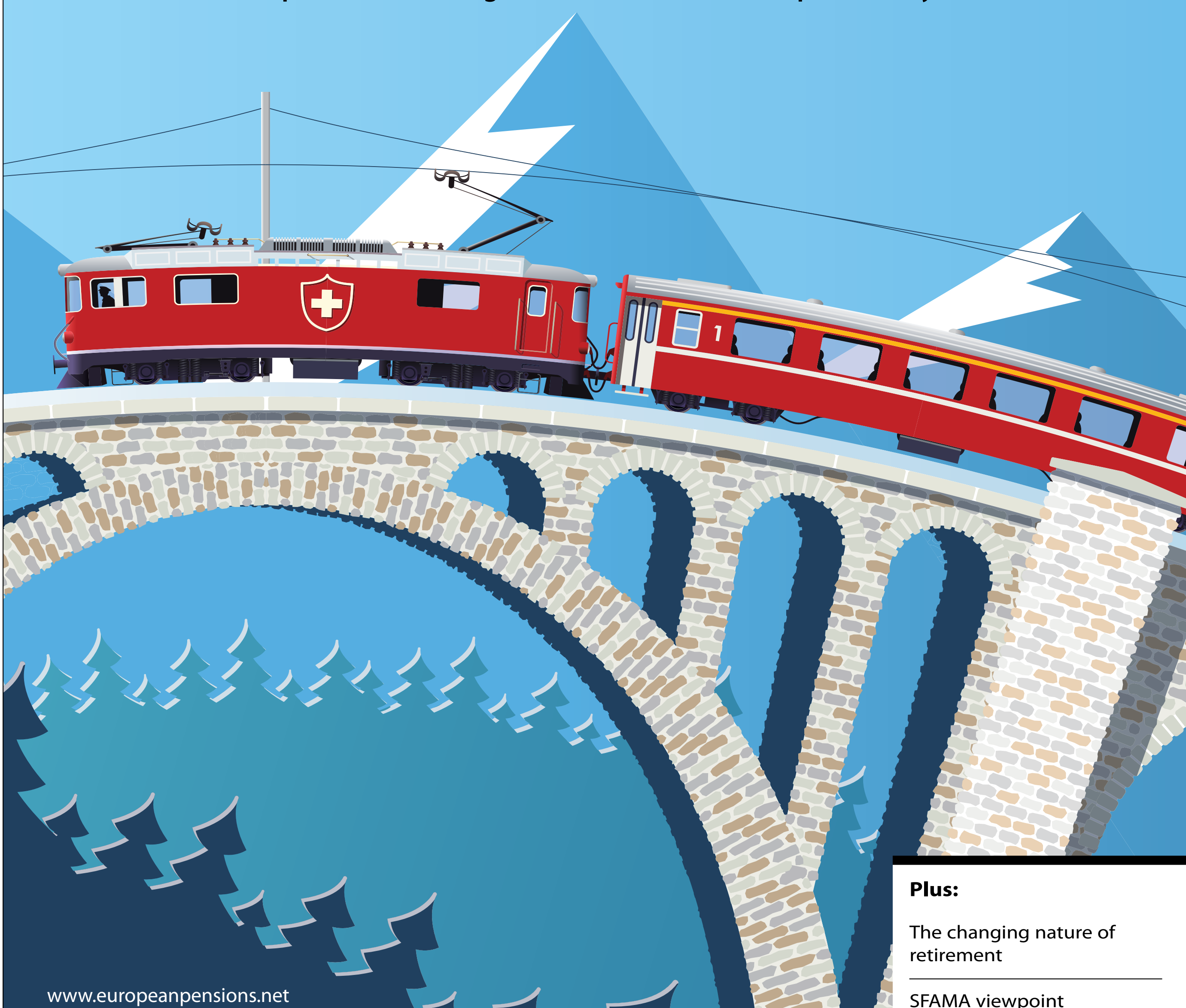
European Pensions

February/March 2017

Travelling towards change

The improvements being considered for the Swiss pensions system



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See page 14 for the PLSA's reasonings why MiFID II could threaten LGPS infrastructure investment

A helping hand

Political and economic uncertainty continues to sweep across Europe, forcing institutional investors to continuously grapple with changing financial markets. Upcoming elections in Italy, France, Germany and the Netherlands will set the outlook for the Franco-German leadership; we have Brexit developments on the horizon, EMU consolidation and more generally a morphing vision for the future of the EU.

The rise of anti-establishment parties across Europe adds to these turbulent times. Pension funds are directly or inadvertently affected by these developments and must pay particular attention as to how to adapt to to changing times.

One change that is rising up the agenda for many European pension funds is the emergence of fintech. As our feature *Entering the arena* on p.44 states, fintech is influencing the pensions world by using product listings and filtering platforms to provide investors with the information they need to compare investment opportunities and identify new products.

As the need to predict markets and trends intensifies, so does the need for financial technology advancements to help with this. Look-through tools are increasingly being utilised to ensure pension funds have the appropriate visibility into investments and that these investments are in line with their mandates.

FINTECH IS INFLUENCING THE PENSIONS WORLD BY USING PRODUCT LISTINGS AND FILTERING PLATFORMS

Furthermore, with the European pensions population woefully undersaving, the emergence of technologies such as robo-advice can give consumers a personalised savings plan much quicker than face-to-face guidance and ultimately benefit them in the long run.

The pace at which fintech eventually engulfs the European pensions landscape is anyone's to predict, but I would argue that it can only be a good thing. It may be costly for pension funds to implement but in my opinion this cost is worth paying if you can. Technology developments in the UK and across Europe within the pensions landscape are well behind other financial counterparts and there is a game of catch-up to be played here. I'm an optimist, so here's to a bright future despite the ever-increasing political uncertainties sweeping across Europe.

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Subscription rates:
£198 or €299 per annum

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6th floor, 3 London Wall Buildings,
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ISSN 1753-5859

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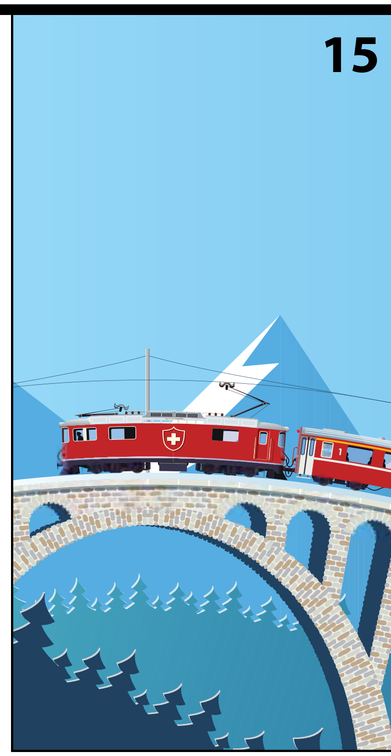

Country spotlight

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Finland and Italy added to top 22 countries for pension assets

IN TOTAL THE LIST FEATURED NINE EUROPEAN COUNTRIES IN THE TOP 22, BUT THE USA LEADS THE WAY WITH 61.7 PER CENT OF THE WORLD'S TOTAL PENSION ASSETS

Written by: Natalie Tuck

For the first time Finland and Italy have been featured in a study of the top 22 countries for pension assets by Willis Towers Watson.

Its *Global Pension Asset Study* 2017 included nine European countries, which are the UK, Spain, Switzerland, the Netherlands, Italy, Ireland, Germany, France and Finland.

The UK featured in the top three countries with the most assets, whereas Spain and Ireland featured in the bottom three. The total number of assets for the 22 countries is $36,435bn, and they account for 62 per cent of the GDP of these economies.

The study looked more in depth at the top seven countries. In terms of asset allocation, the study found that the US, Australia and the UK have higher allocations to equities than the rest of the markets. Switzerland, Japan and the Netherlands have more conservative investment strategies with a higher allocation to bonds.

The report also showed pension fund assets have grown at 3.8 per cent on average per annum (in USD) over the past five years, with the growth rate highest in China (20.3 per cent), where the study covers the Enterprise Annuities market, and lowest in Japan (-5.4 per cent).

Growth in defined contribution (DC) assets continued to outstrip that of defined-benefit (DB) assets, with DC assets now accounting for over 48 per cent of global pensions assets, compared with around 41 per cent in 2006. DC assets have grown at a rate of 5.6 per cent over the past decade, compared with 2.6 per cent for DB assets.

Commenting, Willis Towers Watson global head of investment content Roger Urwin said: “Pension funds worldwide made some progress against their headwinds in 2016. This was largely because equity markets and alternative asset classes produced gains ahead of expectations. While funds in many countries have large pension outflows to deal with, it was encouraging to see overall asset values rise in the vast majority of countries covered in the study.

“The study also confirms a continuing globalising trend as indicated in the reduction in pension funds’ bias to domestic equities markets, with the weighting of domestic equities falling on average from 69 per cent in 1998 to 43 per cent in 2016. Of the markets analysed, Switzerland, Canada and the UK had the lowest percentage allocation to domestic equities markets, whilst US funds had the highest exposure to domestic equities.”

In addition, Urwin noted that managing risk has continued to be a focal point for pension funds around the world.

"Managing risk has continued to be a focal point for pension funds around the world"

“The principal strategy for this is increased diversification, as evidenced in the upward trend in allocations to alternative assets and a sustained shift from domestic equities markets. An increasing number of funds are using more sophisticated liability-hedging techniques, often referred to as liability-driven investing. With geopolitical events adding to existing uncertainty across regions, these are likely to be continuing trends. The key to success will therefore be in confronting global, regional and local risks, in addition to remaining on top of regulatory changes and improving governance practices.

“This study suggests that the key medium-term trends for pension funds continue to be: focus on risk, attention to governance, pensions design with DC models in the ascendant, pressure on talent, streamlining of the value chain and integrating ESG considerations. Each of these is a tough challenge, taken together they multiply to a pretty formidable agenda.”

ATP returns DKK 15.3bn before tax and expenses following 'turbulent year'

IN OTHER PENSION FUND NEWS, THE NORWEGIAN GOVT PENSION FUND GLOBAL SOLD THREE PROPERTIES, AND ERAFP HAS UPDATED ITS SHAREHOLDER ENGAGEMENT GUIDELINES

Written by: Natalie Tuck and Talya Misiri

Danish state pension fund ATP has announced a gross investment return of DKK 15.3bn before tax and expenses, following a "turbulent year".

Net results for 2016 totalled DKK 9.3bn before its life expectancy update. However, as its members' life expectancy has risen to more than expected, the ATP Supervisory Board decided to transfer the DKK 9.9bn bonus potential to existing guarantees. As a result, the annual results amounted to DKK 0.6bn.

Private equity and credit investment also made considerable additions to investment return, at DKK 6.6bn and DKK 3.8bn, respectively.

Declining interest rates last year also lead the value of guaranteed pensions to increase to DKK 659bn, while the fund's liabilities also increased in line with this.

ATP provided DKK 10.6bn for tax on pension savings returns in 2016 and total assets now stand at DKK 759bn.

Furthermore, the Danish fund's administration expenses continued to decrease in the year by 17 per cent, ending at DKK 48 per member per year, down by DKK 9 from 2015. ATP's administration expenses have reduced by 30 per cent over the last four years.

ATP CEO Christian Hyldahl said: "2016 was a satisfactory year for ATP – and for our members. It was a turbulent year, but ATP nevertheless managed to produce a good investment return. The results have enabled ATP to further prolong the lifelong pension guarantees, as the life expectancy of the Danish population is increasing more than expected."

In addition, French public service pension fund ERAFP has updated its shareholder engagement guidelines and its policy for voting in general meetings to reflect the changes to its SRI charter.

While continuing to focus on collaborative initiatives covering issues such as the fight against climate change, combating aggressive tax optimisation and preventing employee-related risks in the supply chain, under its new SRI charter's provisions on monitoring controversial matters, ERAFP will now require its management companies to initiate dialogue with companies involved in proven violations of international standards.

"ERAFP has affirmed its responsible voting policy"

In addition, ERAFP has affirmed its responsible voting policy in a changing legislative environment. With respect to its voting policy, ERAFP will continue to focus on a number of key issues, which will be given priority in talks with issuers regarding the next general meetings season.

These include the transparency of companies' business and financial situations. In 2017, ERAFP is widening its scope and it will no longer focus solely on financial sector companies' country-by-country financial reporting, but will also cover, on a trial basis, the reporting of all companies with revenues of more than €750m.

It will work to promote the principles of transparency, equity and moderation in determining executive remuneration. In 2017, ERAFP expects all publicly-traded companies to implement voting on the remuneration of corporate officers. In addition, ERAFP will give careful consideration to the remuneration committee's responses following any disputes arising from such votes.

Furthermore, ERAFP wants to increase the proportion of women on boards. The fund increase the minimum threshold for women's representation from 30 per cent to 35 per cent in 2017 and now wants to increase it further to 35 per cent to 40 per cent, as required by the Copé-Zimmermann law.

In other pension fund news, Norges Bank Real Estate Management has sold three logistics properties in San Francisco Bay on behalf of the Norway Government Pension Fund Global. Along with Prolongis, the deal was signed on 8 September 2016 and completed in two stages on this date and then on 28 December 2016. The portfolio was bought by JLL Income Property Trust.

The Bank received $38.3m for its 45 per cent ownership interest. Properties were purchased by the partnership during May 2015, and Norges Bank Real Estate Management paid $24.3m for its ownership.

Swedish pensions review committee devises pensions gender gap reduction plan

AS THE PENSIONS GENDER GAP CLOSES IN SWEDEN, FINNISH PENSIONERS HAVE ALSO SEEN AN INCREASE TO THEIR PENSIONS

Written by: Talya Misiri and Natalie Tuck

A plan to reduce the pensions gender gap has been agreed by Sweden's pensions review committee Pensiongruppen, the Swedish government has revealed.

According to *The Local*, at present, women in Sweden earn an average of 30 per cent less than their male counterparts. As a result of this, the country's pension committee, which comprises of representatives from six different Swedish parliamentary parties, has agreed on a strategy to deal with the gender gap.

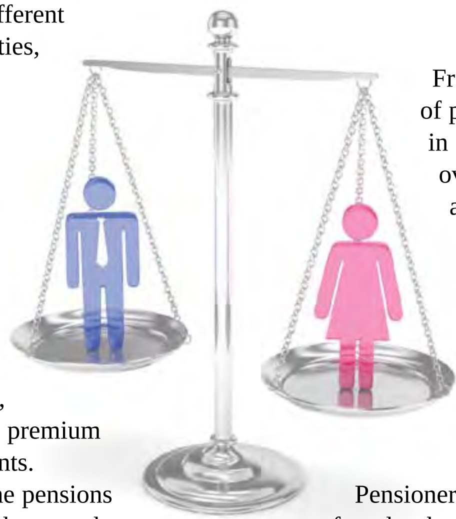
An eight-part plan has been drawn-up to review the 'basic cover' in Sweden's pension system, including the guarantee pension, a means-tested benefit and a housing supplement for those over 65 with a low income, as well as how transferring premium pensions between cohabitants.

"All six parties behind the pensions agreement are determined that together we will have more equal pensions. It's a long-term effort and the action plan is an important step on the road," Swedish social security minister Annika Strandhäll said.

"We know that many pensioners have a tough time and 80 per cent of those taking a guarantee pension are women. An important part of the ongoing work is therefore to see how the basic cover can be strengthened. A comprehensive review of basic cover hasn't been done since it was introduced 20 years ago and it's high time it was done," she added.

A considerable number of gender equality schemes have been launched in Sweden in recent years. Most recently, the government presented a new gender equality authority in December dedicated to a gender-equal society.

Elsewhere in the Nordics, pensioners in Finland have enjoyed an income uplift of a third in the past 20 years, the Finnish Centre for Pensions (ETK) has reported.



