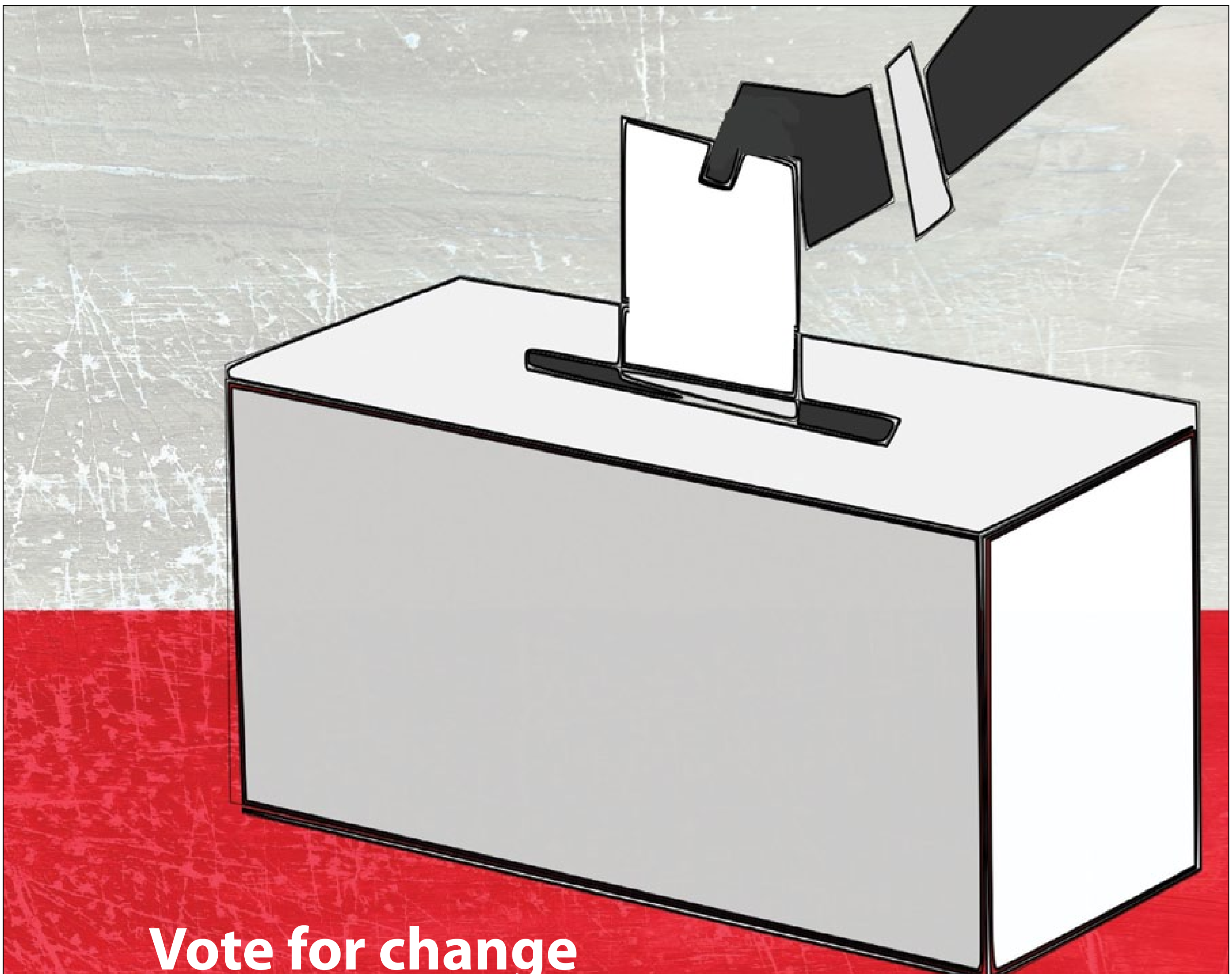
European Pensions

December 2015 / January 2016



Vote for change

How the new Polish government plans to reduce the retirement age and overhaul the pension system

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See page 2 for European Pensions Awards 2016 - Entries now open

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Meeting the challenges

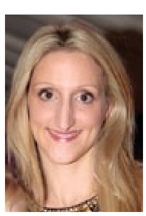
It may seem all doom and gloom in the European pensions arena as 2015 draws to a close - concerns have been raised that the recent extension to quantitative easing, as well as the implementation of the Financial Transaction Tax, could each have their own adverse effects on Europe's pension funds in 2016; while arguments continue to rumble on that the sector is heading towards over-regulation with the oncoming advent of EMIR; MiFID II (albeit potentially delayed); as well as Solvency II, to name just a few examples.

On a more local level, however, 2015 has seen at least some positive developments, as this issue of *European Pensions* shows. Our Nordic roundtable demonstrates how pension funds in the Nordic region have found ways to manage the increasingly difficult search for yield, for example by increasing their allocations to alternative investments; our Irish Pensions Awards supplement showcases a plethora of pension funds and providers who have worked tirelessly to successfully meet the needs of their members in the past year, despite the impact of low interest rates on liabilities; while our infrastructure roundtable explains how access to this previously considered inaccessible asset class is opening up considerably to those pension funds, large and small, who have the patience and the stamina to seek out the increasing number of opportunities available globally.

IT HAS NOT BEEN A YEAR WITHOUT ITS CHALLENGES AND THE MONTHS AHEAD ARE UNLIKELY TO BE ANY DIFFERENT

Uncertainty, of course, continues to reign in many countries - our cover story, for example, considers what the future may hold for Poland's retirees given new government plans looking to reduce the retirement age and overhaul the pension system; while our year review tells how, despite there already having been an almost unsurmountable degree of change in the UK pensions space of late, yet another overhaul may be on the cards.

Suffice to say, therefore, it has not been a year without its challenges and the months ahead are unlikely to be any different. What is a certainty, however, is that the European pensions industry will most likely meet those challenges head on; find ways around the difficulties; and continue to do its utmost to meet the evermore demanding needs of its members. And that's one positive message to take with us all into 2016.



Francesca Fabrizi, Editor in Chief

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

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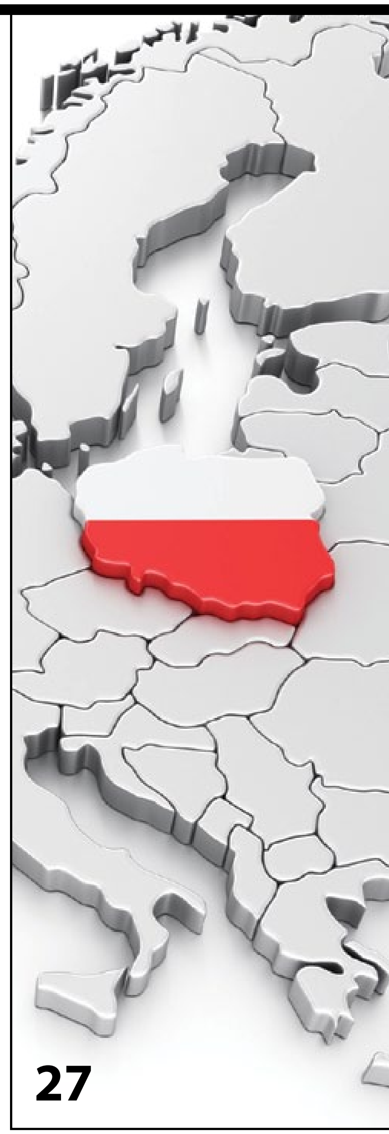

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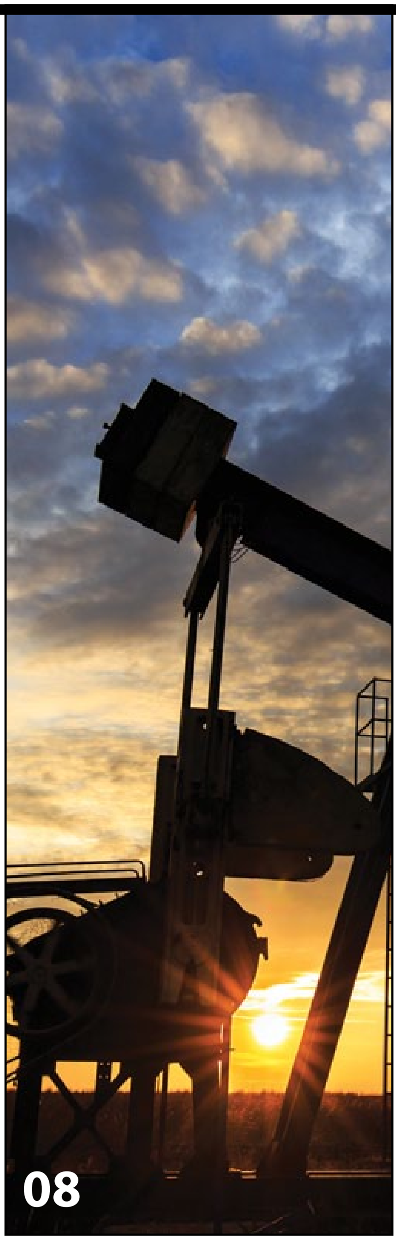

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European Central Bank extends quantitative easing

INDUSTRY WARNS OF THE 'EXTRA STRAIN' QE PLACES ON PENSION SCHEMES

Written by: Lauren Weymouth and Laura Blows

The European Central Bank has decided to extend its quantitative easing activity of €60bn a month until ‘at least’ March 2017, placing ‘extra strain’ on the funding of defined benefit schemes.

The ECB now intends to re-invest the principle payments of maturing assets under QE for ‘as long as necessary’, instead of the September 2016 termination date originally planned.

However, this announcement of further monetary easing did not go far enough for the markets, which interpreted the announcement as ‘hawkish’. This was because the 10bps cut in the ECB’s deposit rate was “less than expected and it failed to increase the size of quantitative easing”, BlueBay Asset Management head of credit strategy David Riley stated.

The result was that the markets reacted with disappointment and European bonds and stocks were sold-off, he added.

AXA IM senior economist Maxime Alimi agreed that the ECB disappointed the market’s “high expectations”.

“Overall, we had expected more from the decision as the ECB had strongly emphasised the need to move quickly against the risk of too-low-for-too-long inflation,” Alimi explained. “On the contrary, the central bank seems to be taking a more gradual approach, with President Draghi underlining that the programme will remain in place for a ‘long, long time’.

According to Alimi, a possible reason for such milder-than-expected easing could have been the result of a compromise with the 'hawkish' members of the Governing Council, "as some of them were very vocal into the meeting".

It also could be a way of making the Fed more comfortable in hiking the rate, and letting it do part of the job necessary in the currency market, she added. "If this assessment is right, there will not be much patience needed to see the global monetary policy divergence start for real.”

However, the question now remains whether these measures will achieve the desired result, Jupiter Independent Funds head of strategy John Chatfeild-Roberts asked, as “the eurozone up to now has only been able to produce the weakest of growth despite enjoying what has essentially been ‘free’ money, subdued energy prices, low inflation and a massive injection of cash from its central bank”.

"We had expected more from the decision as the ECB had strongly emphasised the need to move quickly against the risk of too-low-for-too-long inflation"

Within the pensions industry, the announcement of an extended QE programme was met with concern.

According to Lincoln Pensions head Darren Redmayne, the announcement "places extra strain on funding defined benefit pension schemes and greater reliance on the sponsor covenant standing behind them".

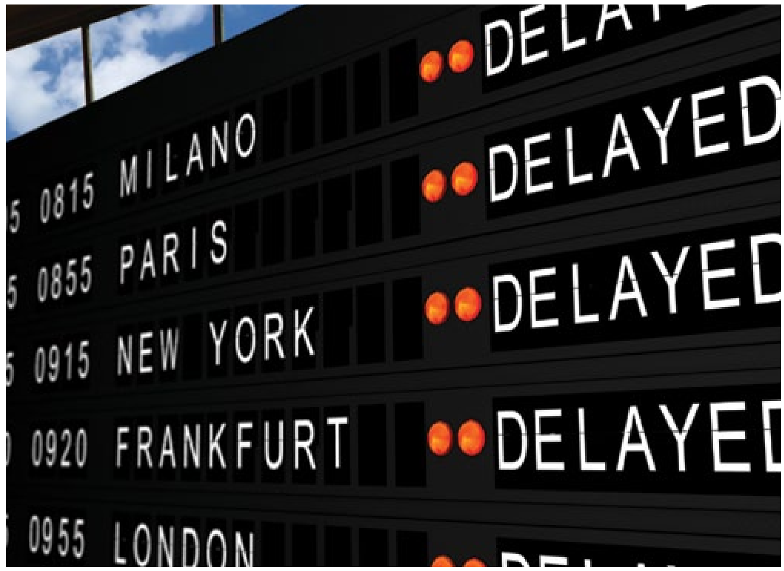
JLT Employee Benefits director Charles Cowling said the QE extension creates the risk of “bad news” for pension schemes, as it suggests the ECB feels interest rates may stay “very low for longer than expected”.

“Most pension schemes are currently following investment strategies which are not fully hedging interest rate exposures - most LDI programmes are only partially hedging interest rate exposures. As a result, if interest rates rise more slowly than anticipated by markets, then this will increase pension scheme liabilities and, potentially, pension scheme deficits," he explained.

MiFID II may be delayed for a year

EUROPEAN COMMISSION WARNS MIFID II LIKELY TO BE DELAYED BY UP TO A YEAR DUE TO TECHNICAL CHALLENGES

Written by: Natalie Tuck



The Markets in Financial Instruments Directive (MiFID) II is likely to be delayed by up to a year, the European Commission has said.

MiFID II, which has been in the pipeline since October 2011, was set to be implemented on 3 January 2017.

The European Parliament voted through the proposals for MiFID II in April 2014 but the European Commission said technical challenges mean the measures may have to be put back by as much as a year.

A director of the Commission Martin Merlin told European Union lawmakers that the institution's "preliminary view at technical level is indeed that a delay is needed" to the planned 3 January 2017 start date.

"Maybe the simplest and most legally sound approach would be to delay the whole package for one year," Merlin said at a hearing of the EU Parliament's Economic and Monetary Affairs Committee.

In response to Merlin's comments about MiFID II, an FCA spokesperson said it was for the Commission, the Council and European Parliament to make a decision on delaying the implementation of MiFID II, not national competent authorities.

"Unless the co-legislators decide on a change, we can only continue to work to the deadline set in the level 1 text of 3 January 2017 for the obligations taking effect," it added.

A recent regulation-ready client study carried out by SGSS, which works with many European asset managers, identified MiFID II as the dominant change agenda item on clients' minds and the dominant spend driver for 2016, followed distantly by UCITS V.

The original MiFID was introduced in November 2007 and introduced competition to the EU trading landscape and provided a 'passport' for trading venues and investment firms to operate throughout Europe on the basis of authorisation in their home member state. It also introduced various investor protection measures.

"As the industry remains on tenterhooks, the timing of an announcement from the European Commission will be key, as the value of a delay erodes the longer it takes"

Commenting on the announcement, PwC asset management partner Grant Lee said asset managers should be "grateful" for the potential reprieve.

"The potential changes required by the directive and regulation are immense and with key text still outstanding, embedding the wholesale changes during 2016 is a massive stretch for the industry," Lee said.

He added that the implementation of the directive would be before considering and working through what the subsequent impacts may be for asset managers from interaction with sell-side firms.

"As the industry remains on tenterhooks, the timing of an announcement from the European Commission will be key, as the value of a delay erodes the longer it takes.

"If the delay were to be granted in mid-2016 this would be too late for most - firms are seeking clarification now on their timetables and deliverables. Until the European Commission officially announce a delay we will continue to work with our clients towards the 3 January 2017 implementation date."

Swiss providers merge for RI association

SWISS PENSION PROVIDERS MERGE TO PUSH FOR RESPONSIBLE INVESTMENT AS SWEDEN'S AP FUNDS COORDINATE THEIR CARBON FOOTPRINT REPORTING

Written by: Adam Cadle and Lauren Weymouth

A number of the largest pensions and insurance providers in Switzerland have come together to form an association for responsible investments.

The SVVK-ASIR has been founded to promote sustainable and responsible investment and strengthen efficiency and cost effectiveness, particularly at a time when investors are being pushed to do more to divest assets affecting climate change.

Members include the first-pillar fund AHV, the public pension fund Publica, the pension fund for the canton of Zurich BVK, ComPlan, PkPost, PKSBB and accident insurance fund Suva. Together, they manage more than €122bn in assets.

The SVVK aims to support its members in making investment decisions, so that they in turn can exercise the responsibility towards the environment, society and economy comprehensively.

"The SVVK aims to support its members in making investment decisions, so that they in turn can exercise the responsibility towards the environment, society and economy"

Elsewhere in Europe, the Swedish AP pension funds have all agreed to coordinate the way in which their carbon footprints are reported in order to boost transparency and allow them to assess their work on climate issues.

The six funds, AP1, AP2, AP3, AP4, AP6 and AP7, will report on their carbon footprints using three principal indicators. This includes the absolute carbon footprint for the portfolio of equities corresponding to the percentage of total emissions equivalent to the fund's equity interest in a company.

Furthermore, the funds will report using carbon intensity as an indicator, where the absolute carbon footprint is related to the fund's equity interest in the company's market value and in the company's revenue. The carbon footprints will be calculated as per 31 December of the current year.

In a joint statement the funds said "as long-term owners and managers of Swedish pension assets, the AP funds have a responsibility to generate maximum possible benefit for the Swedish pension system through responsible investment and management".

The AP funds will include information on the proportion of capital assets assessed, as well as the amounts based on reported and estimated carbon dioxide emissions data respectively.

They will also continue to address the climate issue through dialogue with industry organisations and coordinating agencies such as the Principles for Responsible Investment, the Institutional Investors Group on Climate Change and the Carbon Disclosure Project.

Some of these steps towards responsible investment have come after research found that fossil fuel investments are costing major funds, including Dutch pension fund ABP, billions of pounds.

Analysis from Corporate Knights, 350.org and South Pole Group assessed the investments of 14 funds, including ABP, and determined the total scale of losses over the past three years exceeded $22bn.

