign exchange in your portfolios? Will it make it more difficult to manage your portfolios?

» **Sanchez Balcazar**: The short answer is not necessarily. It doesn't change your process but it changes the way you manage your counterparties. It changes the way you manage the pools of liquidity you have to access. To be honest, part of the problem with liquidity in the fixed income market is that there is more concentration in counterparties that can provide liquidity for you. That means you need to, as a manager, become more aware of where those pools of liquidity are and how you manage your counterparty risk going forward. That is already happening in the US.

» **Baraton**: I agree. It shows that the portfolio management function is evolving from trade idea generation and portfolio construction into factoring in regulatory aspects. This regulatory strengthening will continue. I think it is part of this secular change that we all have to deal with. It means that portfolio managers, to stay nimble and perform, must take the impact of

*"There is more concentration in counterparties that can provide liquidity"*

regulation into account, in particular on the cash available in funds and that they can effectively use. Generally speaking, regulation tends to be an additional fixed cost to manage effectively. There will be some consolidation in the number of counterparties and in return there may also be some consolidation on the asset management side as well because the number of regulatory obligations is making money management more costly even though it is to the benefit of retail and institutional investors. The question is how some smaller firms can really cope with these trends.

» **Chair**: Does it mean you will need more cash for initial variation margin?

» **Sanchez Balcazar**: Not necessarily. You need to have somebody who is focused on managing exactly that on a day-by-day basis. You can say that I am going to have enough cash to cover all margin movements in whatever movement I may have in my derivatives but that will not be efficient from a portfolio management perspective. Should I hire somebody to look at that for me? Definitely yes. Should I add another layer of process to make sure that is running an effective way for the portfolio? Definitely. By requirement, this must be taken care of.

» **Cohen**: That's also what we have seen in the equity world. The volatility of the role cost has gone up dramatically. Having to have people look at the cash margin but also having to have people thinking about whether this is the right vehicle at any given time is absolutely crucial. In the old days these investment vehicles were just left to run.

» **Chair**: Is the regulation changing the way that pensions schemes are managing their derivatives overlays, not just LDI but also currency hedging. Are they looking to bring them into one place for the most efficient use of collateral?

» **Thompson**: I think that is only viable for the bigger schemes otherwise it just becomes another layer of complexity. I don't see it happening yet though. The thing that does concern me is repo. A lot of us use repo and some fund managers go for different sources of repo so it will be interesting to see how that works out.

» **Sanchez Balcazar**: We don't make very active use of repo, which only 10 years ago you would have been very active in as a fixed income investor. With US regulation especially, this has become a big 'no no' in the way you use your counterparty and derivatives exposure. It has become so cumbersome and so taxing for your risk budget that in a way we prefer to refrain from using it. Does that mean we are using less leveraging in our portfolios? Yes, in the sense it is probably being replaced by derivative leverage.

» **Baraton**: I agree. We will continue to use derivatives but portfolio managers must use them for a reason, to express a view and to generate alpha, as an alternative to cash securities when it allows to manage more effectively and at lower transaction costs notably. The industry must keep it simple.

» **Chair**: In the very wide mandate funds where sector rotation and asset allocation is an intrinsic part of the proposition, presumably it is absolutely essential to be able to use derivatives and presumably therefore it makes those funds more difficult to less sophisticated clients?

» **Sanchez Balcazar**: Correct. If you are trying to manage a multi-sector fund not attached to a benchmark where you are trying to find as much diversification as you can to stabilise return, you need to use derivatives to separate the different decisions that you are making when running a fixed income portfolio. You need to separate your rates decision from your credit decision from your FX decision. That by itself already creates a significant amount of derivative exposure in the portfolio if on top of that you use derivatives to generate returns. We embrace this but again it has a cost, a cost of complexity. Unfortunately, it becomes something that is not sellable for unsophisticated clients. We are very wary of clients that are not sophisticated because even if they tell you they understand how things work, then the proof will come when things are difficult, and then you show a certain amount of losses on derivative exposure and the client says that cannot happen. We prefer to keep it simple and to build on the complexity as we move on.

» **Baraton**: It is important to bear in mind derivatives are not evil. When properly used, it is definitely in the retail investor's interest and is important in generating alpha.

» **Thompson**: For large pension schemes when using derivatives, it is

important for trustees to understand what the downside risks are.

» **Sanchez Balcazar**: The drive for yield is so overwhelming now it will dwarf any education effort that you want to have towards the retail space. It is amazing how much the need for yield and return is there.