From a broad investigation into the development of pensions and pensioners' economic welfare in 1995 to 2015, it was found that the average overall pension has increased in real terms by a third. This is mostly due to structural changes within the population of pensioners.

Furthermore, for those who were in retirement, without interruption, from 1995 to 2015, the average pension increased by 21 per cent in real terms. This can be due to index-linked increases as well as entitlement to a surviving spouse's pension or a guarantee pension.

Pensioners' disposable income and consumption were found to have increased by almost half in the last two decades. In comparison to the rest of Europe the Finnish retirement age is slightly better and only a small proportion of pensioners in Finland report great financial difficulties.

ETK's investigation used a number of indicators to assess pension development including pension income, household disposable income, consumption, assets and subjective financial well-being.

"New retirees have longer working histories than before, and they have entered the labour market after the earnings-related pension system was introduced. For this reason their pensions are higher. At the same time there are ever-fewer pensioners depending on a small national pension," said ETK head of research Susan Kuivalainen.

In addition, Finland's earnings-related pension reforms have taken effect with pension accrual rates changing immediately. The changes commenced from the 1 January 2017 and the first new partial old-age pensions can be granted as of February 2017.

In practice, the retirement age will rise in 2018 and it will be possible to apply for the new years-of-service pension at the end of spring 2017. The first years-of-service pensions will be paid as of 1 February 2017.

The retirement age will rise gradually by three months per year from the current 63 years to 65 years. age 65 and after that, the retirement age will be linked to life expectancy.

Pressure mounts on EC to save pension schemes from derivatives reforms

THE EUROPEAN COMMISSION HAS UNTIL MARCH 2017 TO PUT FORWARD AMENDMENTS TO THE 2012 EUROPEAN MARKET INFRASTRUCTURE REGULATION

Written by: Natalie Tuck

The European Commission is seeking to amend regulations around EU derivatives reforms that could wipe €3bn off European citizens' pensions every year.

The UK's *Financial Times* reported that the reforms could hurt pension schemes by forcing them to put aside higher amounts of money to satisfy derivatives rules. However, this need for extra money is seen as a strain on occupational pension schemes, as they do not have a ready supply of money or other highly liquid assets to meet the rules.

As a result, the reforms have been criticised by those within the pensions industry, such as APG, PGGM and MN of the Netherlands and Insight Investment in the UK, which manage €1.2tn assets collectively.

The paper reported that the commission has until March to present its targeted changes to the 2012 European Market Infrastructure Regulation that requires more trading in over-the-counter swaps to pass through market utilities known as clearing houses.

Up until now occupational pension schemes have been exempt from the regulation because of worries that they would struggle to comply with them due to the money needed or highly liquid assets. However, this exemption expires next year.

A commission official confirmed to the paper that it is planning to propose "targeted amendments" to the current law in mid-March. The commission is "assessing various options on pension funds" with one option to change the law to allow another lengthy exemption. These changes would need to be approved by the national governments.

However, concerns have been raised as the French government is reportedly trying to widen the scope of the changes to derivatives rules to include financial regulation for overseas clearing houses. The country is also pushing for the European Securities and Markets Authority, an EU watchdog, to be given more oversight of clearing houses that are active in the EU but based outside it.

The European Commission has repeatedly delayed the application of the rules to pension funds because of concerns about the financial consequences. The current deadline for the rules to apply is 16 August 2018 and the commission cannot extend it any further.

News in brief

- Norwegian oil firm **Aker BP** has reported higher-than-forecasted fourth quarter earnings as a result of a change in the company's pension scheme, *Reuters* has reported. The company said its quarterly results rose due to a one-off $114m income following a change to its pension scheme.

- Net inflows into UCITS and AIF assets dropped by €40bn in November 2016, according to the **EFAMA.** Net inflows into UCITS and AIF totalled €22bn, compared to €62bn in October. The data includes 28 associations representing more than 99 per cent of total UCITS and AIF assets. EFAMA said investor demand for bond funds fell sharply in November following Trump's victory.

- Ireland's Republican Party **Fianna Fáil** has revealed that it will propose legislative measures to stop solvent businesses closing their defined benefit pension plans. According to the *Irish Independent*, the party's spokesperson Willie O'Dea has drawn up an amendment to the Pensions Act 1990 to give the Pensions Authority the power, under certain conditions, to prevent the winding up of pension schemes.

- **The Credit Suisse Swiss Pension Fund Index** reached an all-time high at the end of December 2016. After a subdued start in Q4 the index advanced by 1.29 points to reach an all-time high of 159.91 points, from a baseline of 100 at the start of 2000. After a drop in October (-0.72 per cent) the index recovered in November (0.16 per cent), before a final surge in December (1.38 per cent).

News in brief

■ **Taiwanese President Tsai Ing-wen** has said that passing pension reform, as well as implementing a public infrastructure plan, will be top of the government's priorities over the next six months, according to *The China Post*. In regards to the pension reform, the President instructed Vice President Chen Chien-jen to coordinate with related agencies and draw up a revised bill following the national conference meeting held late January.

■ The **Indian government** is considering allowing the state-run security and pension fund to invest more in the stock market, the Labour Minister Bandaru Dattatreya has said. *Reuters* reported that the government is examining a proposal to let the Employees' Provident Fund Organisation (EPFO) invest 15 per cent of its corpus via exchange-traded funds, compared with 10 per cent at present.

■ The **Australian Chamber of Commerce and Industry** (ACCI) has said the family home should be included in the assets test for the aged pension, according to *ABC Australia*. However, Paul Versteege from the Combined Pensioners and Superannuants Association said the proposal was "massively unfair".

■ The **Kenya Railways Staff Retirement Benefit Scheme** has paid out Sh200m in pension arrears to more than 8,500 pensioners, according to *The Star*. Scheme chief executive Simon Nyakundi said the past two years have been spent laying a firm foundation and rolling out a strategic plan to ensure the scheme recovers, adding it is on sound footing to better serve its members.

No pension reform for Brazil's military

DESPITE THE MILITARY BEING INCLUDED IN ORIGINAL PROPOSALS TO INCREASE THE RETIREMENT AGE, THE GOVERNMENT HAS MADE A U-TURN

Written by: Natalie Tuck

The Brazilian government has decided to exclude the military from its far-reaching pension reforms, according to *Stars and Stripes*.

The pension reform follows a vote last year to limit public spending, therefore, President Michel Temer is pushing ahead with the reforms.

The proposals include requiring both private- and public-sector employees to work until the age of 65, an increase of 10 years on the current average of 55. A vote on the bill is expected in the first half of the year. Temer has stated the bill is necessary to ensure the pension system does not collapse due to a lack of funding, and to make it financially sustainable for future generations.

However, despite being in the original proposal, the armed forces have been excluded from the reforms as there was growing discontent within the forces.

Public opinion polls show that the military is the most-trusted public institution in Brazil. Authorities say they haven't given up on changes to the military's benefit system but these will come only after Congress passes the main reform bill.

Canadian pension funds returned an average of 6.8% in 2016

DESPITE MARKET VOLATILITY THE FUNDS PERFORMED WELL

Written by: Natalie Tuck

Canadian pension funds saw an average return of 6.8 per cent in 2016, an increase of 1.4 per cent on 2015 (5.4 per cent), according to RBC Investor & Treasury Services.

For the fourth quarter of the year the funds returned 0.5 per cent, however, this was down from the 4.2 per cent gained in the third quarter. Canadian equities returned 5.7 per cent for the fourth quarter and 21.9 per cent for the year.

Research by the company found that some of the country's biggest funds, such as the Canada Pension Plan Investment Board, have grown rapidly by directly investing in assets such as real estate and infrastructure, in addition to equities and bonds.

According to the research, this has helped the funds achieve positive returns at a time of market volatility. However, RBC warned that continued uncertainty, and the potential for interest rate hikes, may affect returns in 2017. It said markets would need to adjust to the new US administration and cited developments in Europe following the Brexit vote and uncertainty surrounding the Chinese economy as additional headwinds.

Diary dates 2017

The latest events occurring across the European pensions scene

SUPERRETURN INTERNATIONAL
27 February – 2 March 2017
InterContinental Hotel, Berlin

Now in its 20th year, the three-day SuperReturn International conference will feature a line up of over 375 industry heavyweight speakers. Topics to be discussed include: the new world order, the post-Brexit environment, private equities and fintechs in the financial sector. The event is free for pension funds, endowments, foundations, ILPA members, insurance companies, DFIs and sovereign wealth funds.
Finance.knect365.com/superreturn-international/

MONEY PURCHASE PENSIONS FORUM
21 March 2017
Pewterers" Hall, London

Specifically focusing on the concept of 'value for money' this forum will look at how legal obligations to asses value for members can be met, and will fully evaluate the elements that contribute to the value members receive from a pension scheme. The forum, as one of six annual meetings, will award attendees 2.5 hours PMI Continuing Proffessional Development Credit.
Epfif.com/future-meetings/money-purchase-pensions-forum/

IRISH PENSION FUND INVESTMENT FORUM
4 April 2017
Royal College of Physicians, Dublin

As part of the European Pension Fund Investment Forum (EPFIF), Ireland's bi-yearly forum will provide a macro-economic update, looking at the impact on investments and investment risk management. The forum takes place in April and again in September in the form of a half-day seminar. Further details on the event and its agenda are to follow nearer the date.
Epfif.com/future-meetings/irish-forum/

Not to miss...

AAE PENSIONS COMMITTEE
7 April 2017
Malaga, Spain
Actuary.eu/forthcoming-events/

SWISS PENSIONS CONFERENCE 2017
11 April 2017
Geneva
Cfalive.ch

PENSIONS EUROPE CONFERENCE 2017
8 June 2017
Thon Hotel, Brussels
Pensionseurope.eu/pensionseurope-conference-2017

EUROPEAN PENSIONS AWARDS 2017
22 June 2017
Millenium Hotel, London
Europeanpensions.net/ep/events

If you have any European pensions events to promote, please contact talya.misiri@europeanpensions.net

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 talya.misiri@europeanpensions.net

JASON GUTHRIE

WisdomTree has appointed Jason Guthrie as director of capital markets in Europe. Guthrie replaces Zach Hascoe, who will return to WisdomTree's headquarters in New York. Taking over, Guthrie will focus on enhancing WisdomTree's capital markets efforts and will be working closely with product investors. Guthrie has significant exchange-traded fund experience and he will be reporting into the head of WisdomTree in Europe Dave Abner.

ISABELLE CABIE

Candriam Investors has appointed Isabelle Cabie as global head of responsible development. Cabie will work to build the foundations of Candriam, overseeing the development of the active-ownership strategy, promoting SRI and leading Candriam's corporate social responsibility policy. She has more than 20 years experience in macroeconomics and responsible investments.

GEIR ØIVIND NYGÅRD

Geir Øivind Nygård has been appointed as CIO asset strategies in Norges Bank Investment Management. Nygård previously served as global head of portfolio management and was interim CIO asset strategies since December 2016. He took on the permanent role on 1 January 2017. He joined the fund in 2007 as portfolio manager in equity asset strategies.

GARY JANAWAY

KNEIP has hired Gary Janaway as chief operating officer. Janaway joins from Schroders where he was director of operations and joined in 1991. He has significant experience in fund administration, fund performance, investment risk, project management, product implementation, treasury and cash management, among others. He was also a member of Schroders' European Fund Services Committee, working on European and Asian funds.

ULRIK HOLM OXFELDT

Ulrik Holm Oxfeldt joined Columbia Threadneedle as head of Nordics on 1 February 2017. In his new role, Oxfeldt will focus on leading the firm's sales and client relationships in Denmark, Sweden, Norway and Finland. Before this Oxfeldt was working in business development and senior client-facing positions at PFA Asset Managament, SEB, Nordea and ABN AMRO.

MARIUS DORFMEISTER

RobecoSAM has hired Marius Dorfmeister as its global head of clients and member of the executive committee. Dorfmeister joins from Vescore, where he was global head of clients and served in a similar role at Notenstein Private Bank before this. Dorfmeister has also held positions at Falcon Europe, AIG Financial Services, Merril Lynch and Bank Austria.

JEAN RABY

Natixis has hired Jean Raby as head of asset management, private banking and private equity. Raby joined the firm on 20 February and will serve as a member of the Senior Management Committee. As CEO of global asset management he will be responsible for asset management, private banking and private equity business lines. He has previously served in senior roles at Goldman Sachs across Europe and Russia and later at Alcatel-Lucent.

JAMES SURCOUF

Brooks Macdonald has appointed James Surcouf as an investment manager. Based in the firm's Channel Islands offices in Jersey, Surcouf will be responsible for building client relationships and managing discretionary portfolios. He joins with 15 years' experience in international financial services, most recently at HSBC Asset Management.

IAIN TAIT

Delta Financial Systems has appointed Iain Tait as its new chief information officer. Tait will be driving Delta's business and technology strategy to deliver products for the lifetime savings market. Tait joins Delta from SIPP provider James Hay Partnership, where he was chief information officer. This follows the appointment of John Watson as CFO in November 2016.

LYNN MAH

AllianceBernstein has hired Lynn Mah its head of marketing EMEA. Mah will be responsible for European marketing activity across institutional and retail channels and will drive AB's digital client engagement across the region. Prior to this, Mah spent eight years at GAM, most recently as head of global sales marketing. Previously, she spent 17 years working in various marketing and distribution roles across financial services and asset management.

ARNE TÖLSNER

Allianz Global Investors has appointed Arne Tölsner as head of institutional for Germany and Austria. He will be responsible for leading sales and client account management for institutional clients and occupational pension providers. Tölsner has been at Allianz GI since 2001, having most recently served as global head of product specialists. He started in his new role in January.

Pensions and Lifetime Savings Association

A major threat

JOE DABROWSKI LOOKS AT HOW THE UK'S IMPLEMENTATION OF MIFID II COULD THREATEN LGPS INFRASTRUCTURE INVESTMENT

THE THREAT TO THE LGPS' ABILITY TO INVEST IN INFRASTRUCTURE COMES AT A TIME WHEN THE GOVERNMENT IS CALLING FOR GREATER INFRASTRUCTURE INVESTMENT BY PENSION FUNDS, WHICH SEEMS EXTREMELY COUNTERINTUITIVE

Written by Joe Dabrowski, head of governance and investment, PLSA

Despite the UK's decision to leave the European Union, there has been no reduction in the number of consultations relating to EU legislation. The FCA has stated that firms in the UK must continue with implementation plans for MiFID II, as well as all other pieces of EU financial services legislation.

As a result at the very end of 2016 the Pensions and Lifetime Savings Association (PLSA) responded to the third consultation paper on the UK implementation of the Markets in Financial Instruments Directive (MiFID) II from the Financial Conduct Authority (FCA).

The implications of the consultation are both far reaching and potentially very damaging, due to the proposal to reclassify local authority pensions from per se professional clients to retail clients. This potential new classification threatens the ability of funds within the local government pension scheme (LGPS) to invest in infrastructure, as the majority of investment firms aren't structured to include retail investors.

The overarching aim of the proposals in MIFID II (and of the FCA's implementation plans) seem to be strengthening safeguards for local authorities in order to prevent a repeat of the difficult situation in which some found themselves after the 2008 financial crisis.

This is a commendable aim and we fully support the FCA's attempt to provide more stability for local authorities. However, we do not believe this is an appropriate or serviceable method of achieving that end. Local government pension funds have quite different characteristics.

Additionally, investments by local authorities for pension funds are already subject to high standards under the Management and Investment of Funds Regulations 2016. The regulation includes the requirement for pension funds to take 'proper advice' when appointing investment managers.

The threat to the LGPS' ability to invest in infrastructure comes at a time when the government is calling for greater infrastructure investment by pension funds, which seems extremely counterintuitive. LGPS respondents to the PLSA's most recent annual survey reported that 1.1 per cent of their total assets are invested in infrastructure. When you look across the whole LGPS this would equate to around £2.7 billion of infrastructure investment – all of this would be put at risk by the reclassification of local government pension funds.