The analysis covered recent disclosed holdings of the funds to estimate the potential financial impact if they had shifted their investments from the most carbon-heavy coal and oil companies to companies that derive a minimum of 20 per cent of their revenues from environmental markets or new energy.

Lufthansa cabin crew call off strike action

STAFF HAVE CALLED OFF STRIKE ACTION FOLLOWING THE CANCELLATION OF HUNDREDS OF FLIGHTS

Written by: Natalie Tuck

Lufthansa cabin crew have called off planned strike action after progress was made following talks with the airline on pension benefits. The airline's main cabin crew union UFO had planned strike action from 26 November.

The dispute is a long-running battle over pensions, which resulted in the cancellation of hundreds of flights in November due to strike action.

Organised by the Independent Flight Attendant's Organisation (UFO), the strike affected around 37,500 passengers and 290 flights.

"The company decided to take this step to avert the planned UFO strike action and the associated disruption for its customers. Lufthansa also offered to provide employer-funded retirement pension provision for new cabin crew members, which is in line with those provided at other DAX 30 companies. UFO has rejected this latest Lufthansa offer, too," Lufthansa said in a press statement.

However, *Reuters* reported that the union and Lufthansa have now agreed on a basic concept for retirement and pension benefits that could be used to reach an agreement.

However, the union cautioned that further agreements on jobs needed to be achieved in order to prevent further strikes.

In October the airline proposed an offer that would allow cabin crew to retire at 55 but with a significantly reduced pension. Employees would need to work until 65 in order to obtain the full pension.

As part of this cabin crew would receive a one-off payment of €2,000 each and those who have been with the company since at least 2012 would get a pay rise of 1.7 per cent in 2016 and 2017.

The company said the low interest rates mean it can no longer afford the pension scheme, which cost it €3.6bn last year and allowed workers to retire at 55.

Ireland's largest DB schemes see deficits rise by over €2bn

AIB, THE BANK OF IRELAND AND CIE ARE AMONG SOME OF THE LARGEST SCHEMES TO SEE DEFICITS SURGE

Written by: Natalie Tuck

The deficits of the largest defined benefit pension schemes in Ireland increased by more than €2bn to €5.8bn during 2014, according to LCP Ireland.

The *Accounting for Pensions 2015* report published by the Irish consultancy firm found that the highest deficits were reported by AIB (€1,064m), the Bank of Ireland (€986m) and CIE (€702m).

Kingspan was the only company that was found to have enough assets to meet its liabilities, with a funding ratio of 107 per cent. The average funding level for the schemes analysed fell from 86 per cent in 2013 to 83 per cent in 2014.

Despite the high deficits, the report found that the companies paid €1.27bn into their pension schemes in 2014.

LCP Ireland said the low bond yields, the eurozone's struggle with the economic difficulties in Greece and low economic growth meant that pension schemes were "under pressure" in 2014.

It said the value placed on pension liabilities is very dependent on yields on high grade bonds; lower bond yields result in higher liabilities. As a consequence, pension liabilities remained historically high over 2014 and continued to be volatile throughout Q1 2015.

"The results of the 2015 report highlight that many companies remain under considerable pressure in maintaining their defined benefit pension schemes. A number of schemes have disappeared through wind-up over 2014, benefits have been cut in others and more are implementing other deficit funding programmes," LCP partner Conor Daly stated.

Ryanair, for instance, made a final contribution of €12.5m into its Irish DB plan, which was subsequently wound up. Bank of Ireland's pension scheme, which included elements of defined benefit and defined contribution, was closed to new entrants and a new defined contribution scheme was introduced, he added.

News in brief

■ Czech subsidiary **Investiční Společnost České Spořitelny (ISCS)** has merged into **Erste Asset Management GmbH (EAM)**. This move will turn the wholly-owned subsidiary of EAM into a branch office.

■ **Illinois** has added $6.4bn to its unfunded pension liability, pushing the total to $111bn. According to analysts, changes in some actuarial assumptions at two of the five Illinois public employee retirement systems, along with insufficient state contributions, were the main reasons for the higher unfunded liability.

■ Ministers in Ireland have signed the **European Union Regulations 2015** into effect to establish European long-term investment funds in Ireland. By signing the regulations, Ireland's **Minister for Finance Michael Noonan** has confirmed application forms are now available from the Central Bank of Ireland and it is ready to accept ELTIF applications.

■ New York City **Mayor Bill de Blasio** has urged the city's pension funds to divest their holdings in stocks of gunmakers after the mass shooting in San Bernardino. **The New York City Employees Retirement System** and the **New York City Teachers Retirement System** have already dropped gun stocks such as Smith & Wesson Holding Corp and Sturm Ruger & Co Inc.

■ The cost of pension expenditure in Italy reached €277,067m in 2014, according to the **Italian National Institute of Statistics**. Figures show the 2014 pension spend was 1.6 per cent more than that in 2013.

Japan's pension fund loses $64bn

JAPAN'S GOVT PENSION FUND SUFFERS HEAVY LOSSES IN Q3

Written by: Lauren Weymouth

The world's biggest pension fund in Japan suffered a loss of $64bn, which is the equivalent of 5.6 per cent of its value, in the third quarter of 2015.

Japan's Government Pension Investment Fund suffered the loss primarily as a result of the fall of global stock markets, with much of the loss being regained shortly after.

Results from the $1.1trn fund hint towards increased volatility in the future after it changed its target portfolio to 50 per cent equity last year to boost returns and help service Japan's pension bill, the *Financial Times* reported.

Japan's government chief cabinet secretary Yoshihide Suga said although the volatility of short-term profits has increased, from a long-term perspective, "the risk of a shortfall in pension assets has decreased".

The majority of the losses derived from its investments in domestic and international equities, which were both down 12.8 and 11 per cent respectively. However, domestic bonds generated a modest profit.

Any losses suffered were reported to be almost identical to the GPIF's benchmark indices for those assets.

Canada's top 10 pension funds triple in size as assets grow to C$1.1trn

THE FUNDS SEE RETURNS ON INFRASTRUCTURE AND REAL ESTATE SURGE

Written by: Lauren Weymouth

Canada's largest 10 pension funds have tripled in size since 2003 and now manage more than C$1.1trn in assets, a new study has found.

According to research by the Boston Consulting Group, the funds have quickly expanded by directly investing in assets globally, primarily focusing on real estate and infrastructure projects such as bridges, tunnels and roads.

About one-third of the top 10 funds' investments are in alternative asset classes such as infrastructure, private equity and real estate, according to the study.

"The top 10 have shown impressive growth in investment capabilities and scale to manage the realities of a post-financial crisis world," said BCG partner and managing director Craig Hapelt.

"Their investments also have a broader positive impact on Canada's prosperity," he added.

The 10 largest funds include the Canadian Pension Plan Investment Board (CPPIB), the Caisse de depot et placement du Quebec (Caisse) and the Ontario Teachers' Pension Plan Board, the three biggest Canadian funds that are also in the top 20 public pension funds globally. Seven of the funds are among the top 30 infrastructure investors in the world.

Diary dates 2016

The latest events occurring across the European pensions space

PENSIONS AGE AWARDS 2016
25 February 2016
London Marriott Hotel
Grosvenor Square, London

The Pensions Age Awards, which are now in their third successful year, aim to reward both the pension schemes and the pension providers across the UK that have proved themselves worthy of recognition in these increasingly challenging economic times. The awards will take place at London's prestigious Marriott Hotel on Grosvenor Square and are free to enter.
www.pensionsage.com/awards

PLSA INVESTMENT CONFERENCE
9-11 March 2016
EICC
Edinburgh, Scotland

Formerly the NAPF Investment Conference, this will explore the UK's relationship with the rest of Europe, and other issues to bring some clarity and certainty as to how schemes can best manage their short-term pressures whilst also being responsible long-term investors delivering what their scheme members want and need. Over 900 professionals are set to attend.
plsa.co.uk

EUROPEAN PENSIONS AWARDS 2016
26 June 2016
Grosvenor House Hotel
Park Lane, London

The European Pensions Awards aim to recognise outstanding achievement in the varied fields of European pension provision during increasingly challenging times. The eight previous awards were hugely successful, each receiving hundreds of nominations from key providers across Europe. The 2016 European Pensions Awards are now open for entries. The awards are free to enter.
www.europeanpensions.net/awards

Not to miss...

BARNETT WADDINGHAM INVESTMENT CONFERENCE
27 January 2016
London
www.barnett-waddingham.co.uk

AON 2016 PENSION CONFERENCE
10 February 2016
London
www.aon.com

PMI ADMINISTRATION SUMMIT
29 February 2016
America Square Conference Centre, London
www.pensions-pmi.org.uk

PENSIONS AGE SPRING CONFERENCE
28 April 2016
Hilton Tower Bridge, London
www.pensionsage.com/pa/events

If you have any European pensions events to promote, please contact lauren.weymouth@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 natalie.tuck@europeanpensions.net

GARY SHAUGHNESSY

Zurich Insurance has appointed Gary Shaughnessy as CEO of Global Life and as a member of the group executive committee. He has been CEO of Zurich UK since June 2012. Prior to joining Zurich he was managing director of UK defined contribution and retail business at Fidelity Worldwide Investment. He is also a member of the board of the Association of British Insurers and is the chairperson of the ABI Protection Committee.

JORRIT ARISSEN

Kempen Capital Management has appointed Jorrit Arissen to its real estate team in the role of senior portfolio manager. Over the last six years Arissen worked as senior portfolio manager in the global real estate team of PGGM Investments, focusing on North American and European listed real estate. Prior to this, he worked at F&C Asset Management and APG Asset Management.

CHRISTIAN PUSCHMANN

Neuberger Berman has appointed Christian Puschmann as head of client group – Germany and Austria. He is based in the group's Frankfurt office. Puschmann is responsible for leading client relationship management and business development across Germany and Austria, with a particular focus on Neuberger Berman's institutional client base.

BO THULIN

Northern Trust has appointed Bo Thulin to lead its Nordic business. He joins from J.P. Morgan where he was most recently head of the bank's investor services business in Sweden and Norway. Thulin is responsible for managing the growth and development of Northern Trust's asset servicing and asset management business activities across Sweden, Finland, Norway and Denmark. He will report to Penelope Biggs, head of the institutional investor group for EMEA.

MARTIN HAYCOCK

Fisch Asset Management has appointed Martin Haycock to work within the convertible bond portfolio management team. Haycock joins the company following a 20 year career at UBS. Originally he joined the convertible bond origination team before becoming head of convertible bond marketing and subsequently global head of the newly-formed UBS Index Group.

MATTHEW LAMB

Deutsche Asset & Wealth Management has appointed Matthew Lamb as co-head of alternatives coverage in the global client group, reporting to Dario Schiraldi. Lamb has over 12 years of liquid alternatives expertise. He was previously head of institutional and wholesale distribution for the UK and Middle East and global head of multi-asset sales at GAM.

PANFILO TARANTELLI

Credito Fondiario has appointed Panfilo Tarantelli, founding member of Tages Holding, as the new CEO. He has 35 years' experience in financial services in London. In 1992 he was appointed chief executive of Schroders in Italy and, subsequently, head of continental Europe for investment banking. After the acquisition of Schroders by Citi, he became head of investment banking and later chairman of the Global Banking Division for Europe.

OLIVER COLLIN

Invesco Perpetual has promoted Oliver Collin as fund manager of the Invesco Continental European Small Cap Equity Fund, joining lead manager Erik Esselink. He will also join Jeff Taylor as fund manager of the Invesco Euro Equity Fund. He joined Invesco Perpetual as an analyst in 2014 from BNP Paribas where he led their pan-european mid cap sales team.

MICHAEL MALQUARTI

SYZ Asset Management has appointed Michael Malquarti as head of the manager research and alternative investments team. The role was created as SYZ have merged the alternative and long-only strategies. Malquarti will retain his role as the manager of funds of funds and multi-manager-mandates. He joined the group in 2005, initially developing quantitative and qualitative tools.

JOHN WENT

CBRE Global Investment Partners has appointed John Went as senior legal counsel. He has close to seven years post-qualification experience and joins from legal firm Clifford Chance, where he specialised in corporate real estate transactions and joint ventures. It is a newly created position and he will be a dedicated resource for the legal aspects of the business.

ERIK HULSHOF

Kempen Fiduciary Management has appointed Erik Hulshof as an executive director and will be responsible for realising effective cooperation and integration of the activities in the UK and the Netherlands, with the aim of achieving an optimal proposition and service in the field of fiduciary management. He has extensive experience, having worked for MN and Robeco.

OVERVIEW

Small steps

The European pensions landscape saw a few dramatic shifts in 2015, as it edged itself towards its long-term goal of more regulation. Peter Carvill **explores the events and issues that shaped the industry last year**

WRITTEN BY PETER CARVILL, A FREELANCE JOURNALIST

The pervading sense around change in the pensions landscape across Europe this year was more of a tectonic grind than any sudden and dramatic shift.

Any change there was flowed along the channels of regulation, with the coming advent of the European Market Infrastructure Regulation (EMIR), the incoming Markets in Financial Instruments Directive (MiFID), and Solvency II.

Brussels-based NGO Finance Watch head of policy analysis Frederic Hache says that the big theme of 2015 has been the "big push towards privatising pensions", aligned with a "greater role in forcing pension funds to provide lending to the economy". Key to this, he says, is the Capital Markets Union (CMU), the action plan of which was adopted on 30 September. That plan has a number of aims, including the ability to unlock more investment from the EU and the rest of the world, to better connect financing to investment projects across the EU, to stabilise the financial system, to deepen financial integration, and to increase competition.

"I think this is a big push that will last for a long time," Hache says. "The official objective is to promote growth and jobs. Less-mentioned but just as important is competitiveness. What is interesting is that this whole push to increase private pensions is framed in terms of increasing returns for investors through encouraging a shift in the capital markets. But there is no real debate on the whole underlying assumptions behind privatising pensions. That conversation is very limited and does not cover all the questions that a society might ask."

Regulation

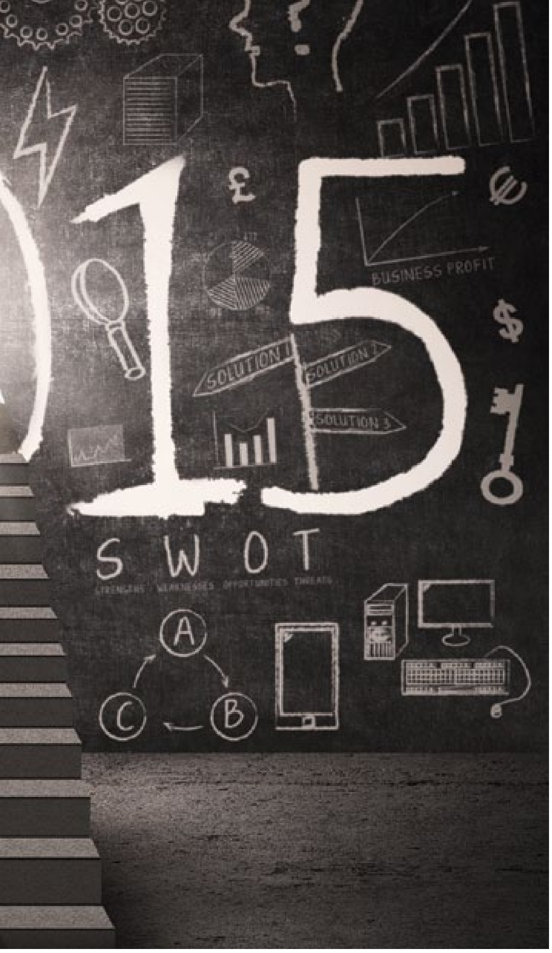
There is a consensus among many that the market was becoming over-regulated.

Others, however, argue that the buttressing through regulation is a good thing. PensionsEurope secretary general Matti Leppälä says that the advent of EMIR, MiFID, Solvency II and their like has been overall a turn for the better.

The piece of regulation that sparked the most debate has been MiFID. The original directive was adopted in April 2004 and came into force in November 2007, with the purpose of 'creating a single market for investment services and activities, and ensuring a high degree of harmonised protection for investors in financial instruments[...]'. Its successor MiFID II - a heavy revision of the original rules - was slated to come into force in January 2017. That legislation, as of the end of November, has been delayed for another year.

Stamford Associates CIO and founder Nathan Gelber places MiFID in the context of the UK's Retail Distribution Review (RDR). MiFID, he says, "[has] the principal idea of getting rid of retrocessions for the distribution of third party funds. That does not seem too dissimilar to the concept underlying the RDR so it raises the question of the business model and investment content that wealth managers on the continent are likely to pursue going forwards, given the emphasis of change has been a shift towards advice-based fees from marketing/sales commissions."

Reaction to MiFID has been varied. In October, one commentator wrote that the directive had the potential to benefit pension funds, calling MiFID "essentially a consumer protection measure". The benefits of MiFID, they wrote, were that the new rules, if implemented properly, would result in better retirement outcomes for millions through the cost reduction.



For others, the issue of transparency is in some ways troubling. Leppälä says that while PensionsEurope has always been in favour of most trade transparency, it has concerns over too much pre-trade transparency. "That's been the main issue," he says, "because with many pension funds, the deal size is quite large and if they have to give out too much information, it will benefit only the high-frequency traders."

EMIR has seen a similar delay. In mid-September, the temporary exemption for pension scheme arrangements from the clearing obligation was extended until August 2017.

Leppälä says that the extension was not inevitable. "I am pleased with it," he says, "and with the fact that solutions will be found. It's not a simple issue and there isn't a clear solution to hand that would alleviate the obvious problem that pension funds would have to use cash as collateral. That would have a big impact in the countries that have to hedge their liabilities."

Legal

The past year has seen a number of interesting legal rulings. Pinsent Masons head of pensions research Raj Sharma says that two key issues have been the proposed holistic balance sheet and the ongoing consultation around the pan-European Personal Pension Product (PEPP), both conducted by the European Insurance and Occupational Pensions Authority (EIOPA). The former is a proposed tool to support the development of a single, European regulatory regime that accommodates national pension schemes, as defined by national social and labour law and decided upon by employers and the social partners. The consultation period for PEPP ended on 5 October, with EIOPA expected to deliver its final advice to the European Commission at the beginning of 2016.