» **Baraton**: It is quite key to use derivatives to achieve a very clear investment objective, to better combine various alpha sources or to protect funds against downside risk.

» **Chair**: Are you saying that the regulators have shifted the systemic risk from the banks to the retail or end investor and to the clearing houses?

» **Sanchez Balcazar**: I think the system now is safer than it was 10 years ago. We as asset managers are playing a part in providing liquidity to the system, but to an extent, we are a much more transparent and already regulated actor than, for example, prop investors before the 2008 crisis. When you deposited your money at the retail bank back then, you didn't know where that deposit was going to end. If you put that money in any asset management house that is regulated, you know what you are getting into, you get monthly reports on assets and you know the amount of leverage or not that the investor is using. Before, if I was buying a senior bond off an investment bank, I could be investing in something quite risky, but the bank wouldn't feel compelled to disclose it to me. Some of the risk transfer did take place from the banks to asset managers. That is not a bad thing.

» **Hartman**: I do agree. There is a lot more transparency than in the past. There are additional costs and these are barriers to start-ups and entrepreneurial thinking but the industry will find ways to innovate and overcome those.

» **Chair**: Going back to unconstrained investing, what do you mean by unconstrained?

» **Hartman**: Effectively it means from a portfolio construction point of view not being driven by index construction. We look for talented investors that can make decisions for themselves about whether a specific risk they take on is going to be rewarded and doing this in a controlled portfolio holistic manner.

» **Thompson**: How do you know they are doing what you expect? If they are not starting from a benchmark where are they starting from?

» **Hartman**: When we talk to the managers we look at their specific skill sets. Some managers may be able to buy levered loans, or illiquid investments but if they don't have that expertise then we will set guidelines that will prohibit those investments. The other important aspect is running through specific scenarios, like running through taper tantrum and seeing how that specific portfolio responds. There is a lot more work to be done in identifying and monitoring unconstrained mandates than there are benchmark driven mandates. Managers in this space are just as much risk managers as they are fund managers.

» **Chair**: Have you found that they have done what you hoped they were going to do?

» **Hartman**: As an industry overall no they haven't. The managers for the most part that we have worked with have delivered, they haven't been straight line positive return but that's not what we were expecting. Overall we have been happy but it does take a lot of effort and a lot of pre due diligence.

» **Chair**: We are very cautious on unconstrained funds because we find it very difficult to find a manager who is good at all the sleeves and is good at asset allocation. It is a very rare talent. Normally what we find is somebody who is good at one or two of the sleeves and giving them an unconstrained mandate actually dilutes the alpha.

» **Cohen**: The challenge for unconstrained, if you go back two years ago the big concern for investors is what happens when interest rates rise? The immediate returns for funds is not what is wanted. The challenge is to articulate the story of unconstrained investing through the cycle rather than people thinking that this is something that will deliver positive returns quarter in quarter out irrespective of what happens to duration. That is the challenge around communication.

» **Baraton**: To succeed in

*"There is a lot more work to be done in identifying and monitoring unconstrained mandates than there are benchmark driven mandates"*

unconstrained funds, you must have a clear definition of what you are trying to achieve. For us, in our total return funds, it means delivering the returns of an asset class over a cycle with less volatility, and notably by mitigating downside risks. It has to be risk controlled and proper risk calibration is essential. We believe it can be of interest to institutional investors even though it tends to belong to the retail space.

» **Sanchez Balcazar**: There has to be a value proposition for the client. You need to provide some sort of downside protection and our view is that we cannot create an all-weather fund. It is very costly. The big surprise for us is that it is really the institutional sector that is driving this demand for unconstrained fixed income because there is a place for this type of investment whereas there is not the skillset internally in a pension fund to rotate between different sectors to obtain the required returns. Delegating that skillset to the manager makes sense, but obviously that manager needs not only to deliver but needs to deliver something different than a low beta version of their long-only fund.

» **Cohen**: This conversation is quite reflective of a broader conversation within the industry. The concept of what is the benchmark was mentioned. I think there is a greater questioning by investors around what am I paying for, what am I comparing it to. Total return is a good example. We see a lot of funds who will say I beat the agg, but we turn around and say is that actually the benchmark you are comparing yourself to. If I load up on high yield, well then the agg is an irrelevant benchmark to me.