Additionally, there is a risk that LGPS funds will be unable to remain in existing mandates with regard to transactions made before 3 January 2018, when the directive comes into force. Clarity is urgently needed around whether or not these transactions may be honoured – it is not appropriate to leave funds with little time to adjust mandates that will result in extensive costs, risks to the funding of the scheme and potentially large market exodus.

The FCA has proposed several work arounds to enable local authority pension funds to continue operating as professional clients. However, we believe these processes are costly, complex and difficult to apply, given the way pension funds make investment decisions.

The consultation allows for elected professional status, which would result in authorities having to go through a significant and time-consuming process with no guarantees that future investment strategies will be able to be effectively executed with existing managers or on existing terms. This process would add unnecessary costs, which the FCA's own market study shows will impact on member outcomes and will also potentially lead to an increased reliance on the advice of investment consultants, another area of concern.

The reasons behind the proposals made by the FCA are commendable, but the results of these changes will be overwhelmingly negative. As a result we recommend that the FCA distinguish between the investment activity of local authorities and local authority pension funds, so the latter may retain its per se professional client status to continue its effective investment strategies. ■

COUNTRY SPOTLIGHT SWITZERLAND

Travelling towards change

Swiss pension funds may currently be well funded, with a solid saving habit engrained in the population, but controversial measures to stimulate the economy, high conversion rates and an ageing population may dent this security. Louise Farrand **examines the improvements being considered to the current pension system**

WRITTEN BY LOUISE FARRAND, A FREELANCE JOURNALIST

Some pensions challenges are universal. Generally speaking, people are living longer and saving less, whilst hoping to rely on increasingly-stretched state pensions. This poses a problem for many governments all over the world.

However, some countries face more acute difficulties than others. Switzerland's policymakers made two decisions in early 2015 in a bid to stimulate the economy. However, the policy moves simultaneously raised questions about the sustainability of the pensions system.

The first was the Swiss National Bank's removal of the minimum exchange rate of CHF 1.20 to the euro in January 2015, leading to the franc's rapid appreciation against the euro and a sharp drop in its main equity index, the SMI.

The second came in April 2015, when the Swiss Federal Treasury became the first European institution to auction benchmark bonds at a negative yield.

"Many industry commentators at the time argued both could have grave consequences for local pensions, due to the resulting significant drop in the Swiss equity market and negative drag on performance for unhedged foreign investments," State Street head of asset owner solutions and strategic market initiatives, sector solutions EMEA, Oliver Berger says.

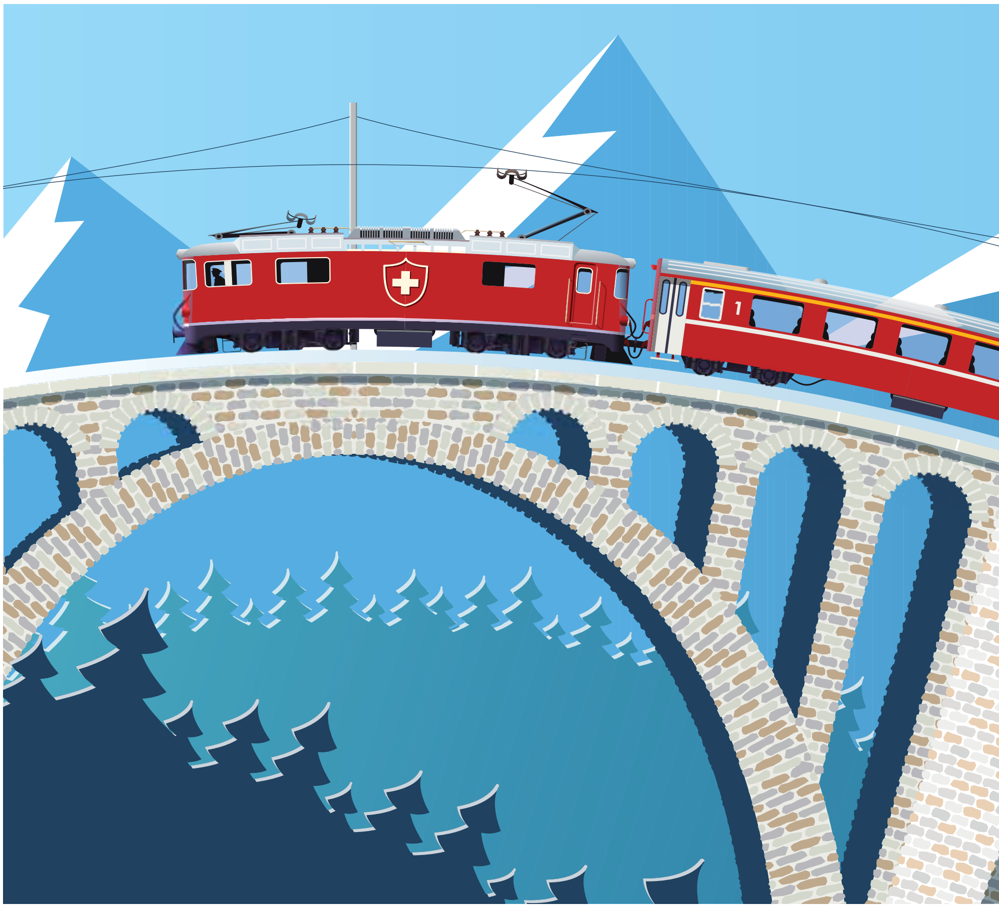
A stretched system

Adding to these problems is the fact that Switzerland's population is ageing fast."According to the OECD, more than a quarter of the economically-active population in Switzerland are aged 65 or over, placing the spotlight fully on pension fund sustainability and the provision of an adequate income in retirement", Berger states.

The imbalance is set to get worse. Switzerland is one of six European countries that is heading towards an old age dependency ratio of above 50 per cent by 2040. That means that there will be less than two people of working age for every retiree, according to the *Melbourne Mercer Global Pension Index 2016*.

Therefore, Swiss occupational pension schemes find themselves under greater pressure than ever to provide for more retirees, with fewer workers contributing to pension pots. Political debate centres on the question of: "How do we distribute the burden of saving more?", as Swiss think tank Avenir Suisse senior fellow and social policy research director Jérôme Cosandey summarises.

Switzerland has a three-pillar pensions system, which consists of a state pension, a workplace pension scheme and a private



pension scheme for those who wish to further bolster their savings. Saving into a workplace pension scheme is compulsory for workers and their employers.

The defined contribution-style arrangement means workers build up a pension pot that is converted into a guaranteed monthly income at the point of retirement, which is usually paid by the pension scheme (retirees can also opt to take their pot as a cash lump sum). A conversion rate is used to calculate the income that pensioners receive.

"The problem we have is that we promise pensions that are too high," Cosandey adds. "The minimum conversion rate of 6.8 per cent assumes life expectancy of 90 years and an annual return of 4 per cent, which we don't have any more. Political reforms aim to reduce the conversion rate down to 6 per cent, which is a step in the right direction but if you talk to actuaries they would say something like 5 to 5.5 per cent would be more appropriate."

"It is controversial to make changes to the conversion rate," Mercer's head of retirement for Switzerland André Tapernoux comments. "Typically, the government would not make changes from one day to the next – they might lower the rate with one year or five years' notice."

Unpopular as it may be among Switzerland's voting public and trade unions, many commentators argue that loweringthe conversion rate is the key to ensuring the long-term viability of the system.

Switzerland's Federal Council has put together a 'Pensions 2020' reform package, which, as Cosandey says, includes reducing the minimum conversion rate of pension funds from 6.8 to 6 per cent. The idea is to increase contribution levels commensurately to account for the reduction in conversion rates, explains Tapernoux.

Many large Swiss pension schemes have already taken the decision to cut conversion rates, unprompted by regulators. Tapernoux cites Credit Suisse as one example.

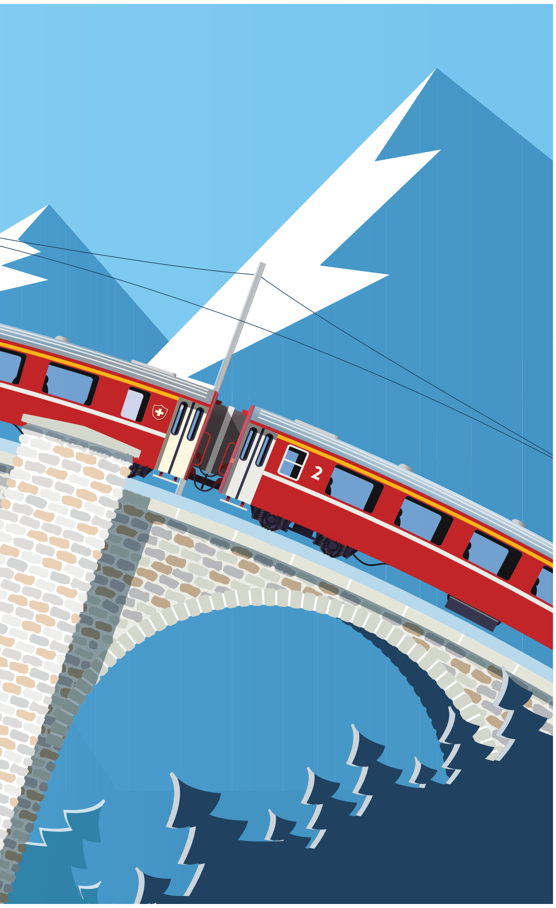
It's a trend Sussex Partners managing director Filippo Montalbano sees again and again, even among relatively-wealthy companies like banks. He uses the example of one bank that has reduced the conversion rate, increased the scheme's retirement age and capped pension income. "I am sure we will see more of this happening – increase the retirement age and decrease the income."

He adds: "For me, pension funds are a ticking bomb in Europe. It's not the fault of central banks. It's the fault of governments, because central bank *[policy is]* just giving time to politicians. It is the job of politicians to change the framework. If they do so, they are not going to be re-elected. This is the whole issue."

Bonded to conservatism

Because Swiss occupational pension schemes must offer a fixed pension to retirees, the vast majority are very well-funded and take a conservative approach to investment.

"The pension fund would be happy to take more risk, but they realise the risk is borne by active members in order to pay the pensions of the retirees. So they don't want to take too much risk.



SWISS PEOPLE MAY BE VERY CONSERVATIVE, BUT THEY ARE WISE ENOUGH TO SEE WHEN CHANGE IS NEEDED

For schemes that are run by insurance companies, it's very important to have a coverage ratio of over 100 per cent or they will lose clients," explains Cosandey.

Willis Towers Watson's 2017 Global Pensions Assets report found that the US, Australia and the UK have higher allocations to equities than is typical among most of the world's other largest pension systems. Meanwhile, Switzerland, Japan and the Netherlands have more conservative investment strategies, with higher allocations to bonds.

Yet the ongoing search for yield is challenging the conservative investment inclinations of most Swiss pension fund chief investment officers (CIOs). "Asset return expectation has been pulled significantly downwards. That is a fundamental challenge. We had the CIO of one of our Swiss clients be very clear that there are only three responses: increase contribution rates, reduce benefits i.e. reduce the conversion rate, or take on more investment risk. Most schemes are looking at all three of those options," says Record Currency Management CEO James Wood-Collins.

Wood-Collins' colleague Jan Witte, who is Record's director of quantitative research, adds: "We see an uptick in interest in, maybe not yet what is seen as riskier assets, but certainly less-liquid assets."

As investment returns are low, the focus has turned towards value for money. Schemes have been cutting their costs and moving towards passive investments in recent years, explains Montalbano

Simultaneously, the ongoing uncertainty within global markets means they are willing to spend more on longer-term and more illiquid investments with potentially lower volatility, like infrastructure and private debt.

The latter offers bond-like returns, Montalbano underlines. "Often pension scheme investors also look for coupons; depending on how you structure it, they can get a quarterly coupon."

Berger echoes Montalbano's view: "As pensions become increasingly focused on finding higher-yielding assets, and feel more comfortable with complex asset classes such as alternatives, a natural trend toward such investments will likely emerge. For example, Swiss pension funds interviewed in our research stated that over the next year they would increase their allocation to hedge funds (single manager), infrastructure and private equity by 78, 52 and 70 per cent respectively."

Schemes are likely to consolidate, in order to access alternative asset classes, Montalbano and Berger emphasise. The latter reports: "Our research found 63 per cent of Swiss pensions intend to consolidate multiple retirement plans within the next three years; as nearly a fifth (19 per cent) felt the greatest benefit of this to be reduced costs. All of which is understandable given 30 per cent strongly believe they are under pressure to cut costs."

Despite the unequivocal challenges the Swiss pension system faces, there are reasons to be cheerful. The government is acting to reduce today's unsustainable conversion rates and improve contribution levels. The country's compulsory occupational pensions system means that the savings habit is ingrained already, putting it ahead of voluntary second pillar systems like the UK's.

Melbourne Mercer's 2016 Global Pensions Index gave Switzerland's pensions system a solid B grade, ranking it alongside Canada, Finland and Sweden, among others.

A 2015 *Financial Times* piece declared that Swiss pension schemes could be bankrupt within 10 years. Montalbano is doubtful. "The advantage of being a small country is that if something is really dangerous, you can react quite fast. Swiss people may be very conservative, but they are wise enough to see when change is needed." ■

COMMENT

Greater focus on returns – a must for Swiss pension funds

Swiss Funds & Asset Management Association managing director Markus Fuchs **explores how a rethink is necessary in the world of Swiss investment**

WRITTEN BY MARKUS FUCHS, MANAGING DIRECTOR, SFAMA

The negative interest rate environment has had surprisingly little impact on the portfolio structures of Swiss pension funds. However, a rethink is necessary in the assessment of investment possibilities if the future challenges in financing occupational pensions are to be addressed. Weaknesses in regulations and requirements also need to be eliminated, and specific measures introduced to promote a returns-oriented pensions system.

On behalf of the SFAMA, the St.Gallen Institute of Management carried out a survey of Switzerland's largest pension funds last year, and the results presented a detailed picture of their investment behaviour. The report was aimed at increasing transparency with regards to the decision-making criteria, as well as the interplay between return and cost factors in the investment processes of Swiss pension funds, while also contributing to the current discussion on the development of Switzerland's pensions system going forward. The survey shows that Swiss pension fund managers regard diversification as the most important criterion in making decisions on the structuring of their portfolios. The risk-return ratio, followed by the net returns, are viewed as being the key figures in assessing the appeal of an investment. Most portfolios are rebalanced and restructured less than once a year.

SWISS PENSION FUND MANAGERS REGARD DIVERSIFICATION AS THE MOST IMPORTANT CRITERION IN MAKING DECISIONS ON THE STRUCTURING OF THEIR PORTFOLIOS

Portfolio structure and costs

In the past, returns made up more than a third of retirement assets. The performance of the financial markets will make it increasingly difficult for this 'third contributor' to maintain this level going forward. Surprisingly, the current negative interest rate environment has thus far had only a limited impact on the portfolio structure of most Swiss pension funds. That said, more than 50 per cent of pension funds are increasingly turning to private equity and real estate, and reducing their bond holdings slightly. The average total expense ratio of the pension funds surveyed is 0.6 per cent, with portfolio management costs accounting for three quarters of this amount. In 2015, bonds (0.1 per cent) and equities (0.3 per cent) entailed the lowest costs. However, their gross returns were also relatively low at 0.1 per cent and 0.6 per cent respectively. There was a different showing for private market investments, with private equity funds posting 12.1 per cent gross returns at 5.8 per cent costs. This demonstrates a positive correlation between portfolio costs and gross returns on the net performance generated. Despite the low net returns, the majority of pension fund managers still seem satisfied with the cost-return ratios of bonds, stocks and real estate, and take a more cautious stance on private market and hedge fund investments. This gives reason to assume that pension funds are not distinguishing sufficiently between the specific cost structures of different asset types to assess their investment options. While cost awareness is an important means of achieving net returns, high costs are not automatically a bad sign. Greater attention should be paid to net returns when comparing different asset classes. Cost efficiency should also be assessed at the level of an individual asset class.