EIOPA's proposal of the holistic balance sheet was met with a wall of criticism, with some labelling the project as "pointless" and even liable to have trustees break their fiduciary duty.

Sharma says that despite some stumbles, he regards the idea as "significant" if it persists. "It's not regarded as most effective in terms of costs and benefits," he says. "There's also the question of whether it is realistic. It's had some cold water poured on it recently."

One legal ruling that could have huge ramifications for the pension industry, says Sharma, is the case originating from Ireland of Maximilian Schrens vs. the Data Protection Commissioner. In that case, Schrens took a case to the Court of Justice of the European Union over the transfer of his Facebook data from Irish servers to US servers, following the revelations from Edward Snowden. In this case, the court ruled that the Commission's US Safe Harbour Decision was invalid. Schrens's contention was that Snowden's revelations had revealed that the US did not ensure an adequate level of protection of his data. "The impact on pension schemes," says Sharma, "is that if an EU scheme transfers data to the US because they have an American parent company, it's going to have to put in place an adequate replacement service because the safe harbour framework has been ruled invalid."

National

Cardano head of innovation Stefan Lundbergh says that on a national level, the big story in Europe this year may be the UK government's proposal to change the pension system, given in July. Under that proposal, presented to parliament as an incentive for people to save towards pensions, those paying into a scheme will now be taxed on their contributions, while those in retirement will find their pensions free of tax. Lundbergh is not a fan of this proposal.

"The government is cash-poor," he says, "and trying to get all their money from the future to spend now, this is what I think this proposal is. It's postponing your salary and tax revenues for the government when you retire. The retirees are going to consume a lot of public services like healthcare. The government may get the tax revenue today but the working population will have to pay everything for the retired population. And if the business cycle is volatile, it means that tax revenues will go up and down."

The gradual changes across 2015 originated a long time before the year's beginning and will extend far beyond its end. From then to now, it has to be an accepted truth that this is how change will be, one footstep at a time. ■

SCHEME DESIGN

Modern tailoring

A report by PensionsEurope **has thrown light on the need for a fresh DC concept that fits comfortably with workers' new expectations. But can former styles be moved aside to create the right design?**

WRITTEN BY MAREK HANDZEL, A FREELANCE JOURNALIST

For many of tomorrow's Europeans, there is a real danger that sewing together a pension income will be a much harder task than it ever was for their parents and grandparents.

Employers across the continent have left behind defined benefit structures, fewer states are offering anything other than a basic social security safety net, and people are living longer. This lethal combination has left workers like a new apprentice in a tailor's store. They know they need to put some clothing together, but they are uncertain of which material to use, or what the right dimensions should be.

The lobby group PensionsEurope has recognised this dilemma. In November, it published a paper outlining its vision for a DC design which is fit for the rest of the century. Punter Southall head of international consulting Julia Whittle says that the report is very welcome, given that Europe has been crying out for a new debate on DC plans.

"The concentration has been on third pillar work for too long," she says. "At last we are starting to look at occupational DC, which is where the majority of individuals in the European Union sit."

PensionsEurope has identified many of the key requirements for a new breed of DC, JLT Employee Benefits head of technical John Wilson comments.

In particular, JLT endorses the need to engage members - by making it easy to ascertain whether they are on track both in terms of the age at which they want to retire, and the level of income they hope to retire on.

Other requirements it backs include making schemes easier to join, good management and oversight, techniques to encourage more saving, and management committees to oversee plans that have been entirely handed over to insurance companies.

In a world where there are so many unknowns surrounding retirement dates, along with economic and work positions, State Street Global Advisors head of European DC Nigel Aston likes the stress the report has placed on giving members agility and adaptability. This, perhaps more than anything else, sets a modern DC scheme apart from the original model. The former can be moulded around a member's individual circumstances. The latter uses clunky lifestyle funds to spit every member out at their retirement age with whatever amount the financial market gods decide to bestow upon them.

The best way to serve the participants in a DC scheme, says Aston, is to create a seamless transition between the saving and the payout phases.

"Certain parts of Europe are better at that than others," he says. "The Netherlands, Switzerland, and Germany to a degree, stitch the two bits together more effectively. It's like you're actually saving up for your retirement income, rather than something which could turn into retirement income.

"However, in the UK for example, there's a dislocation between decumulation and accumulation. As a saver you've been in a well governed, low cost, inertia-led world and all of sudden, you're in the exact opposite place."

Prior to that, he says, as the paper highlights, a good default, cradled in the right architecture that offers simple choices, is also essential.

"We mustn't try to teach people to be their own CIO. Any pension system that relies on experts for it to work is doomed to failure. You need a system that can deliver good outcomes regardless of how well engaged people are," Aston says.

Finding a common design

Aside from some minor criticisms – some commentators would have liked to see more depth, in particular on governance standards - the report reads like a blueprint for the ideal DC plan.

However, drawing up a blueprint and seeing that replicated across the European Union's 28 member states are two very different tasks.

"Countries have done different things in the DC space," Whittle underlines.

"They have transferred from DB to DC, but at different rates of speed. And there are large discrepancies in DC contribution rates between nations."

UK Ensign Retirement Plan CEO Andrew Waring says that implementing a single set of DC rules would be very difficult without a common basis for the taxation of contributions and benefits.

"Getting a consensus agreement regarding how this might operate is likely to be problematic," he says.

Then there are the particular patchworks of rules that have built up over time in various states, as Towers Watson head of the international consulting group Chris Mayo points out.

Take Belgium and Switzerland, he says, where there are still minimum investment return requirements, or the insistence placed by the Dutch on benefits being paid out in annuities.

"So all those ideas about giving people choices about decumulating or changing lifecycles become somewhat irrelevant, because you've got legislative barriers that get in the way," he says.

Another block lies in the fact that different countries have varying levels of urgency when it comes to DC provision.

Mayo says that the impact of PensionEurope's report will be more apparent in places where strong DC cultures already exist, such as the UK and the Netherlands.

"It is less relevant in France for example, where most of the benefits come from the state, and will do for the foreseeable future," he points out.

As a result, argues Whittle, more realistic goals should be set. The solution for European pensions, in her view, is to run it on a supermarket trolley model.

After establishing a common legal entity and then making sure each saver's trolley has the essential elements, they are then allowed to select at-retirement choices that match their requirements. So for example, in one country, full annuities or drawdown plans will be on offer. In others, a full cash option may be applicable as it currently is in the UK.

Equally, when it comes to the default fund, restrictions based on former country-specific behavioural economics could be cast aside under the supermarket model.

"Lifestyle funds are common in some countries and not in others. And in some countries fixed interest and cash have been the main vehicles, as people are afraid of the risk attached to anything else," Whittle states. "But that isn't to say that people in other countries wouldn't be interested in something else if they were allowed to enter into that.

"Portugal is a classic example where there are various types of plans. And they all have different levels of risk."

Getting the right fit

Whichever path DC does take, there is no reason why it can't apply new principles from the smallest scheme to the largest collective plan, according to Waring.

"In essence, DC provision can be broken down into contributions, investment and benefits," he says.

Although there are clear differences in governance for collective DC and mastertrust schemes, as opposed to single employer DC arrangements - such as processes to allow individual employers to sign up to a scheme and a central body of trustees to run it - Waring argues that their effect on members is minimal.

"Whilst this would be likely to lead to some difference in rules' wording when compared to a single employer provided DC scheme, there is no need for the scheme rules to look significantly different from a member perspective."

The same is not the case for cross border schemes, however. The same tax rules and legislative differences that hamper a one-type-of-DC hegemony in Europe are holding back their growth.

Wilson reveals that there are still only 75 schemes operating cross-border and that in JLT's experience, employers with presences in different parts of the EU still operate separate schemes for employees based in each country in which they do business.

Whittle says that the issue needs to be addressed. "Some companies really do need a vehicle that is cross-border," she says.

"They need something that is not only easy to use from their perspective, but that actually provides some equality. Then when they go from one country to another to work, employees are not going from a highly functioning type of pension arrangement with highly exceptional pension benefits to something that is very poor, without realising it." ■

Nordics roundtable:
THE CHALLENGES AND CHANGES

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Chair:

DOROTHEE GNAEDINGER
Principle, Mercer

Dorothee heads up the international consulting business at Mercer in Denmark, and is based in Copenhagen. She recently transferred from Mercer Sweden where she looked after some of the largest Swedish multinationals. Prior to Sweden, Dorothee worked for Mercer in London, where she spent over five years working in the pensions industry. Dorothee is also pursuing a PhD at Warwick University on private pension provision in emerging markets.

Panel:

ROBERT HEANEY
Director of Fixed Income, M&G Investments

Robert Heaney is based in Stockholm and is focused on developing M&G's business with institutional clients in the Nordic region. Robert has covered the Nordic region since 1999. Prior to M&G he spent five years with RBS in Stockholm where he was responsible for coverage of the Nordic insurance sector, and nine years with Credit Suisse in London, where he was latterly the Nordic country manager within the equities division.

PETER LIDBLOM
Head of Nordic Region, ETF Securities

Peter has over 19 years of international banking and sales experience and was most recently at NSBO Ltd, a specialist global institutional broker, where he was responsible for China macro/sector thematic sales to Nordic institutional investors, banks and corporations. Prior to his time at NSBO Ltd, Peter headed up the equity finance and prime finance product sales team at Nordea and was head of prime brokerage sales for SEB Securities Finance in the UK.

OTTO SCHAUMAN

Business Development Manager, Aberdeen Asset Management

Otto joined Aberdeen's Nordic business development team in 2013 and since January 2015 has been responsible for developing institutional relationships in Sweden. Before joining Aberdeen, Otto spent five years at DNB Bank in Helsinki as a relationship manager covering large corporates. Prior to DNB he worked for Societe Generale Corporate & Investment Banking in London.

ERIC HUITZING

Market Business Leader Nordics & Eastern Europe - International Consulting Group, Mercer

Eric is the business leader for the Nordics and Eastern Europe in the international consulting business at Mercer. He is the global pension risk lead for the Nordics and global relationship manager for a number of big Nordic multinationals. Eric is also consulting multinationals on a range of international benefit issues. He has extensive experience advising domestic Dutch pension funds and performing local accounting valuations.

JAANA LOFBERG-SNELL

Compensation and Benefits Manager, Fortum

Jaana Löfberg-Snell, who has a master's in business and economics, has strong and diverse experience in the pension and insurance industry. Since autumn 2013 she has worked at the Finnish energy company Fortum, as compensation and benefits manager, having responsibility for Fortum's employee benefits worldwide. Prior to that she was employed at Aon where her role involved assisting multinational companies in developing their benefit portfolio.

Chair: As some of you were here last year it would be really good to hear your thoughts about what has changed from a Nordic pension perspective?

» **Löfberg-Snell**: From an employer perspective I think the pension issues have remained the same in the Nordics. There is still a very clear shift from defined benefit to defined contribution plans. Of course, regarding statutory pension plans, there is still a lot of pressure when it comes to increasing the retirement age due to higher life expectancy. In Finland, there is also the upcoming pension reform, which will come into force in early 2017.

» **Heaney**: I think the challenges facing pension providers and the insurance sector have intensified with regards to asset allocation. The massive experiment that is quantitative easing continues to impact markets and at the same time you've got the ongoing overlay of regulatory issues, including Solvency II, which is proving an extremely tough challenge. Along with the asset allocation challenge of these regulations there's also all the infrastructure required in terms of back office system etc to ensure reporting compliance and the like with these regulations. So, it's not just the asset selection and the analysis of which assets best meet competing demands of returns vs. capital required, but it's the whole infrastructure around reporting and the data provision.

» **Chair**: Do you think the industry is prepared for what you see?

» **Heaney**: The Nordic pension funds and insurers are highly professional and there has been a lot of work going on. Some institutions appear to be better prepared than others and there was also always going to be a transition period as investors adapt to the new requirements.

» **Huitzing**: Robert *(Heaney)* mentioned Solvency II, and I think pension funds might be be exposed to this; not necessarily due to the funding requirements but by being distracted from their growth strategies, so distracted from actually seeking their return on investment. There is a difference between pension funds and insurance companies with regard to Solvency II; insurance companies have to apply Solvency II in Norway from the 1 January 2016, which means we will probably see a shift in the asset allocation, in the sense that pension funds become more risk averse. Whereas the capital requirements that are currently applicable for the Norwegian pension funds are from a different type than the Solvency II requirements, so we'll probably still see pension funds still take more risk in their asset strategies, when compared to insurance companies. I think what's typically interesting to see is how Swedish pension funds, and especially the Treasury departments, will look at this. For example, they have sometimes been trying to get control of their UK assets but in my experience they have never really managed to get full control. I think that's because the trust have to act in the best interests of the participants, so the trustees decide by themselves.

» **Schauman**: I agree with the previous points that there's uncertainty on how to adapt to new regulations and how quickly. With the Nordics, I think there is a mentality of wanting to be best in class, but it remains to be seen how this will affect returns. In addition, talking generally about the region, during the last year the differences across the Nordic countries have accentuated. For example, the Finnish economy is in a very different state compared to the Swedish economy at the moment. Finland is grappling with growth issues and high unemployment and these are definitely implications affecting the pension insurance and pension system, whereas the Swedish economy is doing well.

» **Chair**: That's a very good point, would you mind exploring this further?

» **Schauman**: Finland, as Sweden, is an export-orientated economy but we have the euro in Finland so it's more difficult to adapt to changes in global demand for example. I would also say that Finland has been more prone to external shocks, for example sanctions on Russia are affecting the economy harder than many other western European economies in relative terms. Also, the government is trying to push through reforms in Finland, but it remains to be seen how well they manage. In any case, this is an important issue for Finland at the moment.

The economical impact

» **Chair**: Would anybody like to comment on how the economy has impacted the pension systems?

» **Löfberg-Snell**: Yes, in Finland we have the upcoming pension reform. The purpose of it is to expand the working careers and reduce the sustainability gap in the public finance. As in many cases, this is done by increasing retirement ages to 65 and beyond. At the same time the approved pension benefits will decrease. This change to the statutory system leads to tremendous consequences for all the employers in Finland whose defined benefit pension plans are linked to statutory pensions. On the other hand the reform has a huge marketing potential for all the life insurance and pension companies. I believe we will see them become more active in selling their new products, especially to people in old defined benefit plans. However, it is not so simple from an employers' perspective, as if they switch from defined benefit to defined contribution they have to make sure that all their employees understand the big differences between the plans and this is the biggest challenge for all employers now in Finland.

» **Chair**: And do the providers go from a DB plan to a full scale DC plan or do they have an in-between version?

» **Löfberg-Snell**: I believe that's what they are aiming for because these defined benefit solutions are not attractive from the providers' perspective, because of all the liabilities they have.

» **Chair**: So from an employer perspective where are you?

» **Löfberg-Snell**: Members of our pension fund in Finland will make their own decisions on how the reform is considered. The decision will be made next year.

» **Huitzing**: You asked about the state of the economy and what kind of impact that has on pension plans. I think it has different elements. The Nordic countries have been pretty good in managing the longevity risk. In Sweden we went from defined benefit to defined contribution a couple of years ago. In Norway there's a pension reform going on from defined benefit to defined contribution. In Finland, the state pension has been linked to life expectancy, so there's balance in that pension system. Denmark is a defined contribution country, so in that sense compared to other countries the Nordics, have been dealing with this pretty well. The economy has a big impact on pensions across the globe. For example, we have seen pension reforms in the UK, US and Australia has had defined contribution for a while and this country is facing other challenges now. I think the

"The differences across the Nordic countries have accentuated. For example, the Finnish economy is in a very different state compared to the Swedish economy at the moment"

economy has a huge impact on pension plans and the challenges we, i.e. corporates, will face in the future to get the best return on their investments made by individual decisions.

» **Chair**: Ok let's move on to Sweden, would anybody like to share their thoughts on their decision to close the AP6 fund? Can someone give a short summary of what's going on?

» **Huitzing**: In summary they want to close the AP6 funds and merge them into the AP2 fund, and I understand the main reason is to save on costs. There's a huge debate about whether they should diversify these funds over the different AP funds, which currently happens, or whether to minimise the number of funds. I think there's also a debate around how much influence politicians have on the AP funds.

» **Heaney**: A simplistic observation has been that a lot of the large wealth funds globally appear to take a concentrated approach. However, in Sweden with the current AP fund set up there are very good arguments in favour of preserving the current structure.

» **Lidblom**: I think this is obviously part of a bigger review of what they're doing. There is one positive, which everyone seems to agree with, in terms of the investment mandates. They did a review about what kind of asset classes and investments they've been permitted to invest in and it seems to be agreed that they should expand that to allow for more asset classes and other types of investments.

» **Heaney**: As Peter *(Lidblom)* mentioned, the funds have fairly strong restrictions on what they can do, for example the low thresholds on unlisted assets. Following a review, if we don't have a restructure maybe they'll end up getting more freedom to invest where they see the opportunities. From a provider's point of view that would obviously be a positive.

Investment strategies

» **Chair**: Let's move on to investment strategies, as it will be interesting to get your opinions and thoughts about how they have changed over the last 12 months, if they have at all.

» **Schauman**: The basic challenge is the current low interest rate environment, which has been a long ongoing trend, and where it is has proven difficult to generate returns. What we see is a further shift into the alternative space. We're talking private equity, property, hedge funds, and for example infrastructure solutions as alternatives to fixed income investing.

» **Chair**: What have you seen the most interest in over the last 12 months in the Nordic pension funds?

» **Schauman**: We have a very strong property business focus, so naturally this is what we have seen and discussed quite a lot across the Nordics. Hedge funds are another alternative that are interesting, especially as in recent years hedge funds have been questioned, but we are now seeing better transparency and lower fees so hedge funds could be something that is returning in favour.

» **Chair**: Are there any other challenges that you have seen?

