Opening the door
THE CHALLENGES AUSTRIA FACES TO INCREASE ITS SECOND AND THIRD PILLAR PROVISION

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A little education

Let’s start with the good news. Austrians enjoy a generous state pension system. It consists of 10.25 per cent contributions from employees and 12.55 per cent from employers. Individual benefit calculations are based on the 18 highest paid years of a career, length of contributions and retirement age. It is possible individuals can reach 80 per cent of average lifetime earnings, with a contribution record of at least 45 years, subject to a cap.

Now for the bad news. The state pension certainly doesn’t look sustainable in its current format in the long term, but for now Austrians can rely on this better-than-many first pillar provision. The trouble though is what will occur when its ageing population causes this pillar to crumble and people have to increasingly rely on their second and third pillar savings.

Despite this, Austria is struggling to grow momentum for its second pension pillar, the Pensionskassen. Despite reasonable returns and over €20 billion of assets, it still only serves around 20 per cent of workers; about 770,000 active members and 86,000 pensioners. These numbers are growing very slowly, with only minimal tax incentives for employers or employees to use occupational or private pensions.

Austria’s issue, as our cover story (see page 27) explains, is one of perception and education. Austrians tend to have low-risk appetites and are more comfortable saving in land and property, not equities. The details may be different, but these problems are certainly not unique to Austria. Countries across Europe and beyond are trying to make people understand that the first pillar safety net is starting to tear, and that individuals will increasingly have to create a ‘net’ of their own.

The efforts from governments to increase public understanding, such as the introduction of the Pensionskonto system in Austria, which allows people to see how much income (or lack thereof) they are likely to receive from the state pension, are to be applauded and more of this work should continue.

However if these endeavours to grow second and third pillar savings are to truly succeed, more financial awareness and education is sorely needed. And not just specifically pensions, but also understanding money’ and ‘finance’ generally – for people to know where their money goes and how it grows. Only then, once people appreciate the benefits of saving, will second and third pension provision increase.
May 2015

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EFAMA has recommended a pan-European pension product known as a European Personal Pension (EPP), to help cross-border pension providers centralise some of their functions.

According to a recent report from the association, the key reason for the creation of an EPP would be to help the centralisation of functions for cross-border pension providers, which would create economies of scale in the areas of investment management and administration.

In addition, EFAMA believes it would make it easier for EU citizens to continue saving in the same product when moving from one country to another, which would further contribute to a Capital Markets Union.

However, it found there is no one size fits all default option and there will always be a middle of the road compromise but an EPP would have to choose a default option for individuals who do not make specific investment choices.

EFAMA stated a single market for personal pensions would be advantageous for both consumers and providers.

The body proposed that pre-enrolment communication provisions for potential EPP holders should be standardised and applied uniformly by all providers in a way that facilitate the comparison between EPPs, to help consumers to make the right choice.

Furthermore, it added the level of advice accompanying the sale of EPPs should be calibrated to their level of standardisation.

“There is indeed a trade-off between the protection offered by professional advice and the costs associated with the provision of advice. EFAMA therefore encourages EIOPA to develop an EU framework for a standardised EPP to reduce distribution costs and in this way encourage more consumers to save for retirement,” EFAMA stated.

The idea was originally proposed in September 2013, when the body published a report on the blueprint for a European brand of pension product referred to as an Officially Certified European Retirement Plan, but after comments from the industry, has been renamed European Personal Pension, to facilitate the public’s understanding.

EFAMA believes that the current fragmentation of the EU pensions market is hindering competition, innovation and scale.

“In such an environment, the choice between different types of pension products and providers remains limited, the portability of pension savings across borders is almost impossible, and the cost of pension products is high,” EFAMA stated.

In another area, according to a report by the Track and Trace Your Pension in Europe (TTYPE) project that has been handed to the European Commission, a European pension tracking service (ETS) is “feasible” and appealing.

TTYPE has said a European pension tracking service would help citizens track their pensions, who have worked in different countries European countries. In addition, it could help savers in other European countries where there is no tracking service available. It stated it could help EU member states to set up a national tracking service.