NEGATIVE INTEREST RATE ENVIRONMENT HAS HAD SURPRISINGLY LITTLE IMPACT ON THE PORTFOLIO STRUCTURES OF SWISS PENSION FUNDS

Weaknesses in regulations – specific measures for improvement

The shortcomings in the regulations and requirements for Swiss pension funds are also weakening the occupational pensions system. The fact of the matter is that pension institutions are generating returns that are too low. If the operating conditions remain the same, this will inevitably lead to reductions in benefits. This would in turn jeopardise the purpose set out in the Swiss constitution, namely for occupational pensions together with the first and second pillars to enable the insured person to maintain their previous lifestyle in an appropriate manner. Pension funds also have limited room for maneuvre, due to various restrictions.

This is further exacerbated by the fact that the ordinances and practice have increasingly moved away from the wording set down in the act. For example, there is no provision in the act for the strong focus on nominal security. The security of benefit delivery should be brought back to the fore. Focusing on nominal values is not expedient, and not a sustainable solution for the security of our occupational pensions system. With simple measures, significant improvements can be made to the second pillar through specific adjustments to the ordinances. By adopting an approach geared toward returns, pension institutions will be better able to use the capital market as a source of contributions. SFAMA has various proposals in this regard, including a requirement to give reasons for imminent cuts in benefits, the lifting of the current restrictions for individual asset classes, and reporting and information requirements focused on decisions. As part of the public debate on this issue, these proposals are aimed at highlighting the weak points in the present system and at introducing possible measures to promote a pensions system that focuses on returns. ■

INVESTMENT

How to protect from market corrections?

Mark Reinisch, **Berenberg London - Asset Management, explains how a dynamic risk overlay can protect investors from market corrections**

What is a dynamic risk overlay?

A cost effective way to protect specific asset classes in portfolios, normally equities, fixed income and currency, from falls in valuation as a result of market corrections.

Why do investors need protection from market corrections – equity markets are close to all-time highs, fixed income has risen in value for nearly a decade and currencies mean revert?

It is precisely because of the above that now is the time that investors should be looking to protect the gains that they have enjoyed from the record runs that we have seen in markets. Most commentators believe that markets are no longer cheap, and some believe that a sharp downward correction in both equity and bond markets is overdue. Whilst funds could reduce exposure, the opportunity cost of doing so if the march in markets continues would be painful and costly. A dynamic overlay allows funds to maintain cash exposure to markets, whilst using the futures markets to protect the capital value against general market falls.

How does a dynamic overlay work?

Dynamic overlay uses futures and OTC forwards to secure mid- to long-term market price risk. Unlike a static hedge, which constantly secures the full exposure, the hedge ratio is actively managed. It is increased when the underlying depreciates and decreased when the underlying appreciates. Thereby, an asymmetric risk-return profile can be achieved that limits market price risk and allows investment gains.

Can investors not achieve the same result more simply and cheaply by using put options?

Put options can certainly protect portfolios in the same way as a dynamic overlay. However, there is a fundamental difference between using futures and options that impacts on the price that the investor pays. An option is priced based upon the implied volatility of an asset, whilst a future is priced off the realised volatility. As implied volatility is almost always higher than realised volatility, the cost of an option-based strategy is almost always higher than the cost of a dynamic overlay.

Where can investors use a dynamic overlay?

Any asset that has a liquid futures market associated with it can benefit from a dynamic overlay i.e. most developed and emerging bond and equity markets, gold, silver oil and most commodities. Additionally, through the use of forward currency contracts, dynamic overlay is also employed to protect against falls in foreign currency destroying the returns of an overseas asset when translated back to a home currency. This is dynamic currency hedging.

When does a dynamic overlay not add value?

As a trend following strategy, the dynamic overlay works best when there is a clear trend in place – be it upwards or downwards. The time when the strategy can detract from performance is in range bound markets with no clear trend up or down. Many investors regard this as the time when they pay the 'insurance premium' for the protection they will receive when they really need it in a falling market.

You mentioned currency and dynamic currency hedging – why replace an existing passive currency hedge?

Whilst a passive currency hedge will protect an overseas asset against loss of market value caused by a decline in a foreign currency, it precludes any benefit from an appreciation in the overseas currency. Additionally, when a foreign currency that is subject to a passive hedge appreciates, the resulting loss in the hedged position (the difference between the exchange rate at which the asset is protected and the new, higher exchange rate at the end of the contract) is settled in cash. These cash flow losses can be significant. By using a dynamic approach, where the only input into the process is the underlying exchange rate, the opportunity to avoid losses and participate in gains caused by currency movements is far greater than when using a passive approach. ■

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POLITICS

Turbulent times

With 2017 set to be another big year for global politics, Natalie Tuck **examines what pension funds need to look out for and how they can mitigate risks**

WRITTEN BY NATALIE TUCK

There's a key difference between the beginning of 2016 and the New Year we have just welcomed – in the world of politics we have been reminded that the unexpected can happen. First there was Brexit, followed by the election of President Trump, and this year the world will witness many more significant political events.

For a start, British Prime Minister Theresa May is on track to trigger Article 50 to begin the process of the UK leaving the European Union and, mere weeks into the job, President Trump is already making changes to US policy.

In Europe, upcoming elections in the Netherlands, France, Germany and possibly Italy could see the election of far-right parties, as support for them grows across the union. However, KBI Global Investors chief economist Eoin Fahy believes that out of all the countries in Europe, the Netherlands is where the far right is the strongest. This could lead to a referendum on 'Dexit' – deciding the fate of the Netherlands' membership of the EU – which would "have a negative impact on markets".

It is France, however, which is most concerning, as if far right candidate Marine Le Pen wins, there will almost certainly be a referendum on France's membership of the EU. Fahy believes that if France votes to leave the bloc then "it's very hard to see how *[the EU]* could survive".

Looking further afield, a referendum in Turkey could increase President Erdogan's powers and there will be a presidential race in Iran. The Communist Party in China also faces a big year as it looks to select its new top leadership at its 19th National Congress.

The outcomes of all of these events, and others, have the power to send seismic shockwaves around global financial markets.

Unfortunately, pension funds lack crystal balls, but as Fahy explains, forecasting political outcomes in 2016 would not have necessarily been beneficial.

"If you had known that Trump was going to win, the chances are many fund managers would have sold risk assets and they would have been wrong because, of course, markets turned out to like his policies," Fahy notes.

Regardless, if insight is helpful there are opinion polls to consult, although they were heavily criticised for being wrong with Brexit and Trump. However, Fahy disputes this, noting that in the case of Brexit opinion polls showed the vote would be close, with the swing towards remain very much in the margin of error of opinion polls. In the USA, opinion polls showed Hillary Clinton lead by a couple of percentage points, which she did, but, what pundits didn't get right was how this would translate into electoral college votes, Fahy notes.

'Trumponomics'

Whilst Europe faces a huge year, across the Atlantic President Trump has caused controversy with his strict immigration policy, which at the time of writing has been banned, and he has cancelled the Trans-Pacific Partnership – an Asian trade deal. He also still plans to build the wall on the US/Mexico border, which he insists Mexico will pay for.

"*[Trump]* is unutterably unpredictable, he delights in being unpredictable and its part of a very intelligent strategy of his, to keep people off balance…he quite deliberately doesn't want people to know what's coming next," Fahy says.

Despite this, World Pensions Council head of research Nicolas Firzli notes that European institutional investors should not underestimate the Trump administration, whose members "include several shrewd war veterans turned corporate strategists and financiers".

He notes that 'Trumponomics' could have a "transformational impact on the global economy", including the economies of Britain, France and Germany. "Trump's brand of 'America First' mercantilism stems from a radically-different worldview: the new US administration will seek to encourage the repatriation of US capital and, simultaneously, to develop inbound foreign direct investment through aggressive financial incentives".

Trump has already demonstrated this by cancelling the Asian trade deal but there is a risk of a trade war between the US and China. Experts warn that if we see tariffs increase by over 20 per cent then there would be a 'significant market correction'.

What can pension funds do?

With the uncertainties that lie ahead, pension funds need to prepare, but it is not all bad news. In terms of the US, Firzli believes that the new era could offer "remarkable opportunities" for pension superpowers in Europe such as Britain, the Netherlands and Denmark, which have "trillions of pounds worth of pension assets and deep, longstanding economic and geopolitical ties to the US".

For example, Trump plans to boost infrastructure with new highways, railroads, airports and wastewater treatment plants, that Firzli says will boost the revenues of Amec Foster Wheeler, Balfour Beatty, Carillion and other FTSE 250 construction and civil engineering firms already present in North America.

More importantly, he says, hundreds of billions worth of new 'infrastructure bonds' will be issued by the US government at federal, state and municipal level, offering solid, superior-risk adjusted returns to yield-hungry pension investors foreign and domestic.

"When choosing between say a long-dated Italian government bond and a federally guaranteed infrastructure debt instrument issued by the state of Pennsylvania, many Northern European pension investors will probably prefer the latter," he adds.

However, funds should be careful of reputational damage, in particular if the wall along the US/Mexico border is built. As Fahy notes, such a controversial policy could cause a movement around the world for investors to divest from companies that help to build the wall. It may be unlikely, but it is something to take note of.

However, in more general terms, funds should remember diversification and with reference to the political uncertainty in Europe, reduce their European weighting. "It is not the time to have highly concentrated portfolios in a certain geography. I think it is a time to have well-diversified portfolios so that if there is a crisis of some kind that affects one part of the portfolio, then at least other parts can counter balance". In addition, he advised against domestic biases, which can be "dangerous" in these circumstances.

Fahy also believes pension funds should encourage fund managers to look at quality stocks – companies that can survive a downturn if needs be – whose balance sheets are not too stressed. He also suggested looking at long-term factors that can drive performance that go beyond the economic growth of countries. Instead, he says funds should look at the types of stocks that will do well in a secular sense.

"There are interesting long-term trends going on, regardless of what happens between China and the US, as an example, there are exciting things going on in the areas of alternative energy and water. You can look at things like water, regardless of what is happening people will always need water." He said that although they are subject to risks, they should provide downside protection.

"It's not easy for pension fund trustees to decide how to protect themselves from these kind of risks but if you put all of this together, if you put good diversification across different geographical markets, if you think about investing in quality stocks…and if you can look at investing in some long-term secular growth trends that are likely to persist no matter what the economic growth trends are, I think they are three ways of trying to mitigate those risks," Fahy concludes. ■

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INVESTMENT

Achieving and measuring best execution in FX

Marisa Kurk discusses why pension fund investors need to precisely determine and achieve best execution within FX transactions

WRITTEN BY MARISA KURK, CHIEF OPERATING OFFICER, CURRENCY MANAGEMENT

As we move into a more transparent and regulated world of FX, it is crucial that pension fund managers and their agents focus on achieving, measuring, and communicating best execution on FX transactions. While achieving best execution should always be a primary focus, measuring and communicating these results has become even more important under a new FX landscape. This article will explore the importance of best execution, outside factors that have shed additional light on this topic, key factors for achieving execution quality, and Transaction Cost Analysis (TCA) as a tool to measure and communicate execution results.

Regardless of asset class, fund managers and their agents should always remain focused on best execution; unfortunately, until the last few years the marketplace did not universally demand precision and communication in FX. Beginning in 2009, pension funds started to more carefully evaluate the performance of their custodial managers in executing their FX hedges. It was discovered that by allowing custody providers to have such extensive discretion over the timing and mechanisms of FX execution, the custodian was able to benefit, at the cost of pension funds, by providing unfavourable rates and wide spreads, and being the sole or primary recipient of trade volume. Over the next several years the unscrupulous execution methods of custodians dominated the headlines. Clients were at times provided prices on trades that were significantly different than the actual prices executed by the custodian, or the client's price would be as extreme as buying near the high or selling near the low of the day, depending on the direction of the trade. This was one of the key catalysts for an increased desire of transparency when transacting FX.

Furthermore, as global regulators began to focus more on risk and FX regulations post global financial crisis, additional light and scrutiny was shed on the topic of best execution in FX. Presently the Markets in Financial Instruments Directive (MiFID) states that firms "must take all reasonable steps to obtain the best possible result….." . The updated guidance of MiFID II, set to come into the marketplace as early as 2018, looks to strengthen the language and requirements for obtaining best execution. While the exact market requirements around the heightened fiduciary and regulatory obligations are still being scoped out, it is clear that the standards for achieving best execution will be set even higher.

Best execution is especially important in FX given the typical magnitude of hedge sizes. Let us examine a client that rolls €5 billion in three month maturity hedges, for an annual roll volume of €20 billion. If the execution price is off market by even one-tenth of a basis point, the client will incur €200,000 in hidden execution costs per year, for what is often approximately a tenth of a forward point. Accordingly it is imperative that every effort is made to keep this cost to an absolute minimum as the price of each trade will directly have an effect on the overall performance of the fund.

The following key factors outline some of the primary ways to help ensure best execution:

- **Trading desk experience:** A well rounded, experienced trading team is crucial in providing continual best execution practices. Whether it is dealing with extreme market events such as the SNB EURCHF 1.2000 floor removal, or more common daily situations such as executing a large order, an experienced FX focused trader is invaluable. A variety of backgrounds can further complement a trading team as well. For example, sell-side experience on the trading desk is a significant plus as it provides direct insight into the sell side methods and tactics, better preparing the desk to push back in order to achieve best execution for the fund.

- **Multiple pricing sources:** Obviously a trading desk must know exactly where the market is trading at all times to help ensure precise market pricing on each trade. To obtain this information, access to multiple pricing sources such as Bloomberg, Reuters, Currenex and other various ECN's is essential. In addition, the ability to reach out to multiple counterparties for indicative pricing provides important additional clarity on the actual market.
- **Multiple execution strategies:** A trading desk must have the ability to vary execution strategy depending on the deal to be completed. This may include utilising competitive and/or streaming pricing, having a large order execution methodology or taking into account time of trading day when planning execution.
- **Strong and broad counterparty relationships:** It is important to have strong working counterparty relationships with clear pricing expectations. Counterparties should recognise that excellent pricing leads to increased business, and less than excellent pricing leads to the opposite. Furthermore, the larger the counterparty roster, the greater flexibility available to the trading desk.
- **Large trading volume:** Trading desks with large currency volume have more impact and influence with the counterparty trading desks they execute against. Continual large trade volumes with a counterparty lead to a relationship that is important to the counterparty; typically resulting in high quality pricing.

Even after internally determining that best execution is being achieved, it is important to ensure it can also be documented. The established need for execution transparency has led to the popularity of TCA as a tool to fill this void. The basic elements of TCA are threefold. First, it captures key execution details including spot rate, forward points, execution timestamp, quantity, currency pair, and value date. Second, it selects the benchmark to be utilised for benchmarking; whether it be one data source or a more comprehensive multi-factor benchmark provided by a third party, it ensures spot and forward rates from an external data source are captured along with time stamps. Finally, TCA utilises a systematic process to calculate the costs arising from the difference between the executed rates and the benchmark rates. This analysis can be further broken down into various details such as spot costs, forward costs, costs by currency pair, time of day or order type.

While these basic elements of TCA are similar throughout the industry, variances in methodology may exist among currency managers. It may be possible for similar execution to have significantly different TCA results. Accordingly, before reviewing the TCA results, it is essential to understand the underlying methodology being employed, specifically the benchmark rate source, the application of the bid/ask spread, and the timestamping methodology. As previously stated, benchmarks can vary from a single data source to a more comprehensive multi-factor benchmark. A robust source of benchmark data will serve as a more accurate assessment of the transaction cost. Ideally, the benchmark data feed should include a high frequency of prices from multiple platforms. Next, when looking at bid/ask spreads, the most neutral benchmark will utilise the MIDPOINT rate, even though this rate is typically not an achievable execution price. Thus, utilising the bid or ask may artificially reduce displayed costs. Finally, it is important to understand that the method for applying timestamps will have a direct effect on the results. Ideally, timestamps should be generated and captured from an electronic trading platform. Importantly, timestamps should never be recorded after a trade was completed, as this can artificially influence the cost.