» **Schauman**: Yes, the regulatory framework, as it affects the allocation. We have this top-down perspective and the individual pension funds will have different aspects of their own, so it goes two ways.

» **Lidblom**: Interestingly we're beginning to see that with equities having performed like they've done and fixed income having been in a 25 year bull run, essentially, people are being forced to look at alternatives. This includes hedge funds, commodities and real estate. In particular, we're seeing the interest for commodities pick up, which is positive for us. As a side note, we're also seeing that a lot of the Nordic pension funds are looking into real assets in terms of farmland and forestry and those type of commodities, which are commodities in a very hardcore form.

» **Chair**: When you say forestry and farmland, in which geographical region?

» **Lidblom**: It's been all over the place, but looking at farmland in America and also Central and Eastern Europe for forestry, but it's been quite fairly spread.

» **Chair**: Would anybody like to say anything else on how pensions investment strategies have changed in the last 12 months or what they should be looking at in the future?

» **Heaney**: We've seen a strong intensification of interest from pension and insurance investors in private debt. Private debt is quite a broad area, but within that there are three key areas where we see interest: direct lending, real estate debt and leveraged loans. Leveraged loans are increasingly becoming a mainstream asset class. With them you've got a senior secured instrument, floating rates and the liquidity actually is pretty decent. Direct lending has also been popular; a lot of vehicles out there are seeking to exploit the fact that corporates in Europe still have a financing need, which can't always be met by the banks because the banks are under pressure to shrink their balance sheets due to regulatory pressure from Basel III. I think real estate debt is another similar area that offers very attractive risk-adjusted returns compared to similarly rated corporate credit, although obviously you're getting slightly higher returns because of a degree of illiquidity premium. The flip side of the solvency regulations that makes some areas difficult for insurance companies to invest may actually create opportunities for pension funds that are not subject to those regulations. Such an opportunity lies in asset-backed securities such as residential mortgage bonds, commercial mortgage bonds etc. Under Solvency II the regulations as they stand make it quite difficult for insurance companies to invest in those assets, but the returns on offer can be very attractive indeed.

"We've seen a strong intensification of interest from pension and insurance investors in private debt"

» **Chair**: Would anybody like to comment on multi-asset strategies?

» **Lidblom**: We have a multi-asset product and interest levels have definitely picked up on that, particularly for smaller pension companies. I think historically the bigger pension funds are very sophisticated and have teams to run the different buckets and silos so are content to invest themselves. Smaller pension funds don't have that manpower to select and allocate, so it's quite attractive if they can find a manager that has a product that does that.

» **Schauman**: The appetite for multi-asset definitely depends on the individual investor but generally speaking it is something that is increasing in popularity. There are certainly interesting products out there that are being developed continuously. Multi-asset solutions can create greater flexibility and allow investors to grasp short-term market opportunities.

» **Heaney**: I would say that interest in multi-asset has been growing more rapidly in the UK than in the Nordics, although interest is picking up. Most of the large institutions in this part of the world have fairly high degrees of internal expertise and management within the various asset classes and so strategies where you give your manager carte blanche doesn't immediately seem like the most logical or attractive proposition for some institutions, at least not outside of the external allocations that are being made to hedge funds.

» **Chair**: What would you say has been the trend among the Nordic pension funds in regards to active and passive management?

» **Lidblom**: I think they could be using more passive management, obviously, but we're definitely seeing a pick-up. I think more and more people are becoming aware of ETPs *(exchange traded products)* because of the liquidity, the transparency and obviously the price. It's cheap and it allows people who want to make their own asset allocation decisions the ability to do so. At the same time there is a need for more education and it's in the interests of all passive product providers to educate people more about the benefits. This is not necessarily a discussion about active versus passive as I think they're complementary rather than opposites. We should also mention that there are probably some Swedish providers that have come under fire in terms of how much active risk there should be in a fund or a portfolio in order to be able to call it an active fund. That's something that we feel investors are increasingly beginning to question, which is a healthy development. You need to look at what are you getting and at what cost? Can you do it in a better way? It's not necessarily saying that you should be using an ETP rather than active products, because they are complementary, but I think the trend is clear that more and more investors are discovering the benefits of using cost efficient passive products.

» **Chair**: Do you see a difference between the Nordic countries? Which country is more passive orientated?

» **Lidblom**: Out of the five Nordic countries Sweden and Finland stand out in terms of usage by institutional investors, and especially by pension funds. Denmark is a fixed income country and since we have started offering fixed income ETPs we're beginning to see a lot more interest for use of our products in Denmark.

» **Schauman**: I think is it useful to emphasise the question of costs as well when talking about passive investing. There is an increased focus amongst institutional investors on cost control, which naturally favours ETPs. This being said, I agree too that active and passive products are complementary.

Emerging markets

» **Chair**: Let's move on to the next topic, which is emerging markets.

» **Lidblom**: Well we have a China ETF, which did phenomenally well up until the summer, I mean it was up 140 per cent from when we launched it, so clearly that was a phenomenal investment for people who got it right. I think we launched it in May last year and for those who joined it from the very beginning even to date you're still having a pretty decent return. Clearly China is going through it's own very special problems, which is something that we could spend an awful lot of time talking about but there is a lot of volatility in that market and so you need to look very carefully at what is going on. However, I think there is opportunity within fixed income side and also on the equities side from a pure investment perspective, and that's possibly quite controversial.

» **Chair**: Would anybody else like to comment on China? If not, what role do emerging markets have in pension funds?

» **Schauman**: At Aberdeen we've been investing for a long time in China, but actually Aberdeen prefers investing in China through Hong Kong. We do have a China A shares Fund but Hong Kong is the preferred route or through companies elsewhere who have the majority of operations or income generation in China. We are, and have for a long time, been wary about valuations in Mainland China. Moving on to your question on emerging markets and if they still play a role in pension fund portfolios, I think they do. It comes down to the issue that valuations may seem stretched elsewhere and generally speaking in emerging markets, in our view, valuations are not that stretched and this should offer long-term investment opportunities.

» **Chair**: So you see quite a lot of attention and interest in regards to the emerging markets across the different Nordic pension funds?

» **Schauman**: Well there's a difference here between the short-term view and the long-term view and many investors keep a close eye on the asset class right now. However, we have also seen pension funds communicating that on a long term basis, they are looking to, increase their exposure to emerging markets including Asia, consequently, we believe this is the long term trend. Of course, it may be a bumpy ride.

» **Chair**: Looking beyond Asia, or Hong Kong and China, where do you see other opportunities?

» **Schauman**: In the emerging markets outside Asia, we would maybe pick out Mexico where we see opportunities within the well-run mid-sized companies. Going back to Asia, outside of Hong Kong and China, India is the one that stands out at the moment. The country's new leadership, is promising widespread structural reform so we'll see how that turns out. Aberdeen has liked India a long way back, particularly as we see many well-run companies there. Valuations may look a little bit stretched at the moment, but it's an interesting long-term story.

» **Chair**: What about Eastern Europe? Or Russia? Completely out of the question nowadays?

» **Schauman**: Russia has always been quite problematic from a corporate governance point of view. We do invest in Russia, but we believe the key is to find the well-run companies with a good corporate governance culture. However, generally speaking we perceive that there hasn't been an improvement in corporate governance in Russia during the last decade and this view has only been accentuated during the past two years.

» **Lidblom**:I think one of main points that we stress when we're out speaking to clients is that a funda-mental approach to investing in fixed income can be more appealing, compared to the traditional approach of using market cap weightings, where typically almost 60 per cent of a global government bond index would be allocated to US and Japan. In the fundamental approach that we're applying we get a considerably lower weight to Japan by instead looking at something like Korea, which is looking much more attractive. You have the demographics, which are completely different, and you also actually have better yields.

Risk management and governance

» **Chair**: Let's speak more about risk management and governance, Eric *(Huitzing)* is this your area of expertise?

» **Huitzing**: There is a tendency that I've seen for many years now and it's towards centralisation within the Nordic multinational companies. They want to take control of their asset management strategy globally with regard to pensions, and what that means in many cases in practice, is that they want to apply the same strategy as they apply on their Swedish funds on other funds as well. We clearly see Swedish multinationals trying to pool their assets. They start with their defined benefit assets, and use that as a platform to get more control of their defined contribution assets. This is to achieve low investment managers fees, but also to gain control of how people are investing their individual pension savings. In terms of avoiding pension risk, Swedish pension funds are not used to that as they end up in cumbersome discussions with their trust in the UK, US or Canada etc. However, this has received a lot of attraction from the different boards due to the fact that pension liabilities have increased significantly in the last couple of years. This year we have seen an uptick on the interest rates, so pension liabilities will probably decrease towards the end of the year. However, there are questions on how to avoid pension risk, such as how to avoid interest rate risks because of the long duration of the liabilities. Should a fund go into long duration bond funds now? Should a fund apply derivatives? Should you go for short options for instance? Those questions have been put up for many years.

Then of course there's the longevity issue; companies are paying attention to the longevity risk and moving from defined benefit to defined contribution plans give them more control of longevity risk. A couple of years ago, the perception was that a longevity swap was typically expensive, but if you look in the backmirror that was actually not the case. Life expectancy has increased significantly, so this is a topic discussed by Nordic multinational companies, and specifically Treasury Departments. I haven't seen companies move into the direction of actually buying longevity swaps, but I think it's just a matter of time.

» **Chair**: Do you think that other markets such as the Netherlands or the UK, which are quite advanced when it comes to de-risking options, have an impact on Nordic markets?

» **Huitzing**: I think they do to a certain extent, but the challenge right now is that equity markets have been decreasing quite significantly in the last quarter. Prior to that we saw very low interest rates but equities performing really well, so the assets connected to the liabilities, the pension assets, were at an all time high. The question should be how to capture those asset levels, because once the interest rates increase, the interest rate-linked assets will decrease. I think the Swedish Treasury Departments and the Swedish Board of Pensioners are very well aware of this because they have been arguing for different asset strategies along the way.

» **Chair**: Is there anything else you wanted to say with regards to de-risking options?

» **Huitzing**: Yes, I ask often the question about governance, what comes first: governance or a product that leads to centralisation, it's basically the chicken and the egg story. Multinationals tend to think that they want to define the governance structure first. What often happens is that they pool their assets first or something else. I think those situations lead to an oversight about the global investments relative to pensions but they're going to have to think applying corporate governance on the pension assets that they have.

» **Chair**: Is it fair to say that Nordic companies are setting up pension committees?

» **Huitzing**: A lot of corporates do have pension committees but I don't think they have been very effective as yet as these are led by corporate functions. I'm from the Netherlands and it's the same story, very decentralised companies that do have a pension committee but once they decide on anything they have to sell it internally.

» **Chair**: Moving on, would anyone like to comment on ESG investments?

» **Schauman**: Yes, it's increasing in importance and we do get a lot of ESG questions from our clients, so it's something that's constantly on our minds. My perception is that the Nordics together with the Netherlands are at the forefront of ESG investing. However, there are many different ways to look at ESG and there's no one answer. In fact, it may not always be easy to incorporate ESG efficiently into investment strategies but it is hugely important. Also, profitability is vital; in other words, by incorporating ESG considerations into your investment strategies you also create sustainable value for your clients.

The future

» **Chair**: Looking ahead, Jaana *(Löfberg-Snell)*, particularly in Finland, but other Nordic countries too, how do you think the pension landscape is changing?

» **Löfberg-Snell**: I would say that instead of worrying all the time about these increasing retirement ages and the future levels of pensions, companies and employers should focus on creating a good company culture because in the future we will have a lot more people from different generations and ages working. As a company we need loads of flexibility when it comes to our retirement practices. For example, in a big company where there's white collar and blue collar workers, the physical health can be very different between employees. I believe in the future there is going to be a lot more flexibility when it comes to people's retirement practices, and management solutions will be emphasised as it's not a one-size-fits-all approach.

» **Chair**: There is definitely a lot of focus on ageing workforces. Otto *(Schauman)*, what do you think the pensions age landscape will look like in the future?

» **Schauman**: It seems pretty obvious, looking at how things are developing, that we will have fewer but larger institutions going forward. We've already seen mergers in pension fund space in Finland and in Sweden as well, so this is one change affecting the landscape. I also think that there will be more cross-border collaborations between the pension funds, for example teaming up for joint property investments, not only in the domestic market, but also in more distant locations such as the US, Asia etc.

» **Heaney**: I completely agree with what Otto *(Schauman)* just said. We're already seeing cross-border collaboration happen in the Nordics. We've seen a number of big deals announced recently in real estate such as AMF and Ilmarinen partnering in Finland and recently you had the AP funds announcing some very sizeable joint ventures in European property. I also think that right now we're in unknown territory with regards to low interest rates and quantitative easing. It's going to be very interesting to see what happens when this kind of experiment ends and what's going to happen with interest rates. I think

"In the future there is going to be a lot more flexibility when it comes to people's retirement practices"

we're probably going to see some extreme bouts of volatility and perhaps another kind of major episode, which will potentially cause another round of kind of structural reallocation in different areas.

» **Chair**: Peter *(Lidblom)* would you like to predict your future vision?

» **Lidblom**: Well hopefully this is not just wishful thinking, but I think that cost side of the equation is something that the pensions industry clearly needs to look at. I also see an increased use of ETFs in a sense of in-sourcing or making a lot of the asset allocation decisions in house, and using ETFs as the building blocks.

» **Huitzing**: I think in the short term, focusing on the Nordics, we have to sort out a lot of regulation issues. From a pension perspective, there is the challenge of moving from defined benefit to defined contribution. Over the longer term there is a challenge for companies and investors to translate this investment strategy and how they can help an individual make the right decisions on their investment strategy. Quite often companies solve their defined benefit issue and are more or less in control of their defined benefit plans. This is because they became sophisticated in hedging some certain risks but they also close defined benefit schemes so they know exactly what the cashflow pattern will be in the future. However, they can use the defined benefit assets as a platform for defined contribution schemes. This is what we call a defined benefit legacy and defined contribution strategy, and if you think about the fact that defined contribution strategy, a lot of companies close their defined benefit plans and set up a defined contribution plan and they assume the 'pension issue' solved. That may be the case in the short term but this could present a challenge in the future because if people cannot afford to retire and make terrible investment decisions then they might go back to the company and say: "I can't retire, I need to stay working within the company for a couple of more years." I think a big challenge and an opportunity at the same time for all of us here on this table, is to find out how can we make sure that we get the best return on the investments that the individuals have to make on their defined contribution assets? And how can we make sure that they take the proper decisions when the markets are changing or when they are getting closer to retirement? For instance to change their risk profile? It's a huge challenge for the different providers and the companies to solve this issue, but in the longer term this is definitely something that we need to focus on. ■

300 Club

A long-term look

300 CLUB CHAIRMAN LARS DIJKSTRA EXPLAINS HOW INVESTING WITH A FOCUS ON THE LONG TERM CAN BRING REAL BENEFITS

Over the past few decades, both listed companies and investors (institutional investors and asset managers) have shifted their focus from the long term to the increasingly shorter term. In the words of Dell CFO Tom Sweet, attention is "focused on the 90 day cycle, on achieving the earnings per share target". This perspective is much too short and restricts limited companies' options when it comes to innovation, investment and growth.

INVESTING IN LISTED COMPANIES WITH A LONG-TERM FOCUS CREATES MORE VALUE FOR SHAREHOLDERS AS WELL AS FOR SOCIETY

Research by McKinsey shows that 84 per cent of CEOs of listed companies around the world experience pressure to achieve financial targets within two years. Moreover, 78 per cent of CEOs postpone investment under pressure from their shareholders. This 'underinvestment' leads to companies focusing less on investment for the long term and on the opportunities this provides to create value.

Investing in listed companies with a long-term focus creates more value for shareholders as well as for society. It leads to more thorough quantitative knowledge of companies, thus reducing risk and leading to a more responsible investment policy. Investing in listed companies on public equity markets involves three parties: the assets, in other words the companies in which investors invest, the asset owners such as pension funds, insurance companies and private individuals, and the asset managers. Achieving a shift to the longer term requires a change in behaviour from all three parties.

One can identify four essential preconditions for this change in behaviour.

Firstly, we need a different method of measuring an investment portfolio's performance. This implies not using just the (external) traditional market value-weighted indices as a benchmark, but one chiefly focused on long-term commitments, such as, for example, the long-term cash flow needs of pension funds.

Secondly, the long-term focus is reinforced by long-term engaged shareholders and by devoting greater attention to companies' performance in terms of sustainability. This requires comprehensive reports providing increased information, preferably linking a company's ESG (environmental, social, governance) data to its strategy and outlook.

The third point is the remuneration structure. There are different financial options for rewarding long-term behaviour. The time horizon can be a factor determining the management fee. In concrete terms: the longer a mandate runs, the lower the fee paid to the asset manager by the asset owner, with a graduated scale according to duration. Another possibility is a performance fee. This could be paid after five years and only if the performance has truly contributed to covering liabilities. Long-term oriented rewards for fund managers are also worth considering.

Finally asset owners such as pension funds face long-term financial commitments with durations of up to 30 to 40 years. It therefore adds hardly any value for the asset manager to report daily, weekly or even monthly on trends in the investment portfolio. This will, on the contrary, stimulate short-term behaviour. Applying a quarterly or half-yearly frequency of reports, adding multi-annual reporting to the shorter-term reporting, is a far better option. This also allows for more qualitative reporting on the underlying companies in the portfolio.

The call for shifting the focus back to the long term is growing and change is taking place. This will not only benefit our generation, but future generations too. The asset management industry should show commitment to taking tangible steps contributing to this goal. ■

Written by Lars Dijkstra, chairman of the 300 Club, a group of investment professionals from across the globe who have joined together to ask fundamental questions about the foundations of the investment industry.