“We conclude that the implementation of the ETS is feasible and the proposed design in our report demonstrates its appeal to citizens, providers and national tracking services,” the report stated.
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Quantitative easing is a ‘dysfunctional force’, that will directly cause underfunded schemes to wind up, Dublin City University has warned.

Speaking at the IAPF’s Investment Conference in Dublin, DCU lecturer Colm Fitzgerald said underfunded defined benefit schemes, which count for the majority of Irish pension schemes, will be worse off as a result of QE due to the rapid increase of their liabilities.

The decision to introduce quantitative easing was announced in January by European Central Bank president Mario Draghi. He said the decision on additional asset purchases was taken due to prolonged weak inflation; the aim is to achieve inflation rates below but close to 2 per cent.

Combined monthly purchases will amount to €60bn and the programme, which began this month, will be carried out until at least September 2016.

“Money has indeed been printed, but your existing money is now worth much less than it was before QE,” Fitzgerald said.

“QE has been unfair and unequal, but due to its conflicted nature, the unfairness hasn’t yet come to the surface. It will soon been seen to be most unfair on all underfunded schemes,” he added.

Fitzgerald highlighted how schemes should be able to argue that QE is “directly causing schemes to wind up and causing all DB schemes to die”. “It is a dysfunctional force causing a lot of schemes to do a lot of stupid things,” he added.

However, he said QE creates a form of short-term gains ‘wealth illusion’, which makes the “rich richer, despite making the poor poorer”.

Invesco senior investment consultant Vincent McCarthy also said despite the negative consequences QE has on many pension schemes, it puts “beer googles” on investors, making it look attractive on a short-term basis.

Also speaking at the conference, Trustee Decisions executive director Jim Foley said it is still early days for QE to have any real impact on pension funds, adding that it “was not invented to solve the problems of pension funds”.

“It will, however, cause significant harm and damage, triggering the next stage in the decline of DB schemes,” Foley added.

On the issue of Irish DB funding levels themselves, only a minority of Irish DB schemes have failed to submit funding proposals, showing a ‘considerable improvement’ for DB, the Pensions Authority has said.

According to the authority, only 30 of 703 schemes had no funding proposal in place at the end of February this year. For each of these schemes, the watchdog is now deciding whether to use its powers to direct trustees to reduce benefits or to windup the scheme.

The real total deficit, excluding surpluses, was reported at almost €5bn, which is about 18 per cent of liabilities of those schemes, TPA said.
Asset managers are being ‘pressured’ into socially responsible investment, which is clashing with strong fund performance, new research has found.

According to the Cerulli Edge-European Monthly Product Trends Edition, asset managers are having to ‘bow’ to the growing pressure for socially responsible investment, but where principles and strong fund performance clash, the latter will usually prevail.

ESG criteria, unlike outright ethical considerations, are more concerned with making systematic, quantifiable assessments of the financial consequences of an investment than judgements on what is morally ‘good’ or ‘bad’, Cerulli Associates said.

“ESG has become a ‘hygiene’ factor – no one notices when it’s done right, only when it goes wrong and funds are found to be investing in the ‘unacceptable’,” Cerulli analyst Brian Gorman said.

Dutch pension fund ABP has been urged by its members to axe all fossil fuel investments from its $360bn portfolio.

Members of the fifth largest pension fund in the world handed over a petition to the fund’s managers, urging them to divest from all investments in coal, oil and gas, according to British newspaper The Guardian.

The campaign is part of a movement, originally launched by the group 350.org, to begin encouraging pension funds and other institutions to divest from fossil fuels.

The Guardian said around 60 per cent of those who signed the petition to ABP currently hold their pension with the fund.

Norwegian pension fund manager KLP recently decided to pull out of companies that profit from coal in order to promote the switch from fossil fuel to renewable energy.

Earlier it was also announced members of pension funds representing €32bn of assets are set to vote on divesting from the fossil fuels that drive climate change.

Resolutions have now been filed asking six funds to divest from coal by 2018 and exclude high-risk oil and gas projects from their portfolios.

The six pension funds being targeted are teachers’ scheme MP pension, DIP and ISP (engineers), JØP (lawyers and economists), AP (architects) and PJD (veterinarians). Over 200,000 people are enrolled in the schemes altogether and they cover almost 5 per cent of the nation’s workforce.