» **Sanchez Balcazar**: The initial discussion was how do I get rid of my duration risk and increase my spread risk in my portfolio so I can compensate for that? I think that discussion is over. We moved into a discussion where the managers were saying I want total freedom of constraints and I'll try to forecast the main macro events affecting the market – what we call the 'guru approach' of fund management. This did not work. We are moving into a discussion about the risk management approach strategy. Rather than saying I can forecast every single macro event out there, it is about asking the question of how do I manage the risk of my portfolio appropriately so I can get to the return objective I have.

» **Chair**: Because of the reduction in liquidity and the increase in volatility which are two sides to the same coin, we are now asking ourselves whether the volatility of the alpha is going to pick up just even if you were managing your portfolios in the same way you have always managed them and whether that means the excess returns are going to fall because there is added friction in the system and therefore the efficiency is going to fall and is there anything you can do to offset that.

» **Sanchez Balcazar**: I think the volatility of alpha will pick up just for the fact that we have been through such an extremely low volatility period for fixed income markets in general. If you look at general volatility numbers, they hide a lot of drawdown risk and for an unconstrained manager that is really the key variable.

» **Chair**: The volatility of alpha is surely what the clients look at. If you are a magic investor and you produce excess returns of 50 basis points every month, they are going to prefer you than if you are up 1 per cent down 0.5 per cent, up 2 per cent etc.

» **Sanchez Balzacar**: It depends if what you do is what you say on the tin. It is much more important if you sell something, that you state it upfront and the clients are aware of that. If you change the expectations that client has for you that is much more of a serious mistake than if you are sometimes down 50 and up one. For unconstrained managers, that is the crux of the issue.

» **Thompson**: I agree. If a trustee body allows a manager to do product 'a' you expect them to do product 'a' not product 'b' because someone else could be doing that.

» **Cohen**: Efficiency is really important here. If you are a manager trying to do what you would have done seven or eight years ago in how you are generating alpha, I think you are going to struggle. All of the things we have talked about in terms of liquidity are changing the dynamic. You start to see a shift towards thinking about the efficiency of trying to generate an alpha. This comes back to where does alpha come from? It is the top-down asset allocation risk management aspect and the bottom up, which is how can we use the platform to bring different pieces into the equation.

» **Sanchez Balcazar**: It is a much more interesting discussion building a portfolio from scratch than hiding behind a benchmark. It is much more intellectually stimulating.

» **Chair**: One of our first discussions is what should your beta be? Do you need the beta even? One of the things that we are desperate to try and deal with is this love affair with the agg. It is a bad beta. We have spent a lot of time designing better benchmarks and it is a fascinating exercise. What are the clients really trying to achieve and therefore how should they be invested?

» **Thompson**: What they are trying to achieve almost certainly is outperformance of the assets versus the liabilities.

» **Chair**: Yes but very often they

*"It is really the institutional sector that is driving this demand for unconstrained fixed income"*

don't actually understand that or they haven't properly defined what their liabilities are in some of the jurisdictions. If they can't define their liabilities then we have to do the best we can. This is the case for DB investors. For DC investors it is rather different.

» **Cohen**: We do a lot of work on balanced risk indices and I think the discussion around how indices evolve will be a big one. It is about benchmark, it is about what am I benchmarking to and is it even really relevant to matching assets with liabilities. It is hard to move people away from historical processes however.

» **Baraton**: The low yield pressure is leading the industry to investigate any route or avenue that we can find to improve the sharpe ratios. On the liability side no one is very happy with the increasing market volatility. The industry will continue to look into efficiencies and improving benchmarks and there are lots of simple solutions at hand to construct better benchmarks or portfolios.

» **Chair**: In the next 12 months, let's put the rate risk and political risk to one side, which other risks are troubling you the most?

» **Sanchez Balcazar**: Over time I think Japan is a risk. Through the centuries government debt monetisation has not ended up well. Another scenario to pay attention to is the growth in credit in China. China is going the same way as Japan with its state owned enterprises for example. In general I am concerned about the state of democracies in the developed world. There is a lack of happiness with politicians at the moment and that is going to be reflected in how these countries can manage their debts. From a bond holder perspective this is not particularly encouraging.

» **Baraton**: There is a race against time here. We have secular stagnation forces at play, and all this is not going to go away probably before the second half of the next decade. There is some fatigue with the political class as a result of this low growth/low inflation world but countries try to fix problems and engage structural reforms. Visible progress is made. Look at emerging markets, structural reform, Chinese rebalancing or even the cost effectiveness of Europe generally.  It is a fragile equilibrium which is not necessarily leading to major threats when looking at global growth, due to higher than usual contagion risk and less liquid and hence over-reacting markets, there is definitely a perception of risk that will stay extremely high.