COUNTRY SPOTLIGHT POLAND

Vote for change

Following Poland's Law and Justice party winning the parliamentary election in October, Jaroslaw Adamowski **explores how the new government plans to reduce the retirement age and overhaul the pension system**

WRITTEN BY JAROSLAW ADAMOWSKI, A FREELANCE JOURNALIST

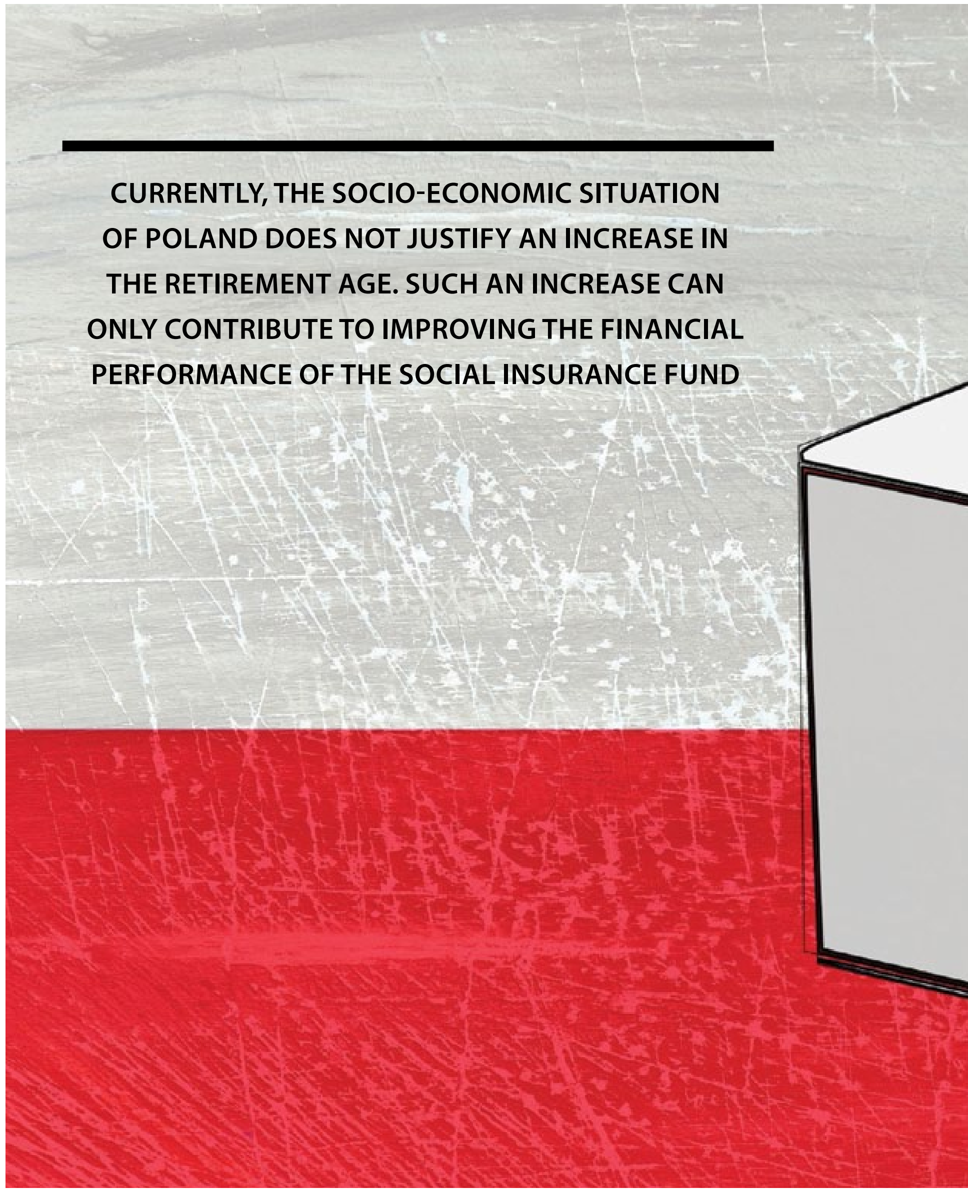
Poland's Law and Justice (PiS) party won the 25 October parliamentary election with a comfortable majority, which allowed it to designate the party's candidate, Beata Szydlo, to form the country's new government. Together with Polish President Andrzej Duda, who was elected last May as the party's candidate, the incumbent government aims to reduce Poland's retirement age from the current 67 years for both men and women to 60 years for women and 65 years for men, only three years after the previous cabinet decided to increase it by two years for men and seven years for women, respectively.

In late September 2015, Duda submitted a draft bill to reduce the existing retirement age to the country's parliament which, due to the October elections, was not able to debate the draft at that time. However, with Law and Justice securing more than 50 per cent of the seats in the lower chamber of the Polish parliament following the vote, the president's draft bill will now most likely have the backing of the parliamentary majority.

"This law will restore the retirement age of 60 years for women and 65 years for men," Duda said, as quoted in a statement released by the Polish President's Office. "If a person reaches this age, they can decide to collect their pensions, but if they feel that they can continue to work to collect a higher pension, they are free to make a different decision."

According to the document, which presents the reasoning behind the planned measure and accompanies the draft bill, should the parliament decide to decrease the retirement age, it would generate aggregate costs of about PLN 40 billion (€9.4 billion) in the 2016-2019 period, of which some PLN 30 billion (€7 billion) would be costs covered by the state budget.

"The decision from 2012 to increase Poland's retirement age and make it equal [for men and women] was arbitrary. Contrary to other countries that decided to introduce such a measure, the concept behind the implementation of such an important modification in the pension system was not a subject of a public debate," the document states. "Currently, the socio-economic situation of Poland does not justify an increase in the retirement age. Such an increase can only contribute to improving the financial performance of the Social Insurance Fund if it results with an extension of the professional activities of the insured. This aim can only be achieved if the employees who are approaching retirement are provided with stable employment."



CURRENTLY, THE SOCIO-ECONOMIC SITUATION OF POLAND DOES NOT JUSTIFY AN INCREASE IN THE RETIREMENT AGE. SUCH AN INCREASE CAN ONLY CONTRIBUTE TO IMPROVING THE FINANCIAL PERFORMANCE OF THE SOCIAL INSURANCE FUND

Instable pension system

Meanwhile, these plans by Poland's ruling party have been criticised by local observers who say that the government is not taking into account the major impact the reform would have on public finances, and, in particular, the financial performance of the state-run Social Insurance Institution (ZUS) which administers the public pension system.

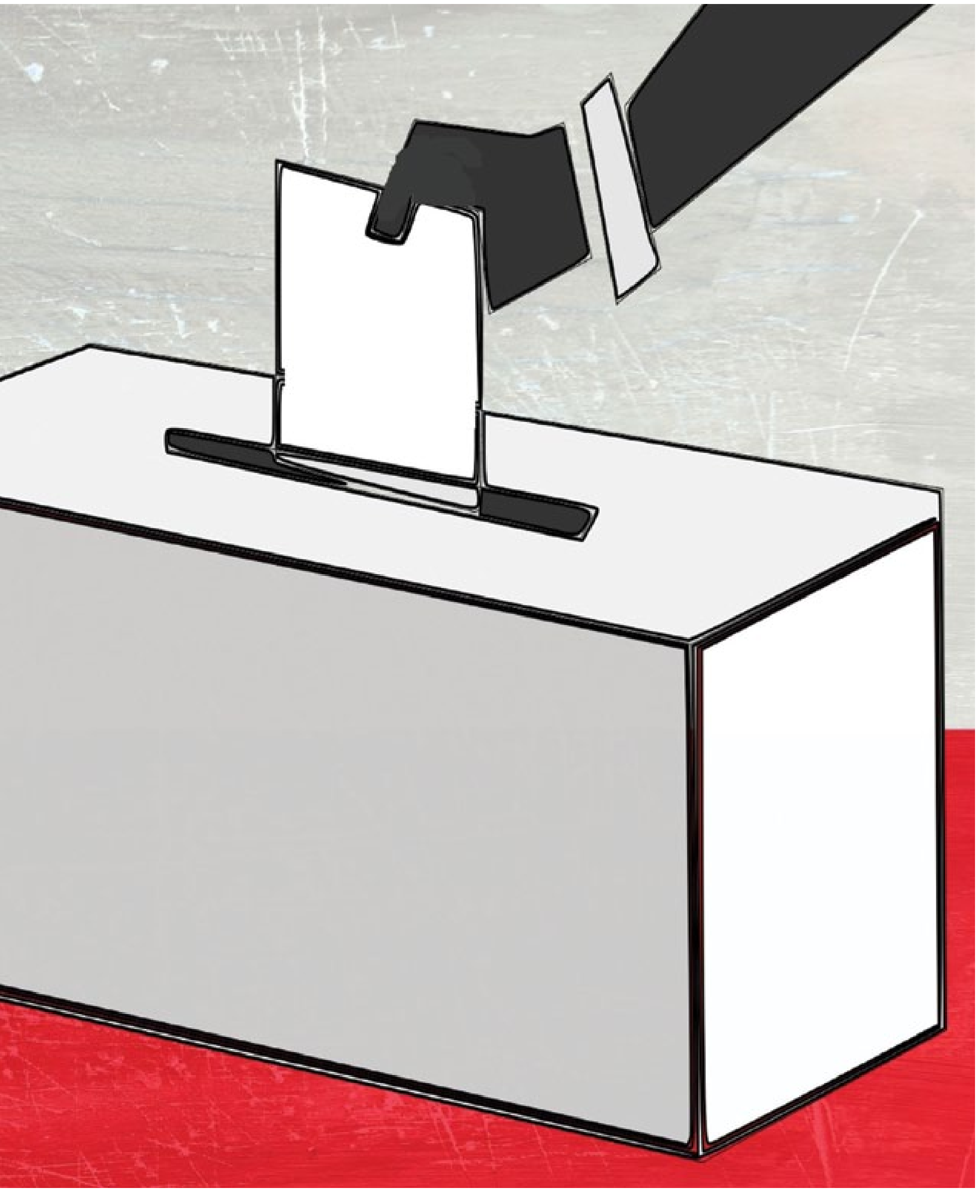
"According to the European Commission's analyses, scrapping the pension reform from 1999 will provide a temporary relief for the state budget, but it will not solve the problem itself, and, in the long-term, it will generate major risks for the system," said the Warsaw-based business association Employers of Poland (Pracodawcy RP) deputy president Piotr Kamiński.

According to estimates by the association's experts, even if Poland maintains a low level of inflation and there is a gradual increase in the retirement age for men and women, by 2060, the state budget will be required to allocate about PLN 2.2 trillion (€517 billion) to the state-run pension fund, which represents 137.5 per cent of Poland's gross domestic product from 2013.

If the new government decides to pursue its plans related to overhauling the country's pension system, its decision could also be challenged at Polish courts by the country's opposition parties and other critics of the draft bill. When the previous government raised the retirement age in 2012, trade unions and Law and Justice, which was then Poland's largest opposition party, took the decision to the country's Constitutional Court, which eventually confirmed the measure was compliant with the Polish constitution in its ruling from May 2014. Following the October election, the Civic Platform (PO) party, whose government paved the way for raising Poland's retirement age, could pursue the same strategy and challenge the measure, thus hampering its implementation.

In its ruling from 3 November 2015, the court stated that "the funds generated by social contributions, which also comprises the money aggregated by private pension funds, are, in light of the constitution, public funds, and not the private savings of the insured. This is because they are generated by the collection of compulsory and general contributions."

As a result, the Polish state "has a relatively significant liberty in managing these funds with the aim to provide the insured with their right to retire. It is the state which is responsible towards its citizens for the organisation of the national pension system and the distribution of their pensions," the ruling said, claiming that further modifications



to the system could be inevitable if "socio-economic conditions change".

Other planned measures by the incumbent government could further weaken the private pillar of the Polish pension system. The ruling Law and Justice party has been critical of the country's private pension funds (OFEs), and many expect the cabinet to hold a referendum for Poles to vote on whether the current system, in which the state pays a portion of pensions and the remaining share is generated by OFEs, should be replaced with a fully state-run pension system. This could seal the fate of Poland's private pension funds.

Government takes over contributions to private pension funds

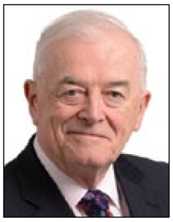
Under Poland's current mixed public-private pension system, Poles see 19.52 per cent of their basic salary allocated to a hybrid pension retirement scheme. Of these, 9.76 per cent is deducted from a contributor's salary, and a further 9.76 per cent is allocated by their employer.

Since 2014, when the former government decided to drastically reduce the contribution's share that is allocated to private pension funds, 12.22 per cent of the basic salary is contributed to the state-run ZUS, and 4.38 per cent on a sub-account which is also controlled by ZUS. Of the 19.52 per cent, a mere 2.92 per cent of the total is earmarked for a private pension scheme operated by a private pension fund selected by each individual.

Furthermore, the current contribution of 2.92 per cent is transferred to private pension funds through the state-run ZUS, which acts as an intermediary. In 2014, the institution took over control over PLN 153.15 billion (€36 billion) of funds which have been aggregated by Polish OFEs since 1999, when the private pillar of Poland's pension system was established. Owing to this, the previous government was able to significantly reduce public debt without cutting spending, raising taxes or increasing government revenues.

While the country's Constitutional Court ruled that the takeover of private funds by the cabinet was not unconstitutional, the cabinet was criticised by a number of economists, politicians and other public figures, who claimed that it effectively nationalised individual pension schemes by Polish contributors. This included Leszek Balcerowicz, one of the co-authors of the reform from 1999 and the former president of Poland's central bank (NBP), who accused the government of aiming to exploit the naive.

The incumbent government of Law and Justice has promised to reduce the country's retirement age and finance a number of costly programmes. These plans, as well as a number of other romises announced by the party during its successful campaign, could boost both public spending and debt, forcing the state to reach out for more funds held by private pension funds, local observers say. ■



INTERVIEW

Serving Europe

The European Parliament Members Pension Fund chairman Richard Balfe speaks to Adam Cadle **about the fund's structure, workings and plans for the future**

WRITTEN BY ADAM CADLE

Can you describe the structure and workings of the European Parliament Members Pension Fund? How is the membership divided up?

The Member's (MEPs) Additional Voluntary Pension Scheme was set up by the European Parliament in June 1990 to provide an additional voluntary pension scheme for members of the European Parliament.

The rules of the scheme provided for a pension fund to be set up to manage the assets of the scheme. Consequently in July 1993 a *"Pension Fund of Members of the European Parliament"* was formed under Luxembourg Law and in October 1993 the first board of directors was elected by the members of the fund.

All parts of the pension scheme and pension fund are strictly governed by rules and regulations determined by either the Bureau of the European Parliament (which manages the rules of the scheme), the Annual General Meeting of Members (which ensures the regulations of the fund) and Luxembourg Law (which oversees the regulations of the fund and Luxembourg banking rules covering the fund's investments).

The 10 members of the board of directors of the fund are elected annually.

The pension scheme closed to new members in July 2009, whilst the fund continues to manage the schemes assets.

A total of 641 former MEPs and 93 surviving dependants of deceased members are now receiving retirement benefits from the scheme. Additionally 72 current MEPs have deferred rights under the scheme whilst 268 former MEPs have deferred pension rights. There are therefore just over 1,000 members, former members and survivors with rights under the pension scheme. The members of the pension scheme represent 27 (of the 28) countries that make up the European Union.

In terms of investment and funding policies how are these laid out? What is the current funding status of the scheme?

The last full review of the fund's investment strategy began with the receipt of a letter from the plan sponsors, the European Parliament, in May 2009 in which the fund was invited "to adopt a more prudent and balanced investment strategy and to avoid exposing the fund to risk of

AT SOME POINT IN THE FUTURE AN ORDERLY TRANSFER OF THE DIMINISHING ASSETS OF THE FUND TO THE EUROPEAN PARLIAMENT WILL BE REQUIRED

fluctuations in exchange rates" and the Boardwas asked to "guarantee an immediate sustainable change in the investment policy of the scheme towards low risks assets".

The board of directors of the fund consequently appointed an investment consultant in early 2010 to conduct a review of its investment strategy.

The result of this review and the investment consultants' recommendations to implement "a more prudent and balanced investment strategy" were implemented in August 2011, when it was agreed that "the equity allocation was reduced to 50 per cent initially" and that "a mix of corporate and government bonds" would be used "to de-risk out of equities".

As part of this process a manager search was also conducted, which lead to the appointment of Candriam Investors Group (now part of New York Life) as the fund's investment managers.

At the end of June 2015 around 50 per cent of the fund was invested in equities, 48 per cent in bonds and 2 per cent in real estate. In line with the fund's long held policy, no more than 35 per cent of the fund's total investments can be invested outside of Europe.

In May 2015 the fund produced a special report on its activities for the 20 year period 1994 to 2014. This report shows that since it was set up in 1993 the MEP's Pension Fund has achieved an annual average return on its investment of 5.7 per cent per year and has earned through these investments €127 million for the European Parliament and the European taxpayer.

For the first time in 2009 (in its accounts for 2008) the European Parliament itself included an item for the actuarial deficit of the fund of €122 million. In the 2009 accounts it was €85 million, in 2010 it was €179 million, in 2011 it was €156 million, in 2012 it was €208 million and in the 2013 European Parliament accounts it is recorded as €195 million.

Has the pension fund incorporated any ESG strategies in its investment decisions?

The fund is now invested in three passive funds managed by Candriam with each of these funds operating ESG strategies.

In relation to the economic climate over the last five years or so, has the fund deployed any de-risking structures/strategies to combat turbulent markets?

In moving to the new asset managers, Candriam, in August 2011 the fund also opted for a downside risk control (DRC) mechanism service from the new managers. One year later in October 2012 the DRC mechanism policy was ended.

Who acts as administrators of the fund and what have been the main administrative issues of the fund since it was launched?

The board of directors manage the fund but the fund has a range of facilities and services provided to it by the European Parliament, and have engaged the services of internationally known bankers, accountants, auditors and specialist advisers to oversee the pension fund's administration and manage the investment funds on behalf of the members.

What are the future plans for the pension fund?