These recent ethical moves are all part of a climate change campaign, which has quickly gained momentum by persuading 180 institutions, including local authorities, universities and churches, to sell of their investments in coal, oil and gas.

At the end of last year, KLP excluded a total of 99 companies from its investment portfolio for “ethics violations”.

According to the firm, nine companies have been axed due to human rights abuses and three to violations of individuals’ rights in war and conflict. A further seven have been cut from the portfolio for violating other fundamental ethical norms.

KLP head of responsible investment Jeanett Bergan said where violations of human and labour rights have been identified, KLP expects companies to respond by “implementing responsible measures to stop such abuses from continuing”.

Written by: Lauren Weymouth
Swedish pension funds invest in leading electricity distributor

Two Swedish pension funds have formed a consortium with other investors to acquire 100 per cent of Fortum Distribution AB, the second largest electricity distributor in Sweden.

Pension funds Tredje AP-Fonden and Första AP-Fonden, along with Borealis Infrastructure Management and Folksam, have acquired the company.

Fortum Distribution AB distributes electricity to approximately 900,000 customers, representing a market share of around 17 per cent, based on number of connections.

Borealis Infrastructure now owns 50 per cent, Första AP-Fonden 12.5 per cent, Tredje AP-Fonden 20 per cent and Folksam has 17.5 per cent. Completion of the transaction is expected during the second quarter of 2015. The acquisition is subject to customary regulatory approvals.

Tredje AP-Fonden is the third Swedish national pension fund and is one of five buffer funds – known as AP funds – within the Swedish pension system. Together, the five funds hold around 13 per cent of Sweden’s income pension system assets.

Första AP-Fonden is one of five AP funds in the Swedish national income pension system. The capital reserves in the AP funds ensure that pension benefits can be paid even when disbursements from the pension system exceed contributions into it.

PensionDanmark invests in UK power plant

PensionDanmark has invested in a new UK biomass-fuelled power plant.

The Brite power plant in Rotherham, UK is due to be completed in the spring of 2017.

The investment is through the Copenhagen Infrastructure II fund, which has a total of DKK 1.6bn in the power plant. The fund currently has 10 institutional investors and a total commitment of just over DKK 8bn. PensionDanmark has committed a total of DKK 3.5bn to the fund.

The power plant will be constructed by a consortium comprising Babcock & Wilcox Volund, headquartered in Esbjerg, Denmark, and UK-based company Interserve. Babcock & Wilcox Volund will also be responsible for the subsequent operation and maintenance of the plant on a 15-20 year contract.

Currently PensionDanmark is also participating in the establishment of two other UK-based biomass-fuelled power plants, based in Lincolnshire and Norfolk, through a joint venture with the Copenhagen Infrastructure I fund and Burmeister & Wain Scandinavian Contractor A/S.

PensionDanmark CEO Torben Möger Pedersen said the investments in the UK power plants will ensure a good return for their members for many years to come.
Vietnam to overhaul pension system

GOVT LOOKS AT WAYS TO GET MORE EMPLOYEES SAVING VOLUNTARILY

Written by: Lauren Weymouth

Vietnam is toying with ways to overhaul its voluntary pension fund in order to encourage a more active membership and to reduce to the burden on its pension system, a senior lawmaker has revealed.

According to Bloomberg, National Assembly vice chairman of the social affairs committee Bui Sy Loi said Vietnam will ease rules, expand eligibility criteria for those entering the scheme and match worker contributions in order to make it more appealing for employees.

“We want everyone from a street vendor to a farmer to have better retirement savings,” Loi said. He also confirmed a draft for changes to the voluntary pension fund will be sent to Prime Minister Nguyen Tan Dung for approval later this year.

The International Labour Organisation has forecast the pension system will have deficits starting from 2021 and risks being depleted by 2034 without any reforms.

Earlier this year, tens of thousands of workers protested new rules to the mandatory pension fund that would prevent them from being eligible for lump-sum social insurance payments when they leave their jobs.

The proposed changes to the voluntary fund, which will take effect in 2018, will lower the minimum earnings requirement to enable more employees to join.