» **Cohen**: A lot of the big issues are not going to get resolved in the next 12 months in a good way because any positive progress that is happening is very incremental. Take China for example. The next 12 months the good scenario for China is the constant balancing act they are doing. The fiscal policy debate is going to come back and this has been dormant for the last three or four years because it is politically untenable for governments to try and do anything. The other risk is monetary policies credibility. Japan is absolutely at the apex of that and it is hard to see where the Bank of Japan goes next. Negative rates have not gone down at all well in Japan.

» **Thompson**: From a trustee perspective there are still a lot of zombie pension schemes out there. Schemes with substantial deficits where there is no reasonable prospect of the employer being able to fund those deficits in the foreseeable future. That is a question which the government is just getting round to starting to think about.

» **Chair**: Not only here but in Europe too.

» **Hartman**: Maybe we need to reset our financial and social expectations in order to deal with what is happening.

» **Chair**: What could trigger dramatic change is some of the zombie pension funds suddenly falling down like dominos.

» **Thompson**: Especially if it is a big pension fund. If it is a sub £100 million it won't affect much, but if you talk about British Steel then that could have big effects.

» **Chair**: My biggest worry is this dash for yield, which rarely ends well, and also that the industry is in a place with negative real yields and there is no way we can provide people with what we say we are going to, which is a comfortable retirement. We may end up where the only comfortable retirements that we are greeting are our own and the clients are ultimately unhappy. That is not a good place for the industry to be in. ■

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# In their own words...

Industry personalities' comments on the hot topics affecting the European pensions space

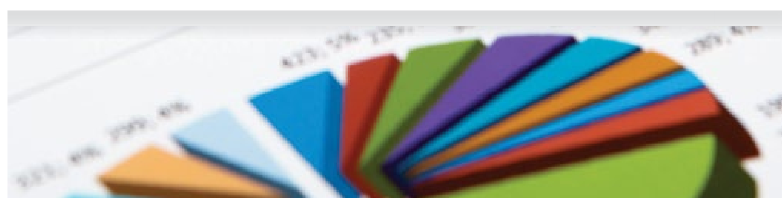
## On the UK's decision to leave the EU

**JOANNE SEGARS**
**PLSA chief executive**
"The ramifications for UK pensions of the UK's decision to leave the European Union will start to become clear over the coming weeks and months. Much will depend on the precise nature of our future relationship with the EU, which may mean that some aspects of UK pension provision continue to be influenced by the EU. In other areas, UK pension law may need to be disentangled from EU legislation."

**DAVID FAIRS**
**KPMG partner**
"Overseas *[from the UK]* investments might appear expensive in the short term. In the longer term, the challenge of whether the UK will grow faster or slower, will be a conundrum. With a falling pound, a higher rate of inflation would be expected, eroding the purchasing power of pensions in payment because most individuals shun purchasing inflation protection. Although those who have a public sector pension will be much better protected as their pensions are largely inflation protected."

*"The vote to leave, which confounded bookmakers' predictions, may make it even harder for policymakers to set a clear pensions strategy. Market volatility and a period of political uncertainty are unlikely to be conducive to setting a coherent long-term strategy for pension provision – it will be important that financial institutions take positive steps to calm markets."*

ACA chairman Bob Scott



## On the EU's need to ease capital rules on pension funds

**JANWILLEM BOUMA**
**PensionsEurope chair**
"The negative impact that the interactions of EMIR with bank capital rules currently have on pension funds needs to be prevented. At present, the cumulative impact of bank capital requirements (CRDIV) and EMIR is overly burdensome for pension funds. A one-size fits-all solvency regime is not appropriate and would have potential significant negative impacts. EIOPA's proposal for the mandatory use of a common framework balance sheet is impractical, unnecessary and costly. It is doubtful whether the outcomes of the common framework balance sheet have any additional use to national financial assessments in day-to-day supervisory practice."

## On LGBTI pension equality

**"We want employers to allow LGBTI people an opportunity to change their single person pension option to a married person pension option after they were finally allowed to marry. The UK government did this with no problem. Some employers (including the government in Ireland) are refusing to do this despite the Marriage Equality Constitutional Amendment – it's quite extraordinary!"**

**Pension Equality honorary secretary Fergus Courtney**

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