Clearly at some point in the future an orderly transfer of the diminishing assets of the fund to the European Parliament will be required. The European Parliament would then assume the responsibilities of paying out the remaining benefits due from the pension scheme. ■

Alternative credit focus:

A NEW POINT OF VIEW

A genuine alternative

Alison Swonnell explains why alternative credit, particularly private debt, should be increasingly appearing in pension funds' portfolios as an extension to traditional fixed income products

PAGE 34

Introducing private debt

Sandra Haurant explores how private debt, long popular with North American pension funds, is gaining traction with European pension fund investors

PAGE 36

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INVESTMENT

A genuine alternative

Alison Swonnell explains why alternative credit, particularly private debt, should be increasingly appearing in pension funds' portfolios as an extension to traditional fixed income products

WRITTEN BY ALISON SWONNELL, DIRECTOR OF FUND OPERATIONS, LCM PARTNERS

The Encyclopedia Britannica defines storm as "a generic term, which is popularly used to describe a large variety of atmospheric disturbances". This certainly seems a fitting description for the European pensions landscape, which has experienced a series of cyclones since the tech bubble explosion of the early noughties. Fifteen years on and, whilst we may have passed through the eye of the storm, balmy sun filled days feel like a distant memory to many pension schemes.

The tech storm exposed the risks inherent in equities with the Nasdaq Composite losing 78 per cent of value from its 2000 peak to the trough in 2002. At that time, with many pension funds invested in so called 'balanced portfolios', holding 60 per cent or more in equities, the industry quickly revised its view on what 'balanced' actually meant. This led to the genesis of liability driven investment solutions (LDI), which sought to more closely match assets with liabilities.

By 2008 LDI had arguably hit the mainstream, but once again financial 'mother nature' bit back, with the collapse of Lehman Brothers and the global financial crisis. This time derivative and bond-based solutions were squarely centre stage for pension funds. So successful have these strategies been that Mercer's *European Asset Allocation Survey 2015* states bonds are now the single

largest asset class within UK pension portfolios, accounting for 48 per cent, with equities 33 per cent. This trend is borne out across Europe with countries such as the Netherlands holding bond allocations of 55 per cent or more. Barclays research shows that fixed income inflows have grown by $1.2 trillion since the crash. Such has been the thirst for bonds that, at the point of highest demand, bond trading turnover decreased by 40 per cent. The gap between supply and demand is stark. Overlay this with a steady decline in bond yields over the period (10 year AAA yields fell from 3.1 per cent to below 0.6 per cent in the five years from November 2010 to 2015) and the latest storm clouds look darker still.

So once again, the industry finds itself caught in a perfect storm; one where more closely matched asset and liability solutions have been implemented, but at a point where bond supply has decreased and yields have become suppressed. With the low cost of corporate debt increasing the magnitude of pension liabilities, asset managers are once again innovating: offering alternative credit products with sustained yields and strong levels of absolute return.

Alternative credit, and in particular private debt, has grown significantly since the financial crash because it is a genuine alternative to fixed income and has stood up to yield depression. Preqin estimates $191.7 billion of dry powder is available today for investment in these funds. This is 4.5x the amount of demand seen a decade ago, making this one of the fastest growing alternative asset classes.

A boom in loan supply for specialist credit funds

Since the financial crisis, European banks have been dealt a continual stream of new rules and regulations. Together these pressure the banks to reduce the size of their balance sheet in an attempt to stay in line with new and increasing capital requirements. With banks offering non-performing loans (NPLs) and performing loans (PLs) for sale as well as scaling back new lending, asset managers have seized the opportunity to step into the gap and offer credit funds.

Divestment of portfolios and non-core business lines enable banks to comply with these capital requirements in an attempt to rectify historical capital deficiencies and meet increased future requirements.

The need to improve return on equity through focus on higher contributing assets and the realisation of operational efficiencies, alongside the regulatory pressures over use of capital, mean that the desire to sell these portfolios is increasing: the IMF first estimated in 2012 that European banks would need to cut their balance sheets by around €2 trillion, largely through the disposal of non-core assets (NPLs and PLs). This has since resulted in year-on-year increases in portfolios available for purchase, with more than €150 billion worth expected to be traded in 2015.

IMF director of the Monetary and Capital Markets Department Jose Vinals recently pointed to these problem loans being the greatest impediment to growth in Europe, saying that the banks must take "decisive action" to tackle the €900 billion worth of NPLs on their books. Furthermore, the recent publication of the European Banking Authority's *EU Wide Transparency Report* revealed the scale of the issue that banks still have to deal with: The European NPL ratio is double that of the US and stock stands at an even higher figure of €1 trillion (7.3 per cent of GDP): 6 per cent of European bank loans are impaired versus 3 per cent in the US.

The supply side pressures are unambiguous and will only continue to build over the next five years as banks scramble to adopt the Basel III capital accord and the IFRS 9 loan loss provision accounting standard, amongst others.

Pension demand

Preqin estimates that two out of three institutional investors are considering investing in private debt. With spreads forecasted to remain tight, buying wholesale credit portfolios in the form of private debt alternative investment funds offers pension schemes a true alternative to corporate and government bonds:

1) High levels of absolute return: a consistent 12-14 per cent unlever-aged yield can be achieved through building a portfolio of NPLs and PLs;

2) Liquidity: investments pay cash from day one and quickly amortise with capital typically returned within three to four years. So even if offered in closed end fund format, they are not illiquid in the same way that a private equity fund can be;

3) Low relative risk: more granular non-corporate credits can spread risk across many thousands of underlying borrowers, which result in low correlations to other asset classes,

4) Control over portfolio performance with limited tail risk: Buying impaired or non-core loans in the primary market and then improving the cash flow profile through loan servicing means that the manager can actively control returns, for example being able to react to correct underperformance. The strategy creates lower risk assets with established track records of payment, which means that the value left in the tail can be readily sold into the market at a premium;

5) Transparency: buying loan portfolios in a wholesale format offers investors greater transparency and look through to the underlying assets. This provides good visibility over the composition and performance of the assets, and coupled with the control aspect, is in stark contrast to buying a securitised product, which may well be investing in exactly the same underlying assets. Such transparency also creates a favourable Solvency II treatment.

Realising the credit opportunity

With the evidence for supply and demand clear, how can pension schemes invest in this privately traded asset class for whole loans?

Despite the fixed income style characteristics of buying whole loans, traditional fixed income asset managers do not typically have the skillsets able to realise this opportunity. Private debt expertise has emerged out of long-term commercial market participants, like LCM Partners who started investing in consumer and SME receivables 16 years ago, or via new entrants that have moved into the marketplace out of the banking sector: Typically former prop desk traders from investment banks, loan managers from commercial banks or via PE houses that have moved into private debt as an expansion of their product offering. Universal to all however is the transaction expertise required to source, underwrite and close deals.

Expertise and experience are of course the fundamentals to the evaluation of any potential investment manager, but in private debt and, more specifically, the purchase of whole loans, LCM would encourage investors to consider three things in selecting the right partner:

1) Sourcing ability: to identify sufficient, attractively priced transactions;

2) Underwriting expertise: a track record of delivering returns across the cycle;

3) Implementation experience: successful onboarding and servicing of a range of portfolios across markets and underlying product types.

With these three components evaluated, institutional investors can be confident that their manager is well positioned to deliver the double digit returns and yields still available in this part of the credit market, which should outshine bonds for the foreseeable future; from wherever the next storm clouds decide to blow. ■

INVESTMENT

Introducing private debt

Sandra Haurant explores how private debt, long popular with North American pension funds, is gaining traction with European pension fund investors

WRITTEN BY SANDRA HAURANT, A FREELANCE JOURNALIST

The pension fund industry has long been involved in lending money in return for steady income. Corporate and government bonds and asset-backed securities (ABS) and more have allowed them to seek out yield by offering credit through an enormously wide variety of avenues. Now, though, a shift in approach is encouraging schemes to look again at the way in which credit fits into their portfolios.

Private debt, a long standing element in North American pension landscapes, may not yet have built up a long history in Europe, but it is making a name for itself. It is a simple concept, says LCM Partners CEO Paul Burdell, and one that is attractive, particularly in a low interest current climate. "Private debt is nothing other than granting debt to counter parties," says Burdell. "In fact, pensions have been investing in credit through the ABS sector for many years. The difference with private debt is the originator."

Credit history

The ABS sector offers pension funds and institutional investors the oppor-tunity to invest in credit such as mortgages and credit cards through the banks, earning a regular income as a result. Seen for a time as an efficient means of investing in credit for pension funds, the credit crisis of 2008, in which US sub-prime mortgages played such an important part, took the shine off this sector, although it has been seeing more enthusiasm in recent times.

M&G Investments announced in October 2015 that it had raised some €1.5 billion for a range of European ABS strategies, with the bulk of capital coming from pension funds in the UK, Netherlands and Nordic countries, looking for yields and security in today's low interest environment through investing in these pools of assets, which can include consumer loans, residential and commercial mortgages and commercial loans.

M&G ABS portfolio manager James King said: "ABS has typically been under-represented in an institutional investor's portfolio but following the resilience of the asset class in Europe during the wake of the financial crisis, we are seeing an uptick in investors wanting to understand more about the role ABS can play."

But while ABS offers one way into the credit market, many argue that a more direct approach can be more successful, and that developments in the credit market since the financial crisis are leading to a more attractive environment for direct lending.

Mind the gap

Part of the shift is due to renewed thinking in the wake of the financial crisis. Europe has, through necessity, moved away somewhat from its previous dependence on banks as primary lenders and this has left behind a gap to be filled. But Europe still needs credit, so where is it to come from? As a report into the private debt market published by StepStone says: "This capital is increasingly provided by pension funds and insurance companies via private credit funds, predominantly populated by former bankers, hedge fund and private equity professionals."

Towers Watson head of illiquid credit Gregg Disdale confirms appetite is real on both sides: "We have seen most demand [from pension funds] in the direct lending area. A lot of people have bought into the migration from banks being primary lender to middle market corporates in Europe, to a point where more private capital is needed alongside those banks. Banks have much greater capital requirements, with the result being a retrenchment in corporate lending. It is therefore an obvious area for pensions to be considering stepping into," says Disdale. "This is also driven, of course, by the fact that asset managers saw the opportunity and started to raise funds to take advantage of it," he adds.

Disdale is also starting to see pensions consider real estate and infrastructure debt, he says, commenting: "They are stepping in where banks have been somewhat less able to lend than they were pre-crisis, given the size of their legacy books. In both of those areas, however, banks have come back and are stronger than they were expected to be. But the trend of greater institutional investor participation is still there, medium to long term."

Private debt is an area that is relatively new for Europe, and has not yet had time to prove its worth, explains StepStone senior adviser John Bohill. "This is a very nascent credit market; it's only really since the downturn that it has existed so there are inherent risks with that, which means it will take a little while [to build a track record], but the market is starting to mature and managers are starting to show performance," he says.

By contrast, North America has built up a real history in this space, one which can be used to understand performance through a variety of investment environments, from the more benign to the downright hostile. "In the US, which has been used to a non-banking dominated market for a much longer period, you can actually look at the success or otherwise of private credit as a strategy," explains Bohill.

With this track record in place, StepStone has looked at a manager who has been operating for more than 10 years in the US, with a substantial amount of loans given to the mid market. Bohill says: "We tracked the performance of those loans through the global financial crisis and beyond, and we compared the performance of that portfolio against public equity, real estate and distressed investing, and what we found was that the correction was much less extreme. It was a much less volatile investment in that period, while public equities obviously had a huge increase and a massive correction. It showed itself to be dependable, not very highly correlated to other areas of a portfolio, and we found it to be a strong product."

A large part of the appeal for pension funds turning to private debt is just that: the dependable, regular income with reasonable yield, hard to come by in today's low interest environment. But their transparency is also a major boon. The nature of these investments means that investors can see, and pick and choose, just who they decide to lend to. "There is a very high level of transparency in private debt," says Burdell. "You get the opportunity to look into each and every loan."

Disdale adds: "There are a few areas where people believe that, because you are engaged in bilateral negotiations in a lot of these private loans, you've actually get better credit protection than in syndicated credit markets." In an asset class where, in Europe at least, scope for access has opened up relatively recently, the fact that investors can peer in and see just what they are getting into appeals.

Slow and steady

Nonetheless, choosing the right way into the asset class remains key to successful investment in this area. "In the private equity world you get bonus points for picking new and interesting managers that have a niche because you're trying to generate absolute returns of between 20 per cent and 40 per cent internal rate of return (IRR). But in credit, what you are really looking for is managers who just go about their business day in, day out, with lots of deal flow, who turn lots of deals down. You don't get bonus points for outperformance, because you might have exposed yourself to significant risk in doing that. You need to look at diversification within a portfolio, how many loans are in there, what industries are they investing in and what leverage multiples are they lending at."

As the asset class develops and managers build on their experience, the role private debt plays within pension funds' portfolios is also evolving. Private debt might once have been found within the portfolio as an alternative to private equity, but, says Bohill, this is changing with pension funds increasingly switching from fixed income into private debt. And, as he says: "Fixed income portfolios are enormous, so the potential capital to be raised from those is substantial." ■

INVESTMENT

Emerging lights

Lynn Strongin Dodds explains why there are now glimmers of hope within the emerging market space and the specific areas of opportunity for investment

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

For the past two and a half years, emerging markets (EM) have been the pariahs of the investment world. Negative sentiment reached the boil in the summer when the Shanghai Stock Exchange crashed and the recent Bank of America Merrill Lynch monthly survey report shows that the majority of fund managers remain bearish. However, there are those who are cautiously going back in and cherry picking the most attractive opportunities.

On the whole, the BAML survey shows that asset managers are the most underweight they have been in the asset class versus developed market equities since the start of the survey 14 years ago. China's slowdown and sliding commodity prices have put them over the edge but they started to whittle down their positions in 2013 during the infamous taper tantrums, when the US Federal Reserve hinted at an impending interest rate hike. The malaise has just continued with valuations hitting an all-time low.

"One of the biggest changes we have seen is the widespread collapse of the currencies," J.P. Morgan Asset Management client portfolio manager for EM equities Claire Peck says. "They have broken through the 2008 levels and are as cheap as the 1998 lows – and remember at that point most of Asia was in crisis and Russia had just defaulted. Cheap valuations are now coupled with cheap currencies."

Calculations by JPAM show that the MSCI Emerging Markets Index fell to a valuation of just 12.8 times 10-year average earnings at the end of September, which is below the previous nadir of 13.5 times during the 1997-8 Asian financial crisis. The cyclically adjusted price-to-earnings multiple is barely half its long-term average of 25 times average 10-year earnings. By contrast, the S&P 500 index is trading at 23.4 times cyclically adjusted earnings, within a fraction of its long-term average of 23.6. Meanwhile, the MSCI Europe Index is at 15.1, against an average of 20.6.

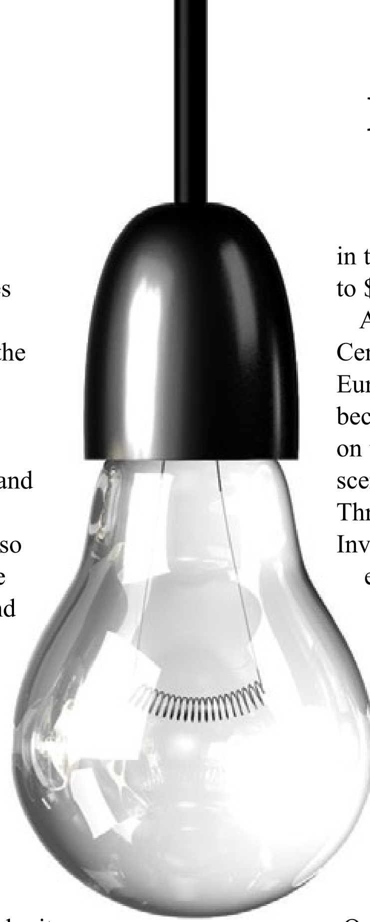
Light at the end of the tunnel

There are though glimmers of hope that the market is stabilising. The MSCI Emerging Markets Index rose for the first time in six months in October while Goldman Sachs is predicting EM economies to grow 4.9 per cent, up from 4.4 per cent in 2015, making it the first acceleration since 2010. Ashmore head of research Jan Dehn also believes many EM countries are in fundamentally better shape than investors think.

"The US dollar has risen by nearly 40 per cent against EM currencies since 2011, aided by plentiful QE liquidity from Western central banks," he says. "This surge quickly triggered panic about EM's abilities to cope with the resulting capital outflows, falling commodity prices, higher inflation via FX pass-through. However, EM economies have undergone significant adjustment because most countries were able to control inflation when their currencies weakened, which helped strengthen their competitiveness. Nowhere is this more evident than in their current account balances."

East Capital chief economist Marcus Svedberg adds: "While the general consensus is that the emerging market adjustment has another leg to go, we believe that attitudes are gradually changing. I think 2016 will be a good time to build positions but it will be much more market and sector specific rather than a general trend."

Within equity investing, Peck believes "in general, you want to be positioned for a cyclical recovery, meaning you would tilt the portfolio towards consumer discretionary, IT and financials and underweight utilities due to regulatory framework in many countries. I would also look at EM small caps because the MSCI



index has not fallen as much as the standard EM benchmarks. These companies offer idiosyncratic growth opportunities.”

Geographical merits

On the country specific level Lombard Odier Investment Managers global strategist Salman Ahmed echoes the sentiments of many when he stresses investors should not ‘lump all emerging markets together’ and, instead, judge them on their individual merits. “The EM universe is currently undergoing significant fundamental differentiation as a fall in commodity prices, Chinese slowdown and risk of Fed rate hikes has put the spotlight on underlying fundamentals.

“This means countries like India are major beneficiaries of lower commodity prices while commodity exporters will continue to feel the pain of this adjustment. All in all, we expect fundamental differentiation to remain in place going forward,” he adds.

Views though are mixed on India, which so far has been resistant to the developing-world slowdown, with the rupee performing better against the dollar than most EM currencies. Some believe the market has become too pricey with the Nifty index of India’s 50 top stocks trading at 16.7 times this year’s estimated earnings against the 10-year average of 15.7. Parts of the economy, particularly merchandise exports as well as machinery and auto parts, have faltered while there has also been disappointment over the progress Prime Minister Narendra Modi has made with some of his reforms, most notably the Goods and Services Tax (GST). It is designed to replace a plethora of complex fees and taxes charged by the 29 states, transform the country into a single market and potentially increase economic output by as much as 2 per cent.