An additional consideration for TCA implementation is whether to conduct the analysis in-house, or use an outside TCA provider. While TCA can certainly be successfully analysed in-house, the desire for third party providers has grown significantly in recent years, as outside providers offer an independent analysis and an increased level of transparency. In addition, the benchmark rate source of third party providers is often much more robust than an in-house TCA. For these reasons the trend toward outside providers will likely continue to gain momentum in the coming years.

In summary, it is critical that best execution is sought and applied in all FX transactions, regardless of agent or method. Additional factors over the past several years such as public custodial shortcomings and new regulations have heightened the need to prove best execution is being achieved. Furthermore, TCA, and the trend toward third party TCA, has emerged as a useful tool to measure and communicate the quality of execution to the client. The combination of a highly experienced trading desk and a quality TCA process will ensure both best execution and clear communication of this achievement. ■

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INVESTMENT

Ripples in the currency market

Lynn Strongin Dodds reveals why managing currency volatility is currently rising up the agenda of pension fund investors

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

After years of steady movements, currency volatility is firmly back on the European pension fund map. Diverging central bank policy, a strong dollar, plummeting pound and impending elections in France and Germany will continue to send ripples across the FX markets this year.

This was evidenced by Mercer's recent *2017 Investment Themes and Opportunities* report, which confirmed that the political upheavals witnessed by the US election, Brexit, rising populism and growing protectionism underlies the importance of having a clear currency strategy that not only mitigates the risk but also actively exploits the prospects that arise.

One of the issues though is that "many pension funds across the EMEA region have ignored currency for a long time", says Millennium Global Investments CEO Mark Astley. "However, doing nothing is a dangerous position to take. For example, using the MSCI World index as a proxy, around 37 per cent of variance comes from currency, so if a fund invests in international equities there is currency risk."

The Swiss experience two years ago also should serve as a salutary lesson. Many institutional investors were caught by surprise when the Swiss National Bank cut the franc's peg to the euro. Willis Towers Watson estimated that as much as CHF30bn (€27.9 billion) may have been wiped off portfolios but pension funds such as AHV, BVK, and Publica, who had hedges in place, were able to avoid the erosive impact.

Passive or not?

To date, passive strategies continue to be the most popular, although active and dynamic are attracting their own following. "People are definitely reviewing their currency hedging strategies because the large macro events we have seen in the past year have had a big impact on currency movements," says Mercer European director of strategic research Phil Edwards. "The simple passive currency hedge with a hedge ratio of around 50 per cent on equities is most common, but hedge ratios vary depending on an investor's overseas exposures and governance structures."

The main criticism is that passive strategies are too static throughout market conditions, such as currency valuations, economic developments, sentiment and the cyclical nature of currency markets. "There are two ways to look at currency – one as an overlay and the other as an asset class and an uncorrelated diversified source of return in its own right," says Insight Investment senior fixed income product specialist Emma du Haney. "We are seeing an increased allocation to the second approach because of greater volatility that creates more opportunities."

Mesirow Financial, which has a systematic and qualitative process, echoes these sentiments, particularly for "European pension funds where a significant chunk of their portfolios will be exposed to the US dollar and British pound", its chief investment officer Michael Miranda says.

These currencies have until recently gone in opposite directions over the past year, with sterling plunging around 20 per cent due to the concerns over the type of Brexit the UK government will negotiate, while the greenback rose nearly 4 per cent against a basket of currencies following Donald Trump's victory last November and is up roughly 25 per cent since 2014.

Although Trump has tried to talk the dollar down, the currency only briefly dipped before rallying on strong economic data and comments made by Federal Reserve chairwoman Janet Yellen that a series of rate hikes were planned throughout 2019. Many believe this divide with the European Central Bank and Bank of Japan, both of whom will continue to suppress interest rates, creates the perfect backdrop for an active strategy.

As with passive frameworks, it will vary depending on a particular pension fund's objectives and constraints, but in general the benefit is that currency hedge ratios are adjusted over time, depending upon the macroeconomic and financial market circumstances of the day, according to Astley. In other words, they will be increased in anticipation of periods of base currency appreciation and reduced when it is expected to decline.

"The aim is to actively reduce risk and add value over periods of time," says Record Currency Management CEO James Wood-Collins. "We think it is particularly relevant now because in Europe and the UK we are in a low-yield environment and any strategies that can enhance yield are attractive. Also the environment for return-seeking strategies looks more favourable now than in many years."

He adds: "Fund managers have different approaches but we have a predominantly systematic process that incorporates four patterns of behaviour – carry, momentum, value and emerging markets. Combining all four provides a good degree of diversification and a smoother return stream for investors."

Historically, the carry trade – buying high-interest-rate currencies and selling those with low rates – has been the most popular and is now making a comeback as central banks are no longer moving in lock step. Value, on the other hand, buys currencies that are undervalued relative to their 'fair value' and unloads those that are overvalued, while momentum involves purchasing currencies that have experienced high recent returns and sells those on the other end of the return scale.

J.P. Morgan Asset Management also believes in adopting a multi-factor approach, including some signals extracted from equity markets in building its active framework, according to its chief investment officer for currency management, Roger Hallam.

One of the issues is that in-depth research is required for active strategies because they are typically limited to G10 currencies. As State Street Global Advisors EMEA head of currency James Binny notes: "If you are an active equity manager, for example, you can choose from hundreds of stocks but in currencies, you typically only make decisions regarding 10 if you cannot use emerging market currencies. This is why it is important to look at as many factors as possible."

Dynamic hedging

One variation that is gaining recognition is dynamic hedging, which takes advantage of the currency factors of carry, value and trend by changing the actual hedge ratio, currency by currency, over time within perimeters around a neutral strategic hedge ratio. According to Russell Investments head, currency and overlay strategy EMEA Klaus Paesler: "Dynamic is reactive to market conditions and though it can be more volatile than passive, it can generate greater return or ensure that the pension fund loses less from currency risk. It differs from a fully active strategy in that it is adjusted monthly according to the three factors and does not take big bets, rather a range around the current currency exposures already in the fund."

Although the more active and dynamic fund managers will vary in their methodologies, they are all under pressure to reduce trading costs and detail their efforts under the impending MiFID II. The new regulations, coming into effect in 2018, imposes tougher best execution requirements on buyside firms, making them responsible to prove they are securing the best trading deals for their clients.

"Currency specialists are much more switched on how performance is being measured because alpha can be taken away by poor best execution," says Binny. "The problem is the definition of the market price is difficult in an over-the-counter market like FX. That is why we outsource the service to a third-party vendor, which not only can effectively measure our TCA but also allows us to demonstrate to our clients that we have achieved good prices."

Mesirow Financial also outsources its TCA to a third party. Its chief operating officer Marisa Kurk adds that "it is one thing to achieve best execution but another to document it. We use a firm that measures us against a more comprehensive benchmark and data points".

While regulatory pressures such as MiFID are an important driver, she notes the trend to look at different providers started four to five years ago due to the fallout from the scandals over poor pricing received from custodians. ■

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INVESTMENT

A tough match up

Adam Cadle explores the developments within the high yield versus investment grade debate and where the popularity lies

WRITTEN BY ADAM CADLE

An environment of low interest rates and economic uncertainty across Europe brings with it the need for European pension funds to continuously analyse and modify their investment strategies in order to obtain appropriate return levels. The fixed-income sector is part of this investment sphere, forming an integral part of many pension funds' portfolios. Linked to this is the high-yield versus investment-grade bond debate, which resurfaces on a frequent basis as European pension funds explore which asset class should form the most significant part of their portfolios.

Due to the long-term investment horizon of pension funds, fixed-income securities represent a large share of portfolio asset allocation with an average 50 per cent of investments, according to EIOPA. "Within their fixed-income holdings, pension funds allocate a large part, around 30 per cent, in sovereign debt to match their long-term liabilities," Candriam global head of fixed income management Nicolas Forest says.

"However, the past 10 years have seen bond yields consistently moving lower, even recording a negative level of -0.15 per cent last September. This low interest rate environment has pushed them to diversify towards higher-yielding products such as investment-grade and high-yield asset classes to generate returns."

These areas are not stable however, as regulation and political uncertainty morph the landscape. Over the past few years high-yield credit has become much more of a lever to generate returns, as investment-grade spreads and yields have decreased to historical lows. "This has been driven by extraordinary European Central Bank bond buying, in both the sovereign bond and corporate bond markets," Janus Capital Group portfolio managers Annika Eiremo and Ryan Myerberg explain. Indeed, according to Stone Harbor Investment Partners portfolio manager, multi-sector strategies, David Scott: "2016 was an exceptionally positive year for credit markets with high-yield excess returns at 16 per cent for the calendar year."

The answer to the question of how to weight exposure to credit asset classes within European pension portfolios largely depends upon the regulatory environment each fund operates in. Due to the size of the market, credit worthiness of the issuers, and yields on offer, investment-grade credit has traditionally played a major role in generating income within portfolios. On the flip side, the growth in the European high-yield market has been driven by many factors, but certainly the availability of relatively cheap refinancing opportunities has been a key driver. One notable evolution of late has been the re-emergence of so-called 'covenant-light' or 'cov-lite' high-yield issues in European markets; where some issuers take advantage of investor demand to reduce the level of investor protections written into new bonds deals.

"As ever, caveat emptor applies, and investors are well advised to ensure that they have a good understanding of the bond documentation, and not just the credit rating, of a high-yield bond issue," M&G Investments head of institutional fixed income portfolio management David Lloyd comments.

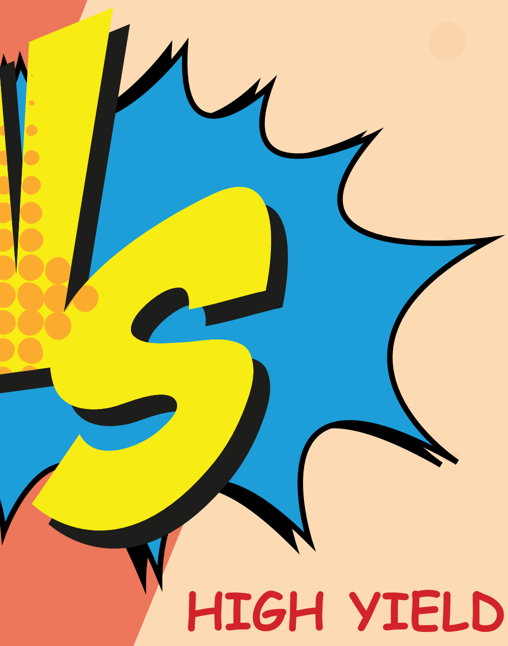
Benefits/negatives

So which asset class is the real winner? As Eiremo and Myerberg put it, "the benefit of investment-grade credit is its ability to provide a yield pick up over the risk-free rate, while not materially increasing default risk".

"However, the outright yields on offer make it difficult for investors to meet prescribed return targets. Likewise, duration risk has increased as yields have gone lower. High yield, as the name suggests, provides the benefit of higher rates of income per annum than investment grade, albeit with higher risk of capital loss."

Eaton Vance portfolio manager Jeff Mueller prefers high yield.

"While compressed valuations leave both the investment-grade and high-yield asset classes vulnerable to a pullback in risk appetite, we continue to favour high yield over investment grade for two main reasons: slow but steady economic growth, decreasing leverage, high interest coverage and low defaults should lead to supportive fundamentals in the high-yield asset class, while the longer duration



characteristics leave the investment-grade market more exposed to moves in underlying yields, which would provide greater headwinds in a rising rate environment. While both asset classes should continue to play a large role in the funding of pension plans in Europe, we believe taking selective credit risk over duration risk should provide more attractive risk-adjusted returns in the current market environment."

For Legal & General Investment Management head of credit strategy, active fixed income, Ben Bennett "nothing comes for free" however.

"If yields fall and credit risk increases, investors may want to be in the relative safety of investment grade credit. Ultimately there is default risk within high yield, and under extreme conditions, some bonds can lose 30 to 40 per cent or more in a year."

Fidelity International investment director Andrea Iannelli says current investment-grade bond valuations are challenging and has high hopes for European high yield.

"As at the end of January 2017 index yields of investment-grade corporate European bonds were just over 1 per cent (Merrill Lynch EMU Corp index ER00) and we expect that, over a five-year horizon, a passive investment in European corporate bonds to return less than 0.5 per cent annualised. This is significantly below the return target of many pension funds.

"Investing internationally in investment-grade bonds doesn't provide significantly better value opportunities or expected returns for European investors as much of the yield differential will be removed once interest rate and currency risks are hedged.

"To target higher expected returns in a balanced way, higher risk and return diversifiers such as high yield can be included in a pension fund's asset allocation. For example, we expect European high yield to outperform European investment grade by in the region of 2 per cent over the next five years, in our base economic scenario."

Political uncertainty

Whilst the benefits and negatives of both investment-grade and high-yield bonds can be discussed at length, both investment areas can be thrown wayward by the threat of political uncertainty. This looks set to continue. Upcoming elections in Italy, France, Germany and the Netherlands will set the stage for the Franco-German leadership, for Brexit, EMU consolidation and more generally for a vision for the future of the EU.

"If Article 50 for Brexit is indeed triggered in March, the negotiations will be taking place during campaign seasons, and may be subject to a lot of posturing, most likely leading to renewed fears of a 'hard' Brexit," AXA IM head of buy and maintain credit strategies Lionel Pernias comments.

"However, the final timeframe and specific details around Brexit negotiations will be unknown for some time. Donald Trump's victory also highlights very clearly the risk that anti-establishment parties may do well at these elections, potentially endangering the current fragile political consensus around ECB's quantitative easing.

"We continue to monitor the situation for more clarity regarding the longer-term implications of economic policy. We think political risk will increase volatility in credit markets. Market concerns are starting to emerge over the far-right presidential momentum with underperformance of French bonds. We think global diversification is paramount and we expect less uncertainty in the second part of this year."

What's the outlook?

The outlook for high yield and investment grade really depends upon the individual pension fund's view on economic growth and interest rates.

"We still think the world is weighed down by too much debt, and ultimately policymakers will struggle to raise interest rates very much before negatively impacting growth," Bennett says.

"If this is the case, investment grade seems the safest option right now. But central banks are likely to step in again with support. And as yields fall once more, we may be attracted by the extra pick up offered by high yield."

The changing of the European political and financial landscape looks to be an interesting one over the coming years, with a multitude of elements potentially having the power to have a significant impact on how it all unfolds. Investment-grade credit and high-yield bonds will be firmly at the core of this as to how European pension funds combat this volatility. ■

INTERVIEW

Building a robust scheme

Francesca Fabrizi speaks to Frances McNally, manager of Ireland's Construction Executive Retirement Savings master-trust scheme, about the latest developments within the fund

It's coming up to nearly five years since CERS was rebranded in June 2012. What were the initial aims and objectives of the scheme and have they changed over the years?

CERS provides low-cost, bespoke pension solutions to the construction and related industry sector. Our objectives haven't changed over the years but how we strive to achieve them has changed over time. The main CERS objectives are to provide members with adequate and sustainable income in retirement through promoting the benefits of making pension contributions, offering a considered range of investment choices, a low charging structure and preferential annuity conversion rates at retirement.

It also aims to provide peace of mind for employers and members through our independent and dedicated board of trustees, which provides strong governance. Transparent information (including charges) is provided in a clear concise format on our website, booklets, and information leaflets. Experienced pension consultants offer one-to-one meetings and annual staff presentations.