Over 90,000 Australian retirees set to lose access to state pension

PRIME MINISTER TO TIGHTEN ELIGIBILITY AS PART OF FEDERAL BUDGET

Written by: Lauren Weymouth

Tens of thousands of wealthy retirees are set to lose access to the Australian state pension under changes expected to be announced in the Budget.

Under current regulations, couples can own a combined total of $1.15m in assets on top of their family home to qualify for the part pension.

However, under the Prime Minister’s plans to target “illiquid assets millionaires”, the threshold will be reduced to $823,000 for couples. This means over 90,000 people will no longer qualify for the benefit, according to Australian news site, WA today.

A further 235,000 will have their pension reduced. However, the bulk of retirees will see either no changes to their pensions, or will receive a small boost.

The amount of assets a person can own in order to receive the full pension will be increased from $202,000 to $250,000 for single home owners and from $286,500 to $375,000 for couples who own their own home.

Social Services Minister Scott Morrison said these changes will see more than 170,000 pensioners receive an extra $30 a fortnight.
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

MICHAEL DE LATHAUWER  
Cardano has appointed Michaël De Lathauwer as co-group CEO alongside Theo Kocken, founder of the Cardano Group. Before joining Cardano, De Lathauwer spent his professional career at Goldman Sachs with postings in London, New York, Hong Kong and Singapore. In the last six years of his time at GS he was responsible for the Pension and Insurance Solutions Group, working with institutions across Europe and globally.

DAMIAN STANLEY  
Damian Stanley has been appointed as principal of the AMP Capital Infrastructure Equity team, reporting to head of origination Europe Simon Ellis. He will be responsible for transactions in the region for the global infrastructure platform and its institutional investors. He has experience leading transactions and managing assets within the infrastructure space.

JEFF BOSWELL  
Investec Asset Management has appointed Jeff Boswell and Garland Hansmann to its global multi-asset team. Both Boswell and Hansmann join from Intermediate Capital Group PLC where Boswell was head of high yield, and Hansmann was head of portfolio management within ICG’s credit fund management division. They bring with them a combined 30 years of experience.

MICHELE CARONTI  
Russell Investments has appointed Michele Caronti as director, head of institutional to lead its institutional business in Italy. He will report to Thomas Schneider, country head for Italy and will be responsible for bringing Russell services and investment solutions to institutional investors. He joins from London Capital Advisors that he founded in 2010. He has held a variety of senior roles, in derivative and structured product distribution.

WITOLD WITKIEWICZ  
bfinance has appointed Witold Witkiewicz as a director in private markets and John Amoasi as a senior associate in fixed income. Witkiewicz joins from Aeriance Investments. He has 15 years of experience in real estate debt and securities markets from both the buy and sell side. Amoasi joins from Goldman Sachs Asset Management, where he worked as a product manager.
Robyn Laidlaw

Vanguard has appointed Robyn Laidlaw as head of institutional Europe. She will relocate to London from Australia where she is currently head of product and marketing for Vanguard Australia. Laidlaw joined Vanguard Australia in 2006 as an institutional sales manager. She has held several roles including head of product management and development and ETF product manager.

David Burnett

Northern Trust has appointed David Burnett as head of Northern Trust Hedge Fund Services in Europe, Middle East and Africa. Based in London, he will lead Northern Trust Hedge Fund Services in EMEA. Burnett joined Northern Trust in 2011 as head of relationship management, EMEA, following Northern Trust’s acquisition of Omnium LLC from Citadel. He has more than 15 years of financial services experience.

Gildas Surry

Axiom Alternative Investments has appointed Gildas Surry as a senior analyst with the role of research and portfolio management. He will be overseeing the Axiom contingent capital and Axiom European financial debt funds. He was most recently a senior analyst covering European banks at BNP Paribas and has been in the European banking sector for 15 years.

Alex Lawton

State Street Corporation has appointed Alex Lawton to senior managing director and head of securities finance for State Street Global Markets in Europe, Middle East and Africa. He will be responsible for developing the securities finance business. He has nearly 20 years financial services experience. He joins from Barclays where he was head of equity finance and equity prime services.