Robeco Group executive vice president and head of emerging market equities Wim-Hein Pals believes that the introduction of the GST next year will help justify the premium of MSCI India due to the positive boost for trade and the reduction in bureaucracy. Korea is also on his list because of the corporate governance and labour reforms that should raise investor confidence and narrow the historical Korean discount caused by low dividend payouts and the lack of attention to shareholder value.

For the more adventurous investors, Alquity Investment Management investment analyst Aaron Armstrong is recommending Asian frontier markets as good hunting grounds. “There are a sweeping number of reforms in other markets besides India,” he says. “For example, Sri Lanka has a new pro-growth government and one of the strongest consumer growths stories while we are also looking selectively in Myanmar at companies such as YOMA, a property and consumer company that has a strong corporate governance record.”

Alquity, along with other managers, also has a soft spot for Vietnam where the government is hoping over the next five years to lift its growth rate by leveraging multilateral trade deals such as the Trans-Pacific Partnership as well as modernising agriculture and boosting investments. Industrial expansion this year has helped the economy grow by an annualised 6.5 per cent in the first nine months of the year, the quickest pace since 2010, while disbursement of foreign direct investment increased by 8 per cent in the same period to $9.7 billion.

Aside from Asia, Central Eastern Europe has also become a feature on the investment scene. Columbia Threadneedle Investments head of emerging market equities Irina Miklavchich notes: “Back in the noughties, the region was plagued by large current account and fiscal deficits. Over the past decade these problems have resided and we now see countries such as Hungary and the Czech Republic running current account surpluses, while Poland is in a balanced position. Budget spending has been ruled-in as well and the fiscal situation is largely stable. They all have a large export sector which should continue to benefit from the recovery in the eurozone and lead to broader pick-up in economic growth and consumer demand.”

On the debt side, Dehn recommends local currency bonds partly because “they offer much more attractive yields than bonds in developed markets and the US dollar is far less likely to hurt you after its long rally. We think that Brazil, which has been badly beaten up, offers the most value despite the economic and political problems. The country is fundamentally strong and it will sort out its problems over time. We also like Mexico due to stronger growth and the fact that the peso may one day follow China’s RMB into the family of IMF’s global reserve currencies.”. ■

Infrastructure roundtable: OPPORTUNITIES AND HURDLES

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Chair:

CHRIS PARROTT
Pensions Manager, Heathrow Airport Holdings
Chris is pensions manager for Heathrow Airport Holdings. Whilst his primary focus is the management of the group's various pension arrangements, Chris is also involved in the operation of the company's wider reward offering.
He has been working in occupational pensions since 1982, holding management positions for the operation of both public and private sector pension schemes.

Panel:

ALISON BOSTOCK
Client Director, PTL
Alison joined PTL as a client director in July 2015 with 25 years' experience in actuarial, investment and DC consulting. In her previous role as a principal and scheme actuary at Punter Southall, she advised trustees of open and closed schemes ranging in asset size from around £25 million to over £500 million. She has dealt with and advised a wide variety of scheme sponsors including quoted companies, private equity-backed and family-owned businesses as well as charities.

CONRAD HOLMBOE
Senior Vice President, Investment Consulting, Redington
Conrad is a senior VP at Redington specialising in helping DB pension schemes and other institutional investors design investment and risk management decision-making frameworks. Conrad joined Redington from DRG Investments in China, where he was an analyst covering private sector investments. Conrad also worked in corporate finance advising foreign owned companies in China on M&A, capital restructuring and financing.

HANS HOLMEN
Principal Consultant, Aon Hewitt
Hans is principal consultant at Aon Hewitt, specialising in infrastructure coverage. His previous roles include working in the global private equity team for Merrill Lynch Europe, where he was responsible for the assessment of direct investments in infrastructure. He also served for seven years at Commonwealth Bank of Australia. Hans' practitioner experience in infrastructure is augmented by a role in academia as the executive director of the Coller Institute of Private Equity.

ALAN PICKERING
Chairman, BESTrustees
Alan is chairman of BESTrustees and a trustee of a number of pension schemes. These include The Plumbing Industry Pension Scheme, which he chairs and the People's Pension. Alan is also a trustee of the Kosovo Pensions Savings Trust and chairs the governance group of the Royal Mail Statutory Pension Scheme. He has served as a non-executive director of The Pensions Regulator, having previously been a member of the Occupational Pensions Board.

JOSEPH TITMUS
Portfolio Manager/ Analyst, AMP Capital
Joseph is based in AMP Capital's London office and is responsible for the analysis of infrastructure companies in Europe and Latin America. He has nine years' experience in the financial industry. Joseph joined AMP Capital's Sydney office in February 2006 as an investment adviser within the global real estate securities team. He moved over to the global listed infrastructure team in October 2008 and relocated to London in April 2010.

JONATHAN ORD
Investment Manager of Alternative Assets, London Pensions Fund Authority
Jonathan joined the LPFA in 2013 as investment principal, and today is investment manager responsible for investments across private equity, real estate, infrastructure, real assets and alternative debt. He also sits on the investment committee of the GMPF & LPFA Infrastructure, a £500 million joint venture for infrastructure assets; and the responsible investment advisory board of the BVCA.

AMARIK UBHI
Alternatives Specialist (Infrastructure), Mercer Investments
Amarik is a senior associate within Mercer Private Markets. Based in London, he is part of the infrastructure team, where he is involved in Mercer's research of infrastructure investments globally, and covers managers based in Europe. In this role, Amarik produces research materials and intellectual capital on the asset class, and advises institutional investors on manager selection, portfolio construction and the implementation of such investments.

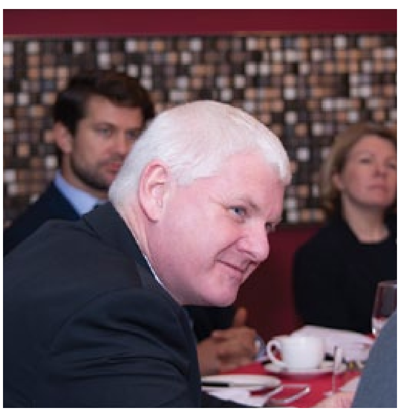
Chair: What is the general sentiment in the infrastructure space at the current time?

» **Ubhi**: It depends on whether you're a buyer of assets or a seller of assets. For those who are existing, direct investors in infrastructure or asset managers looking to realise assets, things look pretty good. What we see generally across the managers that we cover is that their performance has been strong and that's been helped by a healthy appetite for infrastructure from new investors, reflected in the exit market. Also, an environment of slow but steady economic recovery across the developed world has helped performance, while low interest rates have made refinancing easier. So from that perspective, it's looking positive.

It's not necessarily at a bad time if you're looking to enter the asset class now, but you need to be cautious and also disciplined, because certain parts of the market are very competitive for the reasons outlined above. Specifically, there continues to be significant demand for high-quality, large-scale, and cash-generative infrastructure assets in developed markets amongst investors. As a new entrant, you need to think carefully about how you access the market and what the best way of building out a well-diversified allocation to the asset class may be, given that context.

» **Holmboe**: After the financial crisis, we saw a massive pick-up in demand from our client base for the asset class, and that is starting to subside quite significantly. Looking at the returns that you could potentially receive on a relative value basis, infrastructure hasn't looked quite as attractive as some other asset classes. That's predominantly PFI/ PPP assets in the UK. From here on in, however, the general outlook looks OK but there should be some

"It is a good time in the market but we need to be cautious, selective and also patient"



cautious optimism around it.

» **Holmen**: I agree – it is a good time in the market but we need to be cautious, selective and also patient. You have to work a lot harder to find the best opportunities in infrastructure these days and some of those compelling opportunities are a bit further up the risk curve than a few years ago. There is also a big focus on managers that can manage complexity - whether it be around sourcing of assets, negotiation and execution or asset management. If you have a track record of being able to do that, you've got a pretty good chance of us backing you as a manager. We set our bar very high for any new managers that we're looking at.

The macroeconomic environment is also improving but there is a volatility out there with respect to commodity prices and there are a few other elements of the economy that are creating some uncertainty around business plans for asset owners. We've seen some wide gaps between valuations of assets in the market and sometimes there's quite a big difference in price between a winning consortium and a second placed consortium. So there is uncertainty and significant differences in views on price.

» **Bostock**: I think there's going to be demand because potentially this is a matching asset, particularly if we reach a crunch point in capacity for buyout or even for derivatives. So for schemes that aren't headed for buyout anytime soon and are looking at a buy and hold strategy, it's certainly a good idea to be looking at asset classes that provide a long-term income stream that's going to provide some sort of match to liabilities.

» **Pickering**: It's my job as a professional trustee to try and make sure that all my fellow trustees are even-handed in evaluating the available asset classes and the suitability of those asset classes for them. Despite my best endeavours, trustees will often judge an asset class on their most recent experience and some have had bad experiences with this asset class. Of course they need to learn from their past experiences but they also need to think a little bit wider than their past experiences just to see whether this asset class fits into their portfolio.

» **Ord**: We increased our allocation to infrastructure two years ago and we have been quite vocal in our support for the asset class. We recently set up a joint venture with the Greater Manchester Pension Fund to focus on infrastructure. Talking to the wider LGPS and other large UK corporate schemes, it is an asset class that is increasingly attractive and that, to an extent, is coming through in the pricing of certain assets. You look at UK assets at the moment and I think it's fair to say they are on the rich side.

» **Titmus**: Similarly to direct infrastructure, global listed infrastructure has seen very good performance since the global financial crisis supported by increased demand for the asset class. Investors have increasingly recognised global listed infrastructure's unique investment characteristics and for this reason sentiment, at least from a long-term perspective, remains positive. Given the long-term nature of the asset class and its cash flows – identical to those of direct infrastructure funds – some investors are viewing current market volatility as a buying opportunity with expected returns at levels not seen for circa three years.

» **Chair**: My perspective on infrastructure has changed recently. I've always considered it to be a very small market, expensive to get into and difficult to find assets, but with so many things reaching the end of their natural lives, such as the German autobahns, or the Italian airports not being maintained properly over the last 20 years, to name just a few examples, it seems to have a lot more potential.

Investment case

» **Chair**: Moving on to interest and why investment pension funds should invest, what are your thoughts from a risk/reward perspective?

» **Pickering**: Again one has to differentiate between whether you're involved with the building of the project or the running of the project, but potentially infrastructure has a timescale that matches our timescales and indeed can be tweaked to finely match our timescales if we're on a journey to somewhere. Also, I think a move towards infrastructure is a natural evolution of pension funds' traditional relationship with property - I see this as taking property one stage further. In addition, given we are in an era where we're going to have to work quite hard for any sort of return, whether it's to add value or to match liabilities, I think this is a time to be looking at this asset class.

» **Chair**: Any further thoughts on the attractiveness, or otherwise, of the asset class?

» **Ord**: Infrastructure is attractive for us because it's a stable asset, it's a long-term asset, it produces yield and there is inflation linkage. In the current environment pricing is elevated in some sectors but there are still assets that demonstrate these characteristics that can be acquired at the right price. An example of this is a recent investment from the joint venture that we have with the Greater Manchester Pension Fund, where we acquired an interest in the Leeming Biogas plant. A large factor in whether a secondary asset is attractive in the current environment is the price at which you enter into it, and you've got to be careful on that. If you look at the secondary UK PFI market, it is extremely expensive at the moment and there's an argument to be had about whether you think that is a wise investment on a risk/reward basis because there are still inherent risks, even on a secondary PFI project. In this age of austerity, there is extra pressure on these projects and likewise, in the core infrastructure space, you are dealing with real businesses and things can go wrong. So if you don't have a margin of safety within your return then I think you're pricing it too aggressively.

"Infrastructure is attractive for us because it's a stable asset, it's a long-term asset, it produces yield and there is inflation linkage"

» **Holmen**: As I mentioned earlier, we're quite cautious on the asset class at the moment but one of the merits of investing in infrastructure is that it is a very varied asset class and it can be used in a number of ways within a broader portfolio. You can use it as a liability matching tool by potentially investing in some lower risk cash yielding infrastructure and that includes some of the lower risk equity investments and also debt; and you can also use it as part of a growth seeking portfolio; invest in some of these managers who can use skill and networks to manage quite complex navigation paths when it comes to sourcing, execution and asset management.

» **Bostock**: Also there's a sense that trustees will be able to get their heads around it as an asset class because it's a tangible thing that they can understand, which is always important for trustees compared with some other extremely esoteric derivative instruments. So I think there's another potential appealing feature there for boards of lay trustees.

» **Chair**: Certainly the ability to be able to see and touch something has been important to trustees and helpful in gaining their interest.

» **Holmboe**: I think you need to differentiate between the underlying characteristics of the asset class and the risk/reward side of it. Yes the underlying characteristics are attractive - it's a tangible asset and the underlying cashflow is one that we like. But, from a risk/return point of view we don't really find the asset class that attractive. From a client perspective and from a strategic point of view, we think there are more attractive asset classes out there.

» **Ubhi**: If we look at the asset class strategically, taking it out of the context of the current market environment for just a moment, *"One of the key advantages held by institutional investors is the ability to genuinely invest for the long-term"*

and just try to answer the question: "Why should this be of interest to a pension scheme or an institutional investor?" For us, it's the prospect of genuine diversification within an overall portfolio from traditional equity and fixed income investments, and the idea of being exposed to a fundamentally different set of risk/return drivers relative to other investments that we might hold in that portfolio.

Also, one of the key advantages held by institutional investors is the ability to genuinely invest for the long-term and to exploit the illiquidity premium, so there is a natural match with infrastructure. So strategically, for those reasons and more, we think there is something interesting and appealing about the asset class.

Clearly, however, you need to put that strategic rationale into an investment, and also a market context. It's important to remember that asset class characteristics don't necessarily translate directly into investment characteristics. The way in which infrastructure assets are packaged up into infrastructure investments, and managed on behalf of underlying investors, really does matter.

The other question that has been asked around the table is: "How does the current infrastructure market environment look for investment? There is a cycle in infrastructure (as with other markets), so that does need to be taken into account. However, one way of mitigating the potential implications is to invest for the long-term and try and invest through the cycle on a rolling programme basis, rather than at a single point in the cycle on a one shot basis, to try and smooth out any peaks and troughs.

» **Pickering**: But can that package help me as a trustee differentiate between building the stuff and running the stuff, because Boris Johnson keeps talking about 'shovel-ready' projects. Do I, as a trustee, want to invest in a shovel-ready project or do I want to invest in those who are going to run and manage that project? And have I got a choice of buying the two or differentiating between those two elements?

» **Ubhi**: The good news for investors is that now, given the infrastructure manager universe is pretty mature and well-established, you can better differentiate between different types of strategy, different areas of geographical or sector focus, and therefore be more selective in the types of investments that you make within an overall portfolio.This makes building a well-diversified allocation to the asset class easier than it was previously.

The greenfield versus brownfield debate is a genuinely interesting one for institutional investors, but one which may not be fully understood by all. For example, if you take a construction-ready PFI or PPP project where you have a largely standardised design, an established track record of that particular concession regime, an established contractor market and established structures for managing the various different risks, the key residual issues are seeing the project successfully through to the operational phase and being prepared to defer returns (in terms of immediate cash yield).

However, there can be an attractive return premium for investors associated with this 'de-risking' of construction-ready green-field projects into the operational phase. In the current environment, this can be seen most clearly in the PFI/PPP and also the renewable energy markets, where established projects (and portfolios) are in high demand.

It's important to note that not all construction-ready greenfield projects are equal, and we would expect the majority of investments in a well-diversified infrastructure portfolio to be brownfield in nature. However, investors should not rule out taking on a degree of construction-ready greenfield exposure just out of principle – it could be a missed opportunity.

» **Titmus**: Global listed

infrastructure offers investors unique investment characteristics including superior risk-adjusted returns compared to more traditional asset classes. This makes it well-suited to pension funds in particular. These characteristics are essentially the same as those offered by direct infrastructure but with daily liquidity, which can be both a positive and a negative. As the assets, or companies, are traded on a daily basis valuations will obviously be more volatile than their direct infrastructure counterparts, but this also provides the manager with the opportunity to take advantage of mis-pricings, invest funds quickly, and access a diversified portfolio of opportunities. This gives pension funds the flexibility to use global listed infrastructure in a number of ways: to complement their existing (direct) infrastructure or property investments, a quick way to access the infrastructure asset class, or as a hybrid of fixed income and equity risk and return expectations.

Investment opportunities

» **Chair**: So what opportunities are out there at the moment?

» **Holmen**: There is a range of opportunities. We look at infrastructure on a global basis and any pension scheme should do so, in our view, as it maximises your opportunity set. If you just look at the UK, some markets that were previously quite compelling, like the PFI market, are less so now. We used to have quite a positive view on that sector and our view has changed. The greenfield market that supplies new projects has diminished and that has impacted, to some extent, the end supply of deals and pricing in the secondary market/on the brownfield projects where primary capital can be recycled.

On the other hand, we are seeing some opportunities related to the continued fiscal austerity measures across the world. There are assets that governments are selling (eg in Australia); there are opportunities to acquire infrastructure assets from corporates; and I think, due to the recent commodity price volatility, we will see more of that in the oil and gas sector. There'll be more assets spinning out of those types of companies.

» **Chair**: Alison *[Bostock]*, are your clients aware of these opportunities and how to access them?

» **Bostock**: Awareness is growing but I wouldn't say it was high. There's quite a buzz around the topic of infrastructure in the UK at the moment with the various initiatives going on but there is also perhaps a concern that if UK local authorities are going to be forced to invest, will it distort the market?