What would you say have been the biggest successes, and indeed biggest challenges, the scheme has experienced?

Both the pension and the construction industries have faced a challenging few years in the recent past, with the recession hitting the Irish construction industry and also the volatile returns in the markets at the same time, which both made administering CERS difficult at that time for us and also had an impact on our members.

The re-brand of CERS in 2012 was very positive for the scheme and since 2012 we have been concentrating on building awareness of CERS in the industry and continuing to engage with members. Member engagement and education continues to be a considerable challenge for CERS, and indeed for all pension arrangements. It may be improving slightly, with some younger members being more aware of the tax advantages of pension contributions, but overall people are busy working through their adult lives and saving for retirement is the last thing on their priority list until they start to think about retiring from age 55 and then it is too late.

How do you meet the balance of offering a good range of investment choices without confusing the members?

The investment objective of the CERS default fund is to deliver superior long-term investment returns with below-average volatility by protecting the fund and by cushioning it against the severe falls in value that may accompany bond, equity and property bear markets.

The investment philosophy of the CERS trustee board is firmly based on their intimate understanding of the particular requirements of the CERS members. The members, quite rationally, demonstrate a lack of appetite for high volatility in their investment returns, given that construction industry employment is both highly cyclical and vastly correlated to business and investment developments.

The trustee determined, having observed the traumas inflicted on the construction industry and investment markets by the recent financial crisis, that the membership should never again be exposed to such adverse movements.

The CERS trustee developed an investment solution that is appropriate to member requirements, sensitive to evolving investment market conditions, truly diversified and balanced across the range of asset types and cost effective.

The trustee maintains a close relationship with members through ongoing detailed and informative communications with regular updates to the website and through fund factsheets. More formally, regular meetings are held with CERS consultants.

Members are given direct access to the underlying bond, equity, property, alternative assets and cash funds. These options sit alongside the default fund.

The multi-asset fund continues as an ideal default option. A lifestyling process is in place, designed to reduce risk as the member approaches retirement. An ARF lifestyle option is also available.

How are you addressing the ongoing challenges of both robust governance and effective member engagement?

CERS aims to engage and communicate effectively with its members to ensure they are aware of the importance of retirement planning. The CERS trustee board has a strong governance structure in place, with frequent meetings of both the board and investment sub-committee, and it has appointed experienced professional advisers to assist it in making informed and valuable decisions.

The CERS trustee has also appointed an experienced and highly-professional registered administrator (RA), which works closely alongside it for the benefit of the members. The trustee board fulfils their trustee training obligations and have a very strong understanding of the particular requirements of the scheme's membership, as well as having many years of experience in the construction industry.

The scheme is unique in that it is set up under a master-trust arrangement with a structure of sub-schemes for individual employers in the construction and related industries. This allows for the individual schemes to be tailored to meet the specific requirements of all their stakeholders, including whether DB or DC benefits are offered, and using varying contribution structure, while at the same time benefiting from the economy of scale efficiencies of being a master trust.

The trustee offers a dedicated CERS website that offers online access for members, a bespoke pension calculator, access to scheme booklets and trustee annual reports, and a myriad of both CERS and general pension information. There is a dedicated team of pension consultants and administrators available to answer email and phone queries and annual presentations to members and one-to-one meetings are regularly arranged.

The trustee is committed to ensuring that the statutory and general communications that members receive are easy to read.

What do you think are the main challenges facing Irish pension funds today? For instance, is it increasing regulation or uncertain markets?

As I mentioned earlier, member engagement and education will be crucial if we are to try to reduce the effect of the looming 'pension time bomb'.

Increased regulation does affect how schemes are administered but the regulations are there to protect members. Within the current regulatory framework, we need to try to bring pensions back to basics and make pensions simple. We need to ensure that schemes and options available to members remain beneficial, relevant, cost effective and easy to understand.

Over time, 'pensions' and all the acronymns we use for all the different kinds of schemes and options, have created a complicated framework with different rules and regulations, which can be very difficult to understand and this only moves people further away from thinking about retirement saving.

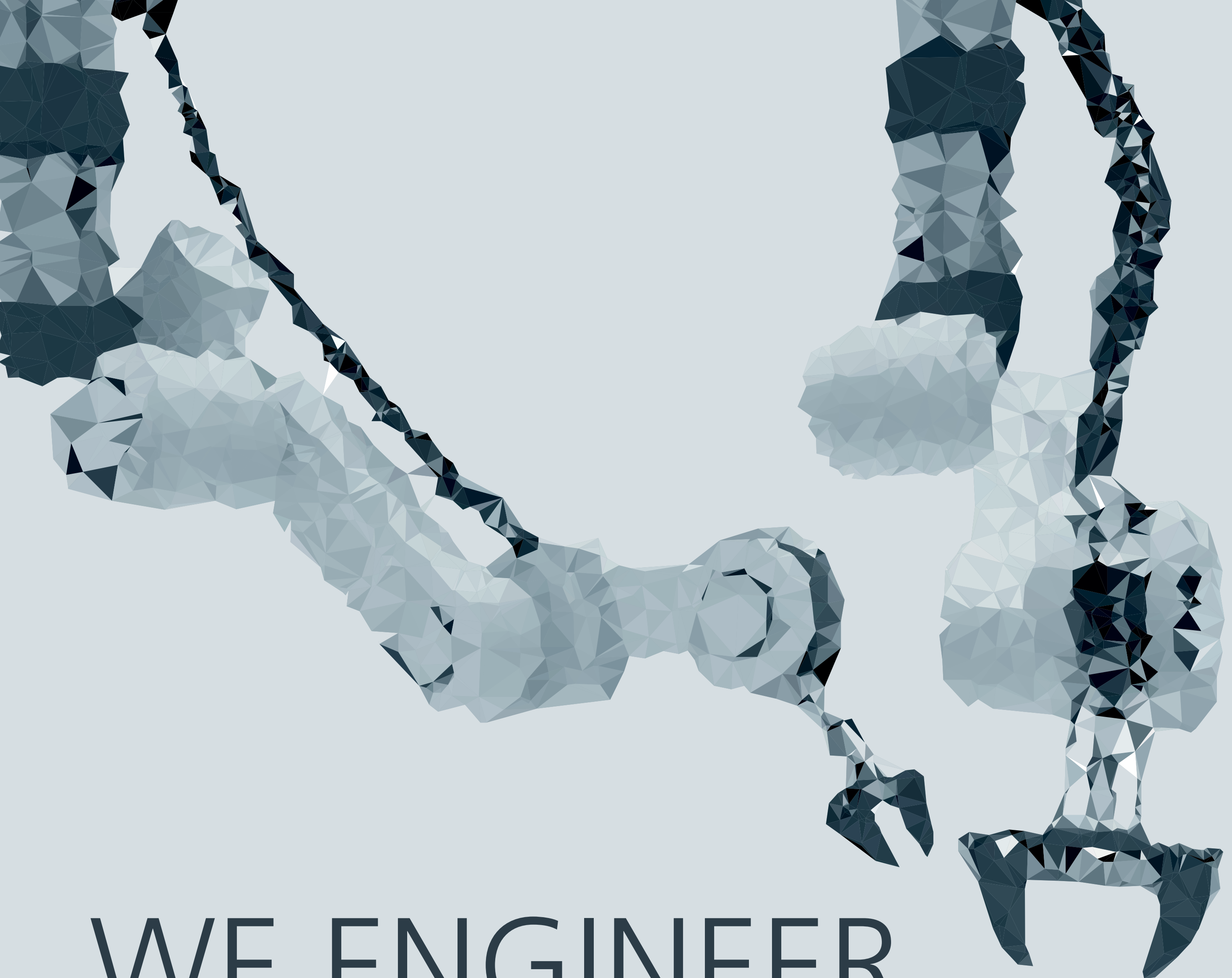
And what other issues is the scheme facing?

Auto-enrolment first comes to mind. Employers are an integral part of the solution. Apart from the tax advantages for them, many employers recognise the really important role that pension schemes play in recruiting and retaining staff. The introduction of auto-enrolment is fast approaching, where employers will be obliged by law to include their employees in a pension scheme. This is the system used in many countries, and was introduced in the last few years in the UK with good success. It is inevitably part of the overall pension solution in Ireland.

I think we will see different types of schemes in future. A recent report from The Pensions Authority revealed that Ireland has more pension schemes than any other country in Europe, even though some of these countries have 20 times our population. This makes no sense from an efficiency and cost point of view. I think we're going to see a move towards master-trust arrangements, like CERS, where there is an umbrella scheme, which lots of employers can then join and personalise their own arrangement to suit their company and employees.

Some employers may not be equipped with the necessary skills to be effective trustees. Worse still, some can end up conflicted between the rights of pension schemes members and commercial pressures they may be facing in their business. I think we will see a further move towards the establishment of independent, professional trustee boards as we have in CERS.

Finally, if we can simplify the whole area of pensions, focus on the tax advantages of them, perhaps widen the rules around transferring from one scheme to another and streamline the rules around drawing down benefits; this will all help to encourage member engagement and will go some way to ensure members are adequately covered when they reach their retirement years. ■



FACTOR INVESTING FOCUS:

ADDING VALUE

Factoring in the best approach

Quoniam Asset Management's Thomas Kieselstein explains to *European Pensions* how best to implement factor investing

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A rose by any other name

Rules-based investment may have had many different names over the years, but its current moniker of factor investing is growing in popularity among European pension fund investors. Sandra Haurant examines how factor investing has evolved and where it may be heading

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INTERVIEW

Factoring in the best approach

Quoniam Asset Management's Thomas Kieselstein **explains to** ***European Pensions*** **how best to implement factor investing**

What exactly is factor investing? How does factor investing differ from other investment styles, such as smart beta or risk premia?

Factor investing is an investment strategy where assets or securities are selected on the basis of attributes such as price-earnings multiples etc. The goal is to generate a higher return than in a passive investment based on market capitalisation only. Similar terms are smart beta or risk premia investing. Probably the best differentiator between smart beta and factor investing is that smart beta is more focused on a risk/return ratio by lowering risk, while the goal for factor investing is to achieve better returns with similar risk. Risk premia investing could be described as a subset of factor investing. It relates to the 'why' there should be a higher return. Some factors could be interpreted as being remuneration for taking additional risks; not necessarily a market risk, but often personal risks. For example, as a contrarian value risk premia investor you are positioned against the crowd and you may be wrong for a long period of time. This may trigger many questions and pose your career at risk.

By contrast, a factor investing strategy like quality does not target remuneration for risk, but exploits inefficiencies in information processing. Quality is difficult to analyse and measure. Investors who are able to identify well-run companies on a large scale can benefit from these information processing capabilities.

How has factor investing evolved? Has it been around long, or is it still quite new?

The key question is more a question about terminology. So the terminology 'factor investing' is fairly new. But the underlying principles are fairly old. In the 1990s we researched factors that outperformed the market. At the time it was called 'market anomalies' and 'style investing'. Obviously, with advanced technology, factor calculations have become more sophisticated.

I think what's fairly new, though, is that you have passive or semi-passive ways to implement factor portfolios, of which many use exactly the same factor definitions. This is coupled with a more active factor allocation policy conducted by in-house teams or consultants. Historically, you would have a quantitative manager who identified and combined factors, but the new idea is to identify or combine factors yourself, or using a consultant, and then hire a passive implementer like an index provider or an ETF. The problem with that is that factor portfolios are not 100 per cent passive in the sense that they have limited capacity. Too many people may be copying the same factor or portfolio, so we run into a factor bubble trap.

How popular is factor investing for European pension fund investors?

Currently we see a growing interest from institutional investors in general. The clear advantage institutional investors seem to see in factor investing is mainly a cost advantage. There is a big pressure because of lower returns in capital markets, and regulatory complications. So there is a strong desire on the asset owner's side to reduce costs within active management. However, the challenge is to see the complexities related to that and that they have to invest in resources to pick and combine factors and choose the right vehicle or manager for implementing factors.

What are the challenges and pitfalls with factor investing?

One benefit is that you have something better than just passive, i.e. market cap investment, with less cost than a full-fledged active product. However, the challenge is that as an investor or asset owner you have to have a good understanding of the factors in question and how they work. You also have to understand what other investors are doing because, as these ideas are quite popular, there may be a problem with capacity.

To avoid this you should clearly understand how many other people are actually following that trend or that factor. You should diversify across multiple factors. For example, you should not only screen for a simple valuation factor but combine valuation analysis with other aspects of investing, like quality.

And you should also try to use more sophisticated approaches and advanced factor definitions to not end up with identical portfolios.

What are the pros and cons of single-factor investing versus multi-factor investing?

The big advantage of single-factor investing is that it is simple. You have a single rule that is well described, so you can implement it cheaply. You can buy something like an index product; it's all very simple. The disadvantage is that it may not work over a long period of time. Let's take the example of 'value'. Something like a value factor means you buy cheap stocks measured by multiples. Now, that worked great after the TMT bubble, where all the overvalued stocks underperformed. But it did not work at all during the financial crisis and the following Euro crisis, where cheap stocks were typically banks or financials or other cyclical stocks. They underperformed, although the market was already falling. One remedy to that would be that you look at multiple factors or multiple dimensions of companies. So you would not buy the cheapest stocks but you would buy cheap stocks if you adjust for the profitability of a company or its leverage. That would mean, in practice, you would not buy banks but you might buy some industrial company.

Is it possible to time factors and if so, how?

It would be great if we always knew for certain which factors work beforehand. However, it turns out that in practice it is quite difficult because you have trends that last for a long time. However, there are techniques where you can at least identify when certain styles or certain market segments are extremely expensive or overcrowded and these are situations where you should probably be careful.

What are the warning signs of factors looking overcrowded?

Warning signs are definitely flows. So if you can identify (technically that's a little bit of homework to do) that a lot of money is going into certain styles or factors, then that is a warning sign. If the dispersion of fundamental characteristics between one factor portfolio and the market is becoming too large, for example if a factor portfolio is becoming expensive measured relative to the market, that's a warning sign. Also if the outperformance of a sector is enormously high compared to history, that's a warning signal too.

Where do you think factor investing fits within an institutional investor's portfolio?

Well, clearly it fits somewhere between pure passive, which I would define as market cap, and traditional active. In my opinion you should have a clear strategy. So if you want to follow the semi-passive route using factor indices or ETFs, then you need to allocate internal resources to it. If you don't have them, then you would be better off using active quant managers with this expertise.

Quoniam has expertise in factor investing since 1999. So we think that, as an active factor investor, we can clearly show that over various market cycles this approach has generated outperformance, while many of the index products, or simple factor portfolios, are relatively new and do not have real life track records. If you look at something like an index ETF, the index is back-calculated and then the ETF product is launched. It is not that you have 10 or 15 year of live track record for the ETF portfolio.

What do you think investors need to do to implement factor investing? What practical tips would you give?