Christian Kronseder

STOXX Limited has appointed Christian Kronseder as chief operating officer, based in Zurich. In his new position as COO, Kronseder will be responsible for STOXX's index production as well as index operations; focusing on infrastructure, service, quality and innovation. He is part of the management board of STOXX, which also includes Hartmut Graf, chief executive officer, and Patrick Valovic, chief financial officer.

Pieter M. De Jong

State Street Corporation has appointed Pieter M. De Jong as head of State Street Global Services in the Netherlands. He has more than 30 years of professional experience in the asset servicing and custody industry and has been with State Street since 2004. He has served as chief operating officer for State Street’s Edinburgh office for the last three years.

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Increases in life expectancy coupled with sluggish economic growth, budget deficits and debt burdens brought about by the financial crisis have increased the need to define comprehensive strategies in order to ensure long-term sustainability and secure the future adequacy of pension income in Europe.

The European Commission strongly believes that the EU needs a common agenda to meet this challenge. In 2012, it provided a clear and meaningful analysis of the situation in its White Paper on pensions, which highlighted in particular that the current reforms of social security systems around Europe will result in lower replacement rates, putting an increased responsibility on citizens to save for their pensions.

This assessment led the commission to recommend that member states take action to increase labour force participation and to enhance the opportunities to increase complementary retirement savings.

The commission has also asked for a technical advice from the European Insurance and Occupational Pensions Authority (EIOPA) on possible solutions to create an EU single market for personal pensions. This is an important initiative because the personal pension market in Europe is very fragmented today. Currently, pension providers have to offer country-specific products in line with national legislation, which increases the costs of engaging in cross-border activity. This market fragmentation limits competition between providers and the choice available to EU citizens.

The case for a European Personal Pension

In March 2015, EFAMA published its second report promoting the creation of an EU-wide standardised personal pension product.
• It would improve the portability of pension savings across borders. This would simplify life for people working and living in more than one EU member country – a trend that will only become stronger.

Industry survey on European personal pensions

To understand how asset managers would adapt their operating models to the creation of an EPP, EFAMA has conducted a survey of its corporate members. The two charts opposite summarise the key findings of this survey.

Chart 1 shows that all respondents would engage in the EPP market as providers of the investment solution. One third would act as distributors and one fourth would have an in-house administration function. This finding confirms that the European asset management industry is fully committed to play a very active role in the EPP market.

Chart 2 shows that an EPP would help personal pension providers operating on a cross-border basis to achieve economies of scale: 94 per cent of the respondents would centralise the investment management function and 65 per cent would centralise the administration function. In general, asset managers would not centralise the distribution function. This means that they would distribute their EPPs by using third-party local distributors and/or linked agents. It is not unreasonable to assume though that the ongoing digital revolution has the potential to create valuable on-line tools that would reduce the complexity and cost of distributing EPPs. Such online tools would also reduce the barriers to market entry, thereby enhancing competition.

Contributing to the Capital Markets Union

The EFAMA 2014 Fact Book shows that the total amount of euro area households’ savings held in bank deposit represented 42 per cent of their financial wealth. One can hardly say that this is an optimal asset allocation. If European households could shift more of their financial wealth into capital market instruments, this would unlock more capital to finance European businesses and economic growth.

A European Personal Pension would play an important role in increasing retail investors’ participation in capital markets. By relying on robust consumer protection rules, such a product should win the trust of people. Also, the long-term nature of retirement savings will ensure that the savings accumulated into EPPs would be invested in long-term projects. Ultimately, EU citizens could also be expected to benefit from a better return on their savings. From this perspective, the creation of a single market for personal pensions should be seen as an integral part of the European Commission’s goal of building a Capital Markets Union.
In the UK, The Pensions Regulator’s 2014 code of practice on funding requirements for defined benefit schemes, the phrase ‘employer covenant’ is mentioned some 90 times. A previous code, released six years prior to the current one, mentions the employer covenant on only nine occasions.

The regulator’s increased attention on pension fund sponsors’ solvency could not have come soon enough.