» **Ord**: Picking up on that point about UK local authorities being made to invest in specific projects, I think it's an unrealistic proposition. Thames Tideway was a clear indication that if the government structures a project attractively, capital will play to it. What we would like to see is further engagement between people like ourselves, the pension funds, people who are holding institutional capital, and the Treasury to make both parties aware of how these projects can be structured and how the risk/reward can be shared. We're not expecting for risk to be taken entirely off the table because then you don't have a return. So it is about that partnership structure and making sure there's good dialogue between central government and the people who invest in these projects.

» **Holmboe**: But that assumes that pension funds have their own in-house teams to look at it. In reality, the vast majority of UK pension schemes don't have in house expertise. There's a trustee

"It's important to note that not all construction-ready greenfield projects are equal"

board and there might be two or three executives so, in that context, if you're looking at global infrastructure, you're looking at a lot of work that needs to be done to make people understand this complex asset class. It is quite risky, esoteric, all the projects are different – is it worth it for what is arguably going to be, say, 5 per cent of the overall portfolio? So, from a consultant point of view, while there are opportunities on a global scale, given the time it will take to get trustees comfortable with it, to help them understand the asset class and to get them to invest in it, for 5 per cent of the asset allocation, I'd rather focus elsewhere. It doesn't feel like a good return for your governance budget. Saying that, for the larger schemes that do have in-house executive teams, where they're moving more towards a Canadian or Australian model, it can make sense.

» **Chair**: So in your view there is no traction on this?

» **Holmboe**: There are two things

here - there is clear demand by the government to get pension funds to do this. But you need to ask, does it make sense for the members? No-one wants to be forced into it and there is a massive gap in terms of expertise and ability within pension schemes themselves to get it done. From a consultant point of view, I have a certain number of trustee meetings a year and I want to ensure my clients focus on those aspects of their scheme that has the biggest benefit from a risk/return perspective.

» **Ord**: But on that, we are seeing, especially in the UK, a range of new ways of accessing infrastructure. We are a £5 billion scheme and have joined forces with the Manchester pension scheme, on our own initiative, to do this via a £500 million JV. The Lancashire pension fund is also doing things directly, themselves. So there are various different models that are being put in place by schemes which aren't the size of BT or USS.

» **Pickering**: You can actually get trustees to move quite quickly. One of my schemes, for example, has within three or four months been able to respond to an employer's desire to bring in LDI and equity options. So from it being a twinkle in the company's eye to the implementation phase with a chosen manager and a chosen strategy hasn't taken many months at all. So I don't buy this argument that lay trustees are incapable of getting their minds around a strange asset class - they don't come much stranger than equity options and LDI.

As we said before, infrastructure is much easier to get your head around than some asset classes. However, there is the scale issue and if you're only talking about x per cent of a relatively small fund, even if I double my money, does it really touch the sides in helping me meet my liabilities? So in a small fund context I'd be more interested in investing in something that is off-the-shelf, a vehicle that is long-term in nature but liquid in terms of buying and selling, which is quite a challenge, but there is the governance issue that if I'm spending 90 per cent of my time on 2.5 per cent of a £50 million scheme, is it really worth it?

» **Holmen**: The point on diversification is important. Increasingly we're seeing clients consider infrastructure as part of a broader private markets portfolio alongside asset classes like private equity and real estate. Infrastructure can act as a real diversifier within a programme, but you do have to be careful what sort of infrastructure you're accessing to get that diversification. If you're investing in, say, toll roads and airports, you do get more a GDP-type correlation on those. If you're investing in, say, a water company, you are getting access to a completely different type of exposure. We do generally think that the asset class can deliver quite strong diversification within a broader portfolio, if your infrastructure programme is structured correctly and that's a key caveat.

» **Ubhi**: The point about access is one that is worth touching on because it can be a bit of a misnomer that infrastructure is only a big investor's asset class, and that you need to be of a certain size and a certain scale to access the market. In reality, for most of the pooled solutions out there, the minimum commitment requirements are actually relatively modest.

There's also good news in that the range of implementation options has improved over time as the infrastructure fund manager market has grown and matured. So again, infrastructure is not just the preserve of the very large pension schemes. Smaller schemes can, and indeed have been accessing the asset class.

The key challenge is actually governance, and getting pension funds over that hurdle of looking at alternative asset classes and saying: "Actually, there is merit in reviewing these properly and considering them for our portfolio, because our overall strategic objective is to get to our funding level target over our investment horizon, but in a less volatile way than is currently the case." The key driver for a lot of alternative asset classes post the financial crisis, not just infrastructure, has been this desire to find alternative sources of growth but to do so in a less volatile way. So, whilst infrastructure might only be a 5 per cent allocation within an overall portfolio context, it does have merit if it helps pension funds get to where they want to be, strategically.

» **Bostock**: I'd agree with that. I still think it's potentially something people can understand but there is definitely an education process that is needed and it will take a few meetings to understand the underlying risks and what diversification it is genuinely bringing.

» **Holmboe**: Yes and the point I was making earlier was more around prioritisation so, if I was your adviser, spending time on LDI and trying to mitigate the two biggest risks in the portfolio - which are interest rate and equity – I would do that rather than spend three months on 5 per cent of the allocation.

» **Chair**: Okay - so we've got through that governance hurdle, we've decided that it is something we are going to invest in and so how do we do that? Does size matter? Is this only for the big boys or is there an opportunity for pooling?

» **Ubhi**: The good news is that the implementation options for small to mid-sized pension schemes are there, but the key thing when making an allocation is to ensure that we have a clear idea of the strategic role that infrastructure is to play within the overall portfolio, and to have an upfront plan of what the allocation will look like once fully built out. Obviously that plan will need to be updated and refreshed over time but it provides some guiding principles and a frame of reference.

As part of that planning process, investors need to have two clear aims: one is to build genuine diversification into the allocation; and the other is to have a rolling programme - to build the allocation over time, and diversify across a number of different factors so you end up with an allocation that's really robust and fit for purpose. It's far better to take your time and build an allocation in a considered manner, than run the risk of investing the entire allocation with a single manager, in a single fund,

"The good news is that the implementation options for small to mid-sized pension schemes are there"

at a single point in time, in an illiquid investment that may have a 10, 15, or even 20-25 year term.

» **Pickering**: We do that in property don't we? In one of my schemes we allocate £150 million to property and some of my trustee colleagues get a bit restless if all that hasn't been invested in three months. I say: "No, no, no, I don't want to buy any old piece of property, I want to get in there as quickly as possible but also as quickly as is sensible." So we're used to earmarking £150 million to property but getting there over a 12-24 month period, so I guess it's no different to that.

» **Holmen**: One thing I would add though, one thing that you wouldn't necessarily expect in infrastructure is the dispersion we are seeing across manager performance, even in the same vintage year. You'd expect it to be quite a low risk asset class with a low level of volatility of performance across managers, but even in some of the lower risk parts of infrastructure, in terms of PFIs and brownfield renewable energy, we've seen some huge dispersion of performance. So the ability to pick the best fund and diversify across different fund managers is important as well.

» **Ord**: In terms of fund managers, there is a wide variety out there and fund managers have also reacted to the demands of LPs and have put in new structures. So you can go from your traditional closed-end fund through to a managed account through to something a little bit more bespoke - co-investment and so on.

» **Holmboe**: For our larger clients, co-investment is something they've certainly looked at. There are a lot of opportunities to not go through a fund structure but co-invest alongside insurance companies, which effectively means you can leverage off their costs and due diligence.

» **Bostock**: I think liquidity is a very important point and it comes back to what we were saying before - it's not even so much a question of the size of the scheme, to a certain extent, it's where you are on that journey plan. If you're headed for a buyout in 10 years it's probably not worth looking at over that sort of term, but if you're a large scheme that's going to be around for the long term, you perhaps need to look at it. ■

In their own words...

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

On the UK's retirement income being amongst the lowest in OECD countries

"The report makes embarrassing reading for the politicians who have been responsible for the UK's pensions over the past 25 years. The state pension was in steady decline for years and even now is improving for lower earners but average pay-outs will not be rising. It is in the private sector though where the real damage has been done; the collapse in final salary pensions has not yet been replaced with well-funded alternatives."

Hargreaves Lansdown head of retirement policy Tom McPhail

On Ireland's largest DB schemes seeing deficits rise by more than €2bn

"The results of the 2015 report highlight that many companies remain under considerable pressure in maintaining their defined benefit pension schemes. A number of schemes have disappeared through wind-up over 2014, benefits have been cut in others and more are implementing other deficit funding programmes. Ryanair, for example, made a final contribution of €12.5 million into its Irish defined benefit plan and the plan was subsequently wound up. Bank of Ireland's pension scheme, which included elements of defined benefit and defined contribution, was closed to new entrants and a new defined contribution scheme was introduced."

LCP partner Conor Daly

On the ECB extending quantitative easing

MAXIME ALIMI

AXA IM senior economist

"Overall, we had expected more from the decision as the ECB had strongly emphasised the need to move quickly against the risk of too-low-for-too-long inflation. On the contrary, the central bank seems to be taking a more gradual approach, with President Draghi underlining that the programme will remain in place for a 'long long time'."

CHARLES COWLING

JLT Employee Benefits director

"Most pension schemes are currently following investment strategies which are not fully hedging interest rate exposures - most LDI programmes are only partially hedging interest rate exposures. As a result, if interest rates rise more slowly than anticipated by markets, then this will increase pension scheme liabilities and, potentially, pension scheme deficits."

On Poland's plans to reduce the retirement age and overhaul its pension system

PIOTR KAMIŃSKI
Employers of Poland (Pracodawcy RP) deputy president
"According to the European Commission's analyses, scrapping the pension reform from 1999 will provide a temporary relief for the state budget, but it will not solve the problem itself, and, in the long-term, it will generate major risks for the system."

POLISH PRESIDENT ANDRZEJ DUDA'S OFFICE
"Currently, the socio-economic situation of Poland does not justify an increase in the retirement age. Such an increase can only contribute to improving the financial performance of the Social Insurance Fund if it results with an extension of the professional activities of the insured. This aim can only be achieved if the employees who are approaching retirement are provided with stable employment."

On the need for new pension scheme design across Europe

"The concentration has been on third pillar work for too long. At last we are starting to look at occupational DC, which is where the majority of individuals in the European Union sit.

"Some companies really do need a vehicle that is cross-border. They need something that is not only easy to use from their perspective, but that actually provides some equality. Then when they go from one country to another to work, employees are not going from a highly functioning type of pension arrangement with highly exceptional pension benefits to something that is very poor, without realising it."

Punter Southall head of international Julia Whittle

"We mustn't try to teach people to be their own CIO. Any pension system that relies on experts for it to work is doomed to failure. You need a system that can deliver good outcomes regardless of how well engaged people are."

State Street Global Advisors head of European DC Nigel Aston

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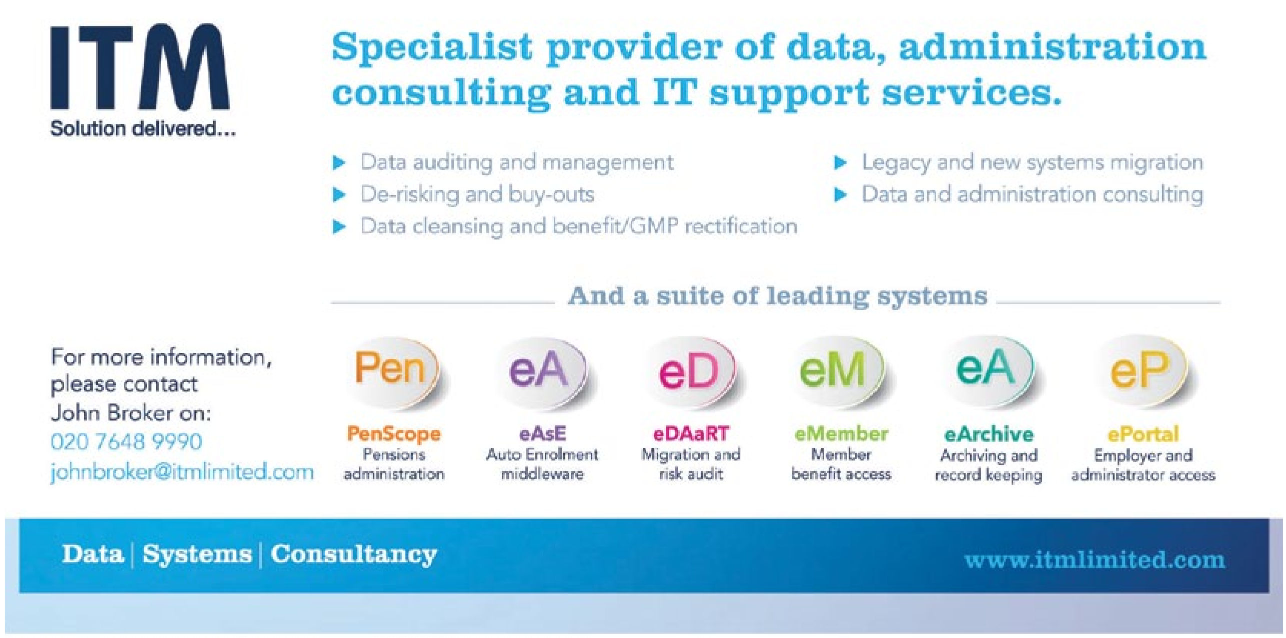

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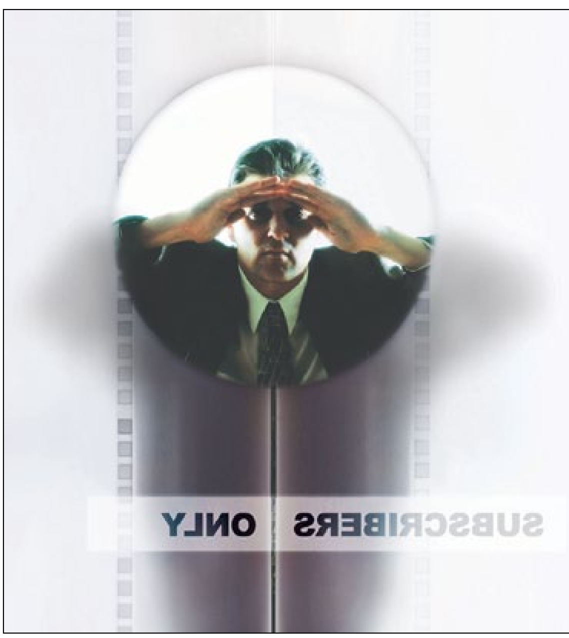

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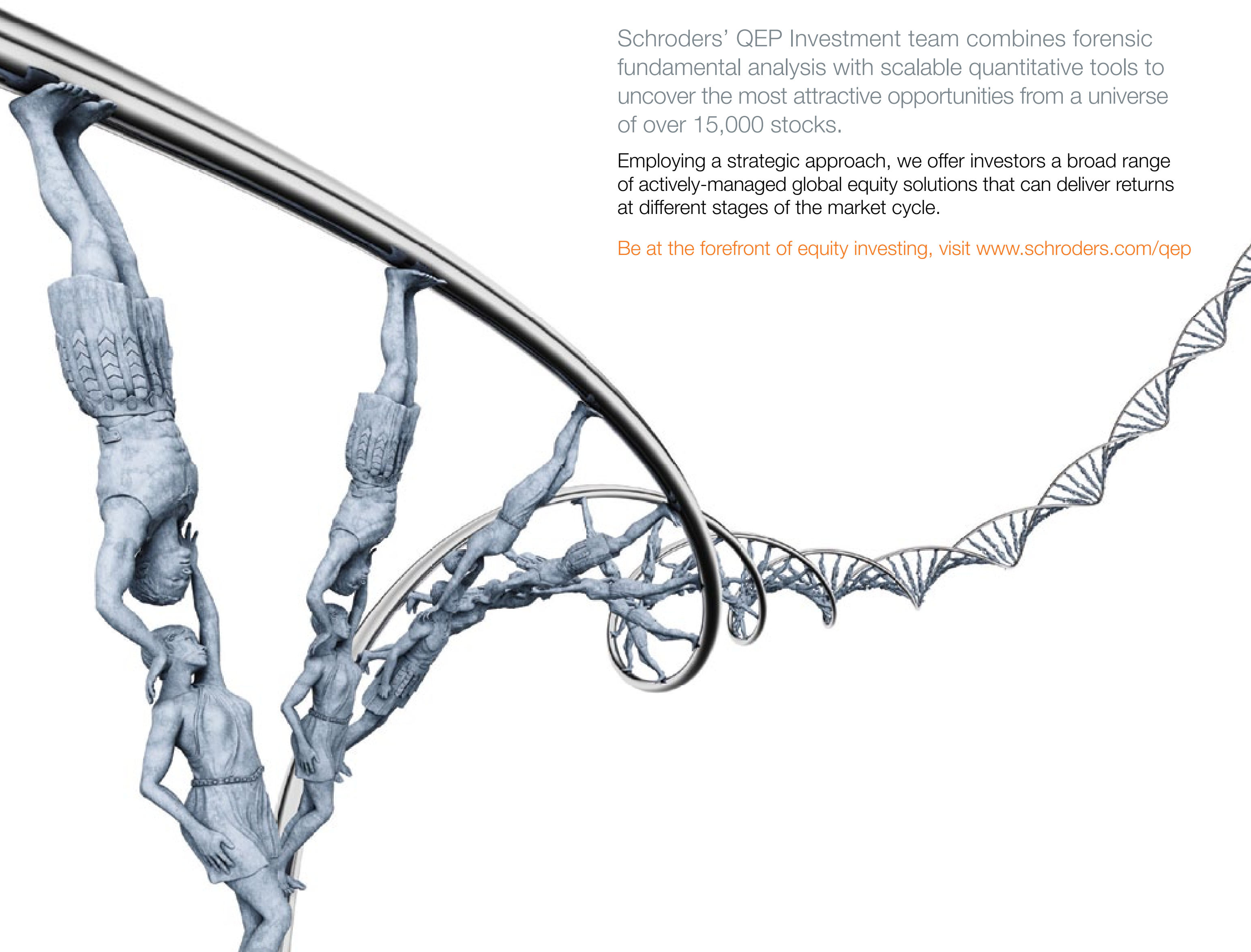

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