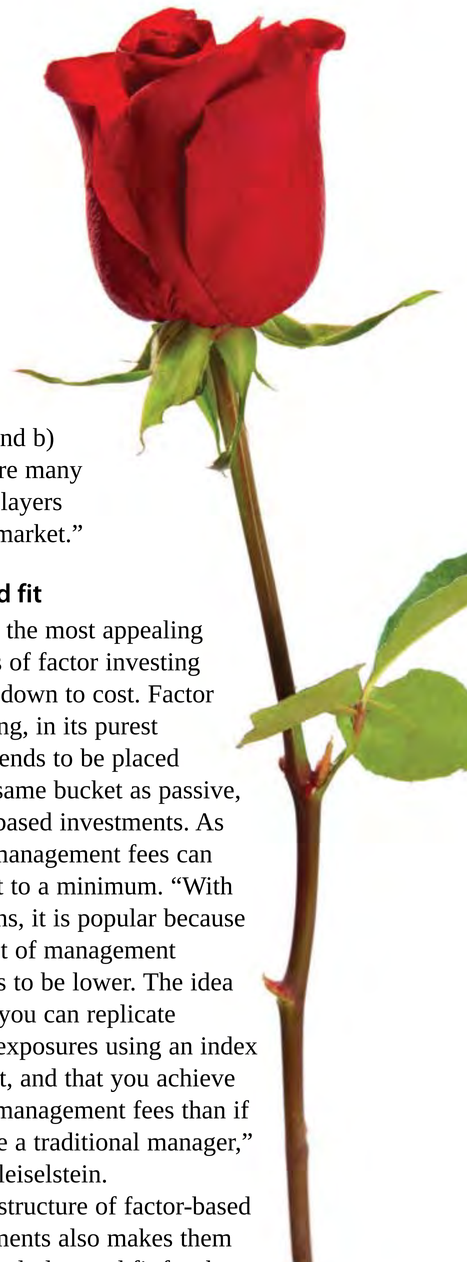
There is always the question of how much you want to do internally versus outsourcing asset management. One approach is to insource lots of things, where you would have to build up an internal expertise on factors. At least you would need strategic portfolio management in house. The other extreme would be to outsource most of the factor allocation and factor combination to external managers. That could be an active quantitative manager. And you have things in between, where for example a consultant would select factors or factor managers. But the more you want to save on costs or on management expertise, the more you need to do in house. So there's nothing like a completely free lunch. ■

Thomas Kieselstein, CIO, Managing Partner, Quoniam Asset Management GmbH

INVESTMENT

A rose by any other name

Rules-based investment may have had many different names over the years, but its current moniker of factor investing is growing in popularity among European pension fund investors. Sandra Haurant **examines how factor investing has evolved and where it may be heading**



WRITTEN BY SANDRA HAURANT, A FREELANCE JOURNALIST

"You could say factor investing is old wine in new bottles," says Quoniam CIO Thomas Kieselstein. The term 'factor investing' is perhaps a recent one, but the approach is well-established and can be traced back over a number of decades.

In essence, factor investing, also broadly referred to as smart beta, involves using certain elements, or factors, within the markets, with an aim to achieving better returns but with lower risk levels. Those factors might boil down to company size, value or low volatility, for example. Assets within a portfolio would then be allocated according to a set of rules relating to the chosen factor.

A factor-based approach, known by other names, has been around in different shapes and sizes as far back as the 1950s and the days of Harry Markovitz's modern portfolio theory, which put emphasis on the relationship between returns and risks.

The theory was questioned in the 1970s, when academics and practitioners said that, in fact, lower risk stocks did better over the longer term. Low variance, one of the earlier smart beta techniques, was already around at this time, but, according to Candriam global head of investment solutions Kristof Woutters, there were very few people investing in this because it was seen as complicated.

"In the 2000s, we had research affiliates coming out with their studies, but their approach was very different," says Woutters. "It was a rules based, using fundamental factors instead of market capitalisation. There was a lot of research and publications, and providers launched indices that became very popular."

In the 1990s, the approach was known as style investing, but whatever the name, this practice of having a set of rules to follow when building a portfolio has had a more or less wide appeal for many years.

"Arguably, factor investing has always been available," says Aon Hewitt EMEA head of investment John Belgrove. "I've seen different cycles and phases associated with management styles, but if we bypass the marketing labels and look at what we are getting exposure to, we can readily see products that are more value focused or small cap focuses."

But, says Kieselstein: "The big difference between the approach in the 1990s and the way it works today is that a) there are many more factors used, and b) there are many more players in the market."

A good fit

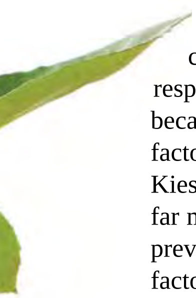
One of the most appealing aspects of factor investing comes down to cost. Factor investing, in its purest form, tends to be placed in the same bucket as passive, index-based investments. As such, management fees can be kept to a minimum. "With pensions, it is popular because the cost of management appears to be lower. The idea is that you can replicate factor exposures using an index product, and that you achieve lower management fees than if you use a traditional manager," says Kleiselstein.

The structure of factor-based investments also makes them a particularly good fit for the pension regimes in certain parts of Europe, according to Woutters.

"Smart beta is extremely good for pension funds in a very rigid prudential regulation, such as in the Netherlands or in the Nordics," he says. "They are in a full LDI investment process, since their pension fund regulation is in effect similar to what you have for insurance companies.

"They have a risk-based supervisory system, meaning that their regulatory capital requirements are a function of the overall risk on their balance sheet, which comes predominantly from the risk within the investment portfolio, and, when using smart beta, you can reduce the risk profile. So they are big buyers of smart beta; certain big pension funds have a very high allocation to smart beta in their portfolios."

Nonetheless, while there are attractive aspects, factor investing can place other stresses on pension funds, particularly when it comes to making the right choices. "It puts much more responsibility on the investor's side because they have to decide on the factor allocation themselves," says Kieselstein. "Asset owners are doing far more of the decision making than previously when we talk about factor investing."



Staying power

"It is a difficult balance," says Belgrove. "Just treating equities as an example, the right equity portfolio for an investor depends on their own risk and return objectives, their investment beliefs, cost constraints, government resources. A fall-back position of choosing an index-tracking portfolio on cap weighting is not a bad place to be. Doing something different to that *[such as factor investing]* exposes you to external scrutiny that you might have done something wrong, and the question is how much do you want to risk that?"

By their nature, single-factor funds are bound by their rules to stick with one factor – and if that factor is not performing how a pension fund would like it to be then there are decisions to be made.

"I think that it is fairly accepted that there are systematic effects in capital markets, and that such factors tend to work," adds Kieselstein. "However, it's not guaranteed that they work next year or over three or five years, so if you are deviating significantly from the market you probably would need a very long-term perspective, and that, I think, puts stress on the governance structures as asset owners."

"It does come with attendant possibility of criticism," agrees Belgrove. "We can empirically demonstrate, for example, that in the very long run certain biases have yielded premiums to investors, and we can assert that this relationship will hold true in the future. For example, being more value based has had a tendency to provide superior returns," he says.

"But the trouble is, you can get into extensive periods where value just stinks as a strategy, and all of those around you are outperforming. Behaviourally, it becomes very difficult, as an investor who has taken that decision, to stick with it," Belgrove adds.

Investors, he says, tend to lose confidence and shed the underperforming factor fund at the wrong point in the cycle, having a negative impact on their long-term record. "You've got to understand, if you do adopt portfolios with biases, that you got to be prepared to be wrong for periods of time and take the consequences of that," says Belgrove.

There are alternatives. Factor-based investing has evolved and single-factor funds are not the only option. "There are effectively three generations *[of factor investments]*," says Woutters. The first generation is single factor – such as value, minimum variance, small cap and so on. The second generation includes multi-factor investing, in which the weighting of different factors is fixed within the fund. So for example, it may contain 30 per cent value, 30 per cent low volatility, and so on. "The third, new generation, is dynamic multi-factor, where the weights of the styles change over time," says Woutters.

Managers of dynamic multi-factor funds are able to use a new level of flexibility, moving out of underperforming factors, changing weighting, effectively re-writing the rulebook, all within a structure that remains led by factors and their attributes. But here, of course, factor-based investing clearly moves out of the realms of the passive sphere and firmly into an active approach to investments, and this means the management costs are higher than in single-factor products.

Factor investing in its current form remains an appealing approach to the markets, and one that has room to grow. "People like it, it is working really well and above all, since it's considered rules-based or semi-rules based, quite often you can buy it cheaper. So it's cheaper and has better performance. Index providers, ETF providers and traditional asset managers have all got involved. It is increasingly popular because the techniques are becoming more refined," says Woutters.

But will its popularity continue? Kieselstein thinks so, one way or another. "I'm pretty sure there will be some disappointments along the way, as some strategies will become overcrowded. But I think factor investing will later come back again, perhaps with a slightly different name." ■

OVERVIEW

Designing in the dark

The occupational pensions sector is undergoing many changes across Europe. The resulting foggy picture means that future-proofing DC scheme design has become a precarious task

WRITTEN BY MAREK HANDZEL, A FREELANCE JOURNALIST

Pressure on the second pillar in Europe has been ratcheting up over the past few years.

Slowing birth rates have resulted in fewer workers paying into state pension plans, while rising longevity has driven defined benefit into its own retirement home. This has all left the second pillar increasingly depending on the success of defined contribution (DC) schemes.

This reliance was recognised last summer by PensionsEurope when the federation released a guide outlining 14 key principles of good governance for workplace DC schemes. Writing in his introduction to the guide, PensionsEurope's chair Janwillem Bouma said that it was essential that individuals had confidence that workplace pension plans operate "in their interests, are robust, well run and offer value for money".

He noted that employers equally needed confidence in their DC plans. They wanted reassurance about their affordability, that they would not expose them to unforeseen risks, and that they would be flexible enough to match their business objectives.

To achieve this, PensionsEurope has said that countries must follow the 14 principles as a minimum requirement. Many of the federation's recommendations make perfect sense: highlighting the need for good communication, a responsible handling of pension fund members' decumulation phases, and value for money. The latter, however, is a principle that could potentially stifle member outcomes in DC.

Missing out on better investment

State Street Global Advisors senior DC investment strategist Maiyuresh Rajah says that with such a strong emphasis on keeping costs low, employers and providers are opting for a tick box, easy investment element to their schemes, particularly in fledging DC markets, such as The Netherlands. This usually begins and ends with a very basic default strategy that uses a crude high-risk-to-low-risk asset allocation lifecycle process.

That is an understandable development says Rajah, but it could mean that an entire tranche of early DC savers are missing out on better returns for their contributions.

"As DC markets become more mature they start looking at more sophisticated investment strategies," says Rajah.

"But what they should do is look at those from the start. What happens is that by the time schemes start looking at diversifying or mitigating risk in a better way,

there's a large section of members who have already built up assets and are close to retirement who haven't had the benefit of these investment strategies."

Rajah says that he doesn't want other countries to suffer the same fate as that of the UK, where the first entrants into DC missed out on better returns due to a low cost or cautious mentality.

"You don't need to wait for your DC scheme to grow, or for the market to pick up before you start incorporating these strategies. For example, you can have active allocation to manage diversification in an active way, but have passive building blocks to keep costs low, giving a pension plan a dynamic asset allocation feature."

Thankfully, he says, there are signs that the time lag between basic and sophisticated investment strategies could become significantly reduced. State Street has been talking to clients in the Netherlands about doing more to improve their approaches to DC investment.

The Dutch dilemma

It's no surprise that the Dutch are catching on to up-to-date investment practices on the DC front, given that traditionally, theirs has been the pensions system that many countries have looked to emulate.

At present, however, those looking for a steer on the future direction of DC from the Dutch may be a little puzzled.

As Pensioenfederatie general manager Gerard Riemen explains, reform of the so-called Dutch pensions contract is much needed, but the current political vacuum is stalling progress.

"We're very much in favour of collective schemes and risk-sharing of course, but on the other hand, we all realise that with longevity and very low interest rates, it's

THE UK COULD SOON BECOME THE FIRST PLACE IN EUROPE WHERE – FROM AN EMPLOYEE'S PERSPECTIVE – PURE PENSION SCHEMES BECOME A THING OF THE PAST

DB scheme," says Riemen.

"Right now though, there is no direction for any reform as there is a political lull as we have a General Election on 15 March. So it all depends on what happens after that.

"We always need a coalition government and this time we expect to need at least four parties to make it happen this time. And if you look at the election manifestos of all the parties, it would be very difficult during the formation of a government to agree on pensions issues."

Nevertheless, Pensioenfederatie, along with the social partners in the Social Economic Council, have continued to work on pension reform. Riemen says that the federation has an idea on the direction that it will take and is very hopeful that soon after the election, the council will be able to hand a new proposal to the new government.

"It's still on the negotiation table but I think the council will go forward with some hybrid construction, so we won't be able to call it a classic DB or DC scheme."

Further clues on details of the new arrangement may be found in critical analysis of the current system. Last June, DNB, the Dutch pensions regulator, said that the past few years had exposed the vulnerabilities of the Dutch pension system. DNB called for new pension contracts that were based on personal pension accounts and individual lifecycle investment policies.

Another change that Riemen wants to see is allowing mandatory schemes to merge.

"That's a problem in the Netherlands and we hope that it will be solved, because if you have economies of scale then you have less governance problems and less pressure on administration and investment costs."

MILLENIALS, IN PARTICULAR, ARE BEING ENTICED TO LOOK AT PENSION SCHEMES THAT INVEST IN A MANNER THAT MATCHES THEIR WORLD VIEW

Changing face of saving

According to JLT Employee Benefits head of technical John Wilson, the UK is also heading towards larger collective pension fund arrangements, in the form of master trusts.

With a new Pensions Bill expected to become law soon, the number of providers, which was nearly at the 100 mark at one point, will be whittled down to alleviate concerns about governance and security of benefits. There will also be a push, says Wilson, to introduce 'Saving for Tomorrow' techniques into schemes. These involve member contributions rising automatically as they receive pay rises.

The bigger news in the UK however, is that of the changing nature of saving in the workplace.

"We have begun to detect a bit of an appetite from employers for wider saving provision in the workplace," says Wilson.

"So for example, for many younger people pensions are not a priority, but getting onto the property ladder is. Some of our clients have begun to recognise that and we have had discussions about adding other types of saving vehicles to the workplace pensions scheme, such as a lifetime individual savings accounts."

If this takes off, then the UK could soon become the first place in Europe where – from an employee's perspective – pure pension schemes become a thing of the past.

"There are the beginnings that this is the direction of travel for saving in the workplace in the UK," says Wilson.

Listening to what members want

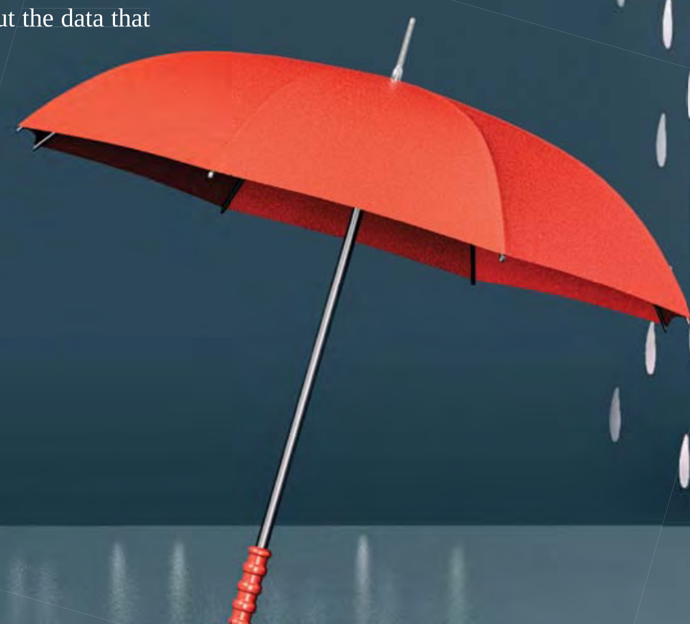
This change in the UK, based on member aspirations, is the blueprint for future DC developments, says Rajah.

"We do a lot of research on what members want and then try to build solutions that we think are appropriate for them. And when we take that to clients and policymakers they're always interested to check out the data that we've gathered," he says.

"That shows that historically there hasn't been enough work done on the underlying member and trying to build upwards in that way."

Acting in tune with members has seen changes in investment in some DC schemes, particularly in Sweden. Mature schemes there have been taking on negative screening, the first step towards ESG strategies, as part of an overall plan to increase employee engagement.