A toxic combination of low interest rates, quantitative easing and market volatility has left trustees of DB schemes sweating over their funding levels as well as their investment returns. According to the UK Pension Protection Fund, the combined deficit of the country’s 6,057 DB schemes on its index had increased to £292.6 billion by the end of March this year. It also meant that the funding ratio for the schemes had decreased to 81.4 per cent.

QE’s negative affect on government bond returns, along with rock bottom interest rates, have also

UK trustees feeling the heat from tough economic times have been forced to take a closer look at the strength of their sponsors to back up their DB schemes. But some companies are still getting hot under the collar when it comes to employer covenant reviews

WRITTEN BY MAREK HANDEZEL, A FREELANCE JOURNALIST
had a detrimental impact on the discount rate used to calculate DB liabilities.

“Rates have got worse and there’s less optimism about it reversing in the short-term than perhaps there was a year ago,” PwC pension credit advisory practice lead Jonathon Land said.

“And given that increased deficit obligation, the focus on the employer’s ability to support that shortfall has gone up the agenda.”

Lincoln International chief executive Darren Redmayne says that the volatility of the past few years has also shaken everyone with a stake in a DB scheme – and left them turning to the companies propping up their pension benefits for answers.

“The way we think about it is that the covenant is like the underwriter - it stands behind the risk. And therefore when you have higher periods of volatility like QE, ultimately it is the covenant that stands behind that,” he says.

Schemes that are highly de-risked have been particularly hit by the QE first launched by the Bank of England and now by the European Central Bank.

Penfida founding partner Paul Jameson, says that this has had a perverse result for many investment strategies. DB plans that de-risked in the first place did so to reduce reliance on the employer covenant. But unless they are fully de-risked, then they are still chasing ever-dimining returns from traditional bond investments, leaving them to have to look at the covenant again.

Reaching out for advice

Trustees have therefore increasingly looked at getting help from outside. Aon Hewitt partner Aiden O’Mahoney estimates that some 70 per cent of DB schemes in the UK now have an external covenant adviser.

This escalation has been pushed by two factors. The first is the regulator’s insistence that trustees explain why they haven’t taken advice in the area; and the second is a recognition by many that a DIY approach to assessing the strength of a sponsoring employer may no longer be appropriate.

As Redmayne says: “We’ve all been to school so we think we understand education. But there’s a big difference between understanding the business and understanding the covenant.”

Using an adviser from outside the scheme has helped trustees to build trust with their sponsors in many cases as well. Although there are still a few cases of entrenched views and discussions based on fear and suspicion, there is generally a far better and transparent dialogue that takes place over funding requirements in the UK, as Jameson explains.

“If we look back eight to 10 years ago, then we had assignments where the sponsors weren’t interested in providing much information at all,” he says. “Today those people consider it right and proper that they should keep the trustees informed.”

This openness is down to improved professionalism on trustee boards, and the behaviour of the regulator. In the case of the latter, its guidance has proved to be of great assistance, but its reluctance to fully exercise its penal arm has ended up being of equal value.

CMS Cameron McKenna partner Neil Smith explains that in the past, employers were quite worried about what the regulator would do to them if they did not go along with contribution demands placed on them by a trustee board. And some trustees were happy to play on that fear.

“Now, companies are aware that the regulator very rarely exercises its powers here,” he says. “At most, if you go to the regulator it will try and bang heads together and try and get you to reach a consensus.”

What’s more, a recent high profile court case involving the Merchant Navy Ratings Pension Fund has
effectively backed up the regulator’s stance, enforcing the need to assess the impact of calls to fill funding gaps.

“The pendulum had swung too far in terms of trustees assessing the covenant and not giving enough heed to companies’ cashflow needs,” says Smith.

“There has been a slight adjustment and, as the regulator has said, it’s generally not in the interest of members when you take action that is detrimental to the company’s business.”

In terms of its overall regulatory framework, the UK is in a better position than some other European countries. Over in Ireland, for example, the situation for trustees is far trickier, as Jameson’s colleague at Penfida, Trevor Civval, points out.

Across the Irish Sea there is a code in place over the covenant, but it is nowhere near as explicit or well defined as in the UK.

“The experience of trustees has been much more challenging in terms of dealing with sponsors in the face of severe economic conditions,” Civval says. “They haven’t had the backing of the regulator like UK schemes have had.”

**Understanding gap**

Although DB trustees in the UK can be grateful for the backing they have from the regulator, there is still work to be done when it comes to raising understanding of the exact nature of a covenant review among employers. Particularly when advisers come back with bad news.

Some sponsors still confuse assessments with equity analysis or credit reports, which must leave trustees wishing that they could adopt Dutch-style flexible funding recovery plans, with their cuts to indexation of accrued benefits and other adjustment mechanisms.

“A lot of employers are still saying ‘aren’t our scores good and share price good’?,” Redmayne says.

“But you often have to peel back the layers and say well that’s fine, but that isn’t going to answer what the employer covenant is about, which is to generate the cash needed to stand behind the scheme long-term. You have to look at different things for that.”

In certain cases, Redmayne, says, companies see the covenant review as a verdict on their business, or treat it like an exam score, leading them to become defensive and uncooperative.

“You can have the best business in the world, trading really well - but if you have a pension scheme that is 10 times the size and volatile and running risky investments, then you can have weak covenant supported by a strong business,” he says.

“There are many examples of this where the deficits are also bigger than that actual scheme itself.”

The sooner these misunderstandings are ironed out, the sooner a scheme can get on top of the risk it is exposed to by its sponsor, says Land.

He says that the sophistication being used in covenant assessment has been taken to a new level. For example, trustees nowadays, spurred on by their advisers, are far more likely to be looking out for areas where they may be doubling up their risk in investment. So trustees of a construction company’s scheme may decide that they need to diversify away from commercial property as the employer covenant is heavily dependent on it.

“When people are looking for covenant advice they’re looking for some sector insight,” says Land.

“And they’re looking much more at how the covenant is going to fit in with the actuarial valuation and the investment strategy. So rather than saying covenant sits by itself in isolation, it’s about when coming to valuation, using the output of the review to impact into my actuarial valuation and the investment strategy.”
European Pensions
AWARDS 2015
25 June 2015
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- bfinance
- JLT Employee Benefits
- Mercer
- P-Solve
- Redington
- Towers Watson

Investment Manager of the Year
- Aberdeen Asset Management
- BlackRock
- Goldman Sachs Asset Management
- Insight Investment
- Irish Life Investment Managers
- M&G Investments
- Newton Investment Management
- Schroders

Equities Manager of the Year
- AB
- BNP Paribas Investment Partners
- Hermes Investment Management
- Irish Life Investment Managers
- Kleinwort Benson Investors Dublin
- Sanlam FOUR Investments UK
- SKAGEN Funds
- TOBAM
- Unigestion SA
- Union Bancaire Privé
- Vontobel Asset Management

Alternatives Investment Manager of the Year
- Berenberg
- BlackRock
- Darwin Property Investment Management
- Deutsche Asset & Wealth Management
- Irish Life Investment Managers
- Nordkinn Asset Management

Fixed Income Manager of the Year
- BlueBay Asset Management
- Henderson Global Investors
- Hermes Investment Management
- Insight Investment
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- SKAGEN Funds
- TwentyFour Asset Management

Hedge Fund Provider of the Year
- Aurum Funds
- Deutsche Asset & Wealth Management
- Goldman Sachs Asset Management

Property Manager of the Year
- AXA Real Estate
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Pension schemes of all structures and sizes throughout Europe are faced with the same fundamental dilemma. Bond yields in Western economies have been trending down for more than 30 years and it is widely estimated that around 15 per cent of global sovereign bonds are now trading at negative yields. Yet the pursuit of reliable sustainable income is a higher priority than ever before.

“The big problem Europe has is the need to match the liabilities pension schemes have with the assets they invest in,” First Actuarial director Henry Tapper says. “As schemes are mature and the liabilities are here it is not a future issue, and they increasingly need income to meet the needs of beneficiaries now rather than try and obtain some form of magical growth to pay pensions in 30 years’ time.”

Current climate
But, although no-one disagrees with the theory, what pension schemes are actually doing in practice is seemingly a very different matter. Robeco Investment Solutions chief investment officer Lukas Daalder reports that Dutch pension schemes have so far seen few big switches away from government bonds.