Millenials, in particular, are being enticed to look at pension schemes that invest in a manner that matches their world view, says Rajah. "Whether that helps with engagement will have to wait and see, but that's probably an area that will grow." ■



TECHNOLOGY

Entering the arena

Nick Martindale examines the growing use of fintech within the pensions sector and the potential it has to completely overhaul the industry

WRITTEN BY NICK MARTINDALE, A FREELANCE JOURNALIST

In recent years, the phrase 'fintech' has become a byword for a new type of technology set on changing established models in the financial space. Originating from the back-end systems of consumer and trade financial institutions, it has come to signify almost any new development in the sector, meaning everything and nothing at the same time.

Conduent HR Services head of DB client strategy John Breedon defines it as "financial technology, bringing the power of technology to bear to make the end-user's life easier or drive down cost". Currently, its main application in the pensions space is around the use of new tools to demonstrate expected outcomes from DC schemes, he says.

At a basic level, says UK pensions association PMI technical consultant Tim Middleton, this has seen many schemes use smartphones to communicate with members, including through text updates on fund values and performance. "Over time this will expand into apps to allow members to access information about their pension savings," he says, citing the current development of the pensions dashboard in the UK as a case in point.

Robo-advice and cyber-advice

Another example is the growing influence of both robo-advice and cyber-advice, which use of algorithms to help offer basic financial advice for a significantly lower cost than a financial adviser would be able to offer. "With retirees now having more freedom of action with their pension savings, the presence of affordable, if basic, financial advice may well be a valuable benefit," CFA Institute capital markets policy group analyst Sviatoslav Rosov says."The challenge is then for robo-advisers to ensure the suitability of their financial advice for consumers with widely variable retirement needs and goals."

This kind of offering can be given by employers to their staff, as well as directly to members through pension providers. "Technology enables a rich experience that can be delivered inclusively to a workforce," Wealth Wizards director Phil Blows states. "Many people are woefully under-saving, and have no idea what they need, let alone have a plan to get there. Robo-advice can help them understand this, giving them a personalised plan at fraction of cost and in quicker time than traditional face-to-face advice."

This is already evolving into cyber-advice, Punter Southall Aspire principal Stephen Greenstreet points out. "This is a similar concept but typically involves some form of human intervention to provide guidance or advice as part of the process," he says. "But both robo and cyber provide digital financial advice based on mathematical rules."

The use of such technology can also be used to help employers or scheme providers gauge the level of risk employees are comfortable with taking on, KPMG head of DC Richard Birkin says, as well as providing more engaging methods of interacting with members. "We've been working on games that can more effectively measure risk appetite than a list of questions, and animated videos for member engagement instead of letters or emails," he adds.

In the workplace pensions space, fintech is already starting to impact on how organisations approach the whole pensions and employee benefits space, contends Rowlands. "We're seeing clients totally transform how they design pension and benefit programmes for their people and how they then communicate to people," he says.

"The biggest single development is the ability to design pension and benefits that work for every single employee, irrespective of their life stage, gender, age or grade, and that's all being driven by technology." This could result in a greater mix between traditional pensions and financial wellbeing, he suggests, with employees able to select benefits that are most appropriate for them at different points in their working lives.

Big data and artificial intelligence

There are other ways in which fintech is influencing the pensions world too, including the use of product listing and filtering platforms to provide investors with the information they need to compare investment opportunities and identify new products. "Big data and artificial intelligence are still some of the most heavily focused on and invested in areas of technology," mallowstreet CEO Stuart Breyer comments."It is at this intersection that many of the fintech businesses are operating because of the sheer volume of data, the huge industry complexities and the impact of hyper real-time news."

The potential here is huge, he adds. "In pensions, every decision is built on data and analysis," he says. "There is an ever-increasing need to analyse, understand and predict markets and trends. There are probably not many other industries that are more primed for technological advances," Breyer explains.

Broader still, such information will also help pension funds to accurately calculate their liabilities to help define an investment profile which they could then give to asset managers and hedge funds, Misys investment management solution lead Jason Whitaker underlines. "These firms would then set out to achieve the required returns to meet the liabilities," he says. "Look-through tools help pension funds to have visibility into the investments made by their external fund managers so they can check that returns are on track and investments have been made in line with the mandate they have provided."

Issues

Yet despite the huge potential for fintech to influence different elements of the pensions space, there are a number of issues that need to be addressed before this can be fully realised.

AHC head of web consulting and development Sam Charles identifies the twin issues of legacy systems and an industry full of providers whose primary focus has not traditionally been the end-customer. "Historically employers have been the customers for pension providers," he says. "In the banking sector where the individual is the customer, there has been a much more rapid rollout and adoption of fintech solutions as they are geared towards the needs of the end-user."

Employers also have to see the need to invest in areas such as robo-advice or benefit transformation programmes. "In the case of robo-advice, this will only be adopted by millions if it is supported by large organisations," says Blows. "There is always pressure on businesses when it comes to costs but enlightened employers recognise that their people need help, and that unless something changes many won't be able to afford to retire."

It's a point echoed by Rowlands. "Organisationally, pensions and benefits need to be seen as a part of a whole, so one of the structural changes corporates need to think about is how they join up their HR and pensions strategy, which then meets the needs of both the corporate and the individual."

There are other barriers, too, which threaten the attraction of the sector to fintech providers. "Limits imposed on product charges and very high regulatory standards on recommending or supplying new products has meant that few fintech companies have been motivated by the commercial returns," Trafalgar House director Daniel Taylor points out.

Then there's the need to keep data secure, which often makes the pensions sector instinctively mistrustful of any new technology. "The greatest threat is cybercrime," says Middleton. "Common data held by pension schemes will provide all the information necessary to allow successful identity theft, which means that pension schemes would present a particularly attractive target."

A complete overhaul?

If such obstacles can be overcome, however, there is potential for fintech to overhaul the pensions sector in the way that it has in other industries. "I very much doubt that in the long term we'll be talking about pensions at all," says Birkin. "Big data and digitalisation will get us to a place where consumers have complete flexibility and control over their workplace benefits and long-term savings."

Rowlands agrees. "Within three years the personalisation of benefits and communication will completely transform how benefits are designed and communicated to employees," he predicts. "If you think about how quickly Amazon and Facebook have evolved and communicate to people, that's what fintech is going to do to financial services and pensions and benefits. It's going to completely transform how it is delivered." ■

AT-RETIREMENT

Alternative paths

Talya Misiri considers the key elements that characterise the changing nature of retirement across Europe

WRITTEN BY TALYA MISIRI

The population in most European countries is rapidly aging as a result of increased longevity, lower birth rates and the extremely large baby-boomer generation who are now near retirement. These factors are likely to have a significant impact on pension systemsacross Europe.

The nature of retirement is definitely changing. Once an abrupt termination of working life, retirement can now be characterised as a drawn-out process and can differ from one person to another.

"Gone are the days of being in work one day and being a pensioner the next," claims Newton Investment Management global head of distribution Julian Lyne.

Struggling economies and the masses of people reaching retirement ages has meant that governments worldwide are now promoting longer working lives as a result of this demographic change.

"Whilst the UK is in the process of breaking away from Europe, the demographic and social challenges of retirement is one area where the UK & mainland Europe share a very common challenge," Lyne adds.

Cliff edge

Flexibility is a key term when considering today's retirement and pension systems across Europe. Cliff-edge type retirement, whereby people would be employed one day and retired the next is no longer as common as it once was.

The traditional three-stage lifecycle of pre-work, work and post-work is becoming a thing of the past, with less and less people following this rigid path. People are now able to access their pension pots in a variety of forms and choose to retire at differing times.

One example of change can be seen in the Netherlands. Retirees are able to hold risk-bearing assets through variable annuities, while they previously had to purchase fixed annuities at retirement.

Similarly, the introduction of the UK's pension freedoms in 2015 removed the necessity of compulsory annuitisation at retirement and opened up numerous options, including drawdown and cash lump sum withdrawals.

State Street Global Advisors senior DC investment strategist Maiyuresh Rajah notes: "The popularity of traditional annuity products is waning across Europe due to a perceived lack of value by consumers and a reluctance to give up their pension pot for a fixed-income stream.

"Flexibility is becoming the key driver for many retirees when choosing how to access their pension pots instead of a need for guaranteed secure income through retirement."

Nevertheless, while flexible retirement options and pension arrangements are available, this does not necessarily mean that all reaching statutory retirement ages are able to take advantage of these.

Looking back with envy

Now, it is noted that growing numbers of older workers extend their working lives through continued careers ornew post-retirement jobs, with less individuals opting for a traditional, full leisure retirement.

However, this is not always a personal choice. It has been found that since the 1990s, economic and social pressures have encouraged many European national governments to introduce measures to discourage early retirement and promote longer working lives. This is known as 'active aging'.

Active aging is largely promoted by retention factors that explicitly support longer working lives, with active labour market policies that aim to enhance the employability of older workers.

In Germany, there has been a long history of institutionalised early retirement. However recently, since around 2015, this trend has begun to reverse. Like the rest of Europe, the country has also experienced a change in the political climate towards active aging. Particularly, pension and welfare systems have been reformed to reduce the financial attractiveness of

THE RETIREMENT LANDSCAPE ACROSS EUROPE IS CHANGING AND POLICYMAKERS NEED TO DETERMINE WHAT IS THE MOST APPROPRIATE MODEL WITH WHICH RETIREES CAN ACCESS THEIR PENSION POTS

early-retirement.

In the UK, while compulsory retirement is only lawful in occupations in which job specifications justify it, there has been a comparatively high retention of older workers in employment. This has been found as not so much a result of explicit public or employer-led retention policies, but rather an individual-level financial necessity to remain employed. In particular, low-skilled workers often only have access to public pension schemes, which leads to greater economic pressures to remain in the workforce for longer.

In addition, measures have also been taken in the last decade by other European countries to encourage larger amounts of the aging population to remain in employment. In 2001, the Stockholm European Council agreed to ensure that at least 50 per cent of older people aged 55 to 64 are still in employment by 2010. The following year, 2002, the Barcelona European Council also decided to make efforts to increase opportunities for older people to remain in the labour market for longer.

In line with these changes, early retirement policies and incentives that were inherent in the social security systems of the EU15 countries have been gradually phased out.

"Whilst the flexibility will be embraced by many, affordability and health issues (never mind the complexities involved in managing a phased retirement) may mean that others look back at the 'golden generation' with their traditional retirement with envy," Lyne says.

Phased retirement

Discussing the changing nature of retirement, Meaningful Money reporter Pete Matthew said in a recent podcast *The Great Transition* (Season 4 Ep 10): "Fluidity of the great event that is retirement means that for most people, it isn't an event any longer. It's not a line in the sand…"

With active aging policies and economic fluctuations and differences, most European countries are now encouraging phased retirement processes.

This form of retirement is generally characterised by a gradual departure from the workforce beyond the statutory pension age. Older workers are able to reduce their working hours, usually with a reduction of income, gradually working towards an eventual pensionable retirement.

In some European states, with this form of retirement, income may be supplemented with unemployment benefits, partial pensions, other state benefits or employer subsidies.

In a recent study by the European Foundation for the Improvement of Living and Working Conditions, *Early and phased retirement in European Companies*, it was found that a high number of companies in the Netherlands (64 per cent), Belgium (56 per cent) and Finland and the UK (both 53 per cent) offer phased retirement options. In contrast, lower numbers were found in Southern European countries, including Spain (19 per cent), Italy and Greece (10 per cent) and Portugal with only 6 per cent of companies.

When it comes to take-up of this form of retirement, 27 per cent of workplaces offering phased retirement in the Netherlands stated that almost all or most of their employees made use of this option. This was also fairly high in Denmark, 15 per cent and the UK, 13 per cent. Nonetheless, in eastern and southern states, with the exception of Slovenia and Cyprus, between 66 and 90 per cent of companies offering a phased retirement plans stated that virtually no one made use of this option.

With the European pensions climate undergoing significant change, it appears that there is a battle between retirees working longer than their predecessors and attempting to reach a position of flexibility at retirement, whether that be a phased retirement or alternative pension arrangements.

Rajah concludes: "The retirement landscape across Europe is changing and policymakers need to determine what is the most appropriate model with which retirees can access their pension pots." ■

In their own words...

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

On investment worries across Europe

"As DC markets become more mature they start looking at more sophisticated investment strategies. But what they should do is look at those from the start. What happens is that by the time schemes start looking at diversifying or mitigating risk in a better way, there's a large section of members who have already built up assets and are close to retirement who haven't had the benefit of these investment strategies. You don't need to wait for your DC scheme to grow, or for the market to pick up before you start incorporating these strategies. For example, you can have an active allocation to manage diversification in an active way, but have passive building blocks to keep costs low, giving a pension plan a dynamic asset allocation feature."

State Street Global Advisors senior DC investment strategist Maiyuresh Rajah

On the issues facing the Swiss pension system

"The Swiss occupational pension fund would be happy to take more risk, but they realise the risk is borne by active members in order to pay the pensions of the retirees. So they don't want to take too much risk. For schemes that are run by insurance companies, it's very important to have a coverage ratio of over 100 per cent, or they will lose clients."

ECB's first chief economist Professor Otmar Issing

On the use of robo-advice within the European pensions industry

PHIL BLOWS
Wealth Wizards director
"Technology enables a rich experience that can be delivered inclusively to a workforce. Many people are woefully under-saving, and have no idea what they need, let alone have a plan to get there. Robo-advice can help them understand this, giving them a personalised plan at fraction of cost and in quicker time than traditional face-to-face advice. Robo-advice will only be adopted by millions if it is supported by large organisations. There is always pressure on businesses when it comes to costs but enlightened employers recognise that their people need help, and that unless something changes many won't be able to afford to retire."

SVIATOSLAV ROSOV
CFA Institute analyst in the capital markets policy group
"With retirees now having more freedom of action with their pension savings, the presence of affordable, if basic, financial advice may well be a valuable benefit. The challenge is then for robo-advisers to ensure the suitability of their financial advice for consumers with widely variable retirement needs and goals."

On the high-yield versus investment-grade bond debate

JEFF MUELLER

Eaton Vance portfolio manager

"While compressed valuations leave both the investment-grade and high-yield asset classes vulnerable to a pullback in risk appetite, we continue to favour high yield over investment grade for two main reasons: slow but steady economic growth, decreasing leverage, high interest coverage and low defaults should lead to supportive fundamentals in the high yield asset class, while the longer-duration characteristics (3.3yr for HY vs. 6.5yr for IG) leave the investment-grade market more exposed to moves in underlying yields, which would provide greater headwinds in a rising rate environment. While both asset classes should continue to play a large role in the funding of pension plans in Europe, we believe taking selective credit risk over duration risk should provide more attractive risk-adjusted returns in the current market environment."

BEN BENNETT

Legal & General Investment Management head of credit strategy, active fixed income

"We still think the world is weighed down by too much debt, and ultimately policymakers will struggle to raise interest rates very much before negatively impacting growth. If this is the case, investment grade seems the safest option right now. But central banks are likely to step in again with support. And as yields fall once more, we may be attracted by the extra pick up offered by high yield. Whatever the tactical opportunities though, we think pensions funds that have traditionally focused only on investment grade will continue to look across different parts of the credit market in order to boost investment returns – and high yield will be a key part of that trend."

"We continue to monitor the situation for more clarity regarding the longer-term implications of economic policy. We think political risk will increase volatility in credit markets. Market concerns are starting to emerge over the far-right presidential momentum with underperformance of French bonds. We think global diversification is paramount."

AXA IM head of buy and maintain credit strategies Lionel Pernias

On Irish pensioners suffering losses from changes to the Irish state pension

JUSTIN MORAN

Age Action head of advocacy and communications

"We need to put to bed the myth that the state pension was protected by the last government. It was cut, drastically cut, for tens of thousands of older people who have lost substantial sums of money as a result. Under the old system, if you had an average of 20 years of contributions you would be entitled to €228.70. But after 2012, this dropped to €198.60, a cut of more of more than €30 each week. Because the current generation of pensioners get no benefit from the Homemaker's Scheme, it makes it difficult for them to qualify for a full state pension."

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