He says: “Negative bond yields have never occurred on a sustained basis before in any major markets as far as we are aware and everyone is asking how much lower yields can go and whether it’s appropriate to still be invested. But so far pension schemes on a broader scale haven’t changed strategies.”

Kames Capital head of multi-asset investing Scott Jamieson hasn’t come across a single investment consultant advocating that European pension clients restructure their assets around a reliable premium income theme. The couple of clients that have actually moved away from total return objectives have pushed the agenda themselves, with his help.

“To believe the problem is going to go away you have to believe cash can provide real returns but the world economy is awash with debt,” he comments. “The only way out is to either default or expand the world economy and you don’t do the latter by encouraging people to hoard cash, so the world system can’t allow it.”

Equity allocation
Even those investment consultants who beg to differ with Jamieson’s somewhat damning observation acknowledge that switching certainly hasn’t been occurring on a massive scale, with much depending on a scheme’s particular circumstances and the regulatory pressures it faces.

Mercer Investment Consulting principal Nathan Baker says: “The average equity allocation in some European markets, particularly Germany, has been increasing over the last year but I don’t think the move to equities has been quite the great rotation many experts were anticipating. German CTAs (contractual trust arrangements) are less constrained from a regulatory point of view, so it is no surprise they are demonstrating a higher shift towards equities.”

Back in the purely theoretical world, there are plenty of commentators who champion the ability of the larger high-yielding equity stocks to provide more attractive returns.
than government bonds. Capital Group investment specialist Richard Carlyle points out that in 1981 yields on 10-year treasuries and 10-year gilts both reached more than 15.8 per cent but that in 2015 the equivalent yields are just 1.78 per cent and 1.52 per cent respectively. At the end of 2014, however, there were more than 350 listed companies that were yielding 3 per cent or more in the MSCI All Country World Index, and others that were yielding 4 per cent or more in the Euro Stoxx Index.

He says: “Almost half of government bonds in issue yield less than 1 per cent, and an equity income strategy can deliver higher returns and even lower volatility. For example, UK studies have shown that investors in gilts have on average experienced higher volatility combined with lower annualised returns than investors in equities, if invested for more than a decade.”

But there are also experts who maintain that European pension schemes have largely missed the boat on the safe high-yielding blue-chips, feeling that their share prices have now risen to levels that no longer represent good value.

City Noble director William Bourne emphasises the need to look for equities in less fashionable areas, even though these are not without downside capital risk. He singles out the ability of emerging market equities to yield 5 per cent, and he is unusual in seeing attractive income opportunities in Japan. Many Japanese companies now yield around 2.3 per cent, which is fairly comparable with US companies, but Japanese companies could produce stronger dividend growth.

“Japan has never been seen as a yield market but there have been big changes in company behaviour,” he states. “Japanese companies are far more shareholder-friendly, and earnings growth is outpacing other major markets because corporates have been deleveraging and cutting costs. In the 1990’s the aggregate quoted Japanese company was just over 60 per cent leveraged but now the proportion has reduced to only around 5 per cent.”

**Income solutions, infrastructure and hedge funds**

Away from equities, there is also no shortage of income solutions being bandied about but, once again, most commentators refer to potential benefits and to interest being shown by European pension funds as opposed to schemes that have already switched.

Infrastructure arrangements are, in particular, the subject of more talk than action. But this is essentially a supply shortage issue, which has resulted in the cost of those funds...
that are available often being viewed as being prohibitive. The asset class is also more difficult to access for smaller pension funds that lack in-house resources, and the construction risk is always there.

Hedge funds, on the other hand, are clearly registering some concrete successes. Aurum Funds, which deals with a lot of pension schemes for professionals in Germany, volunteers that this year it has already won two new pension scheme mandates with a combined worth of around €60 million.

Aurum Funds chief executive Kevin Gundle, says: “We are having numerous conversations with pension schemes who are very interested in what we have to offer. You could invest in bonds with zero yield but if a multi-manager hedge fund has a track record for realising 4 per cent to 7 per cent a year it seems like a strategy worth thinking about.

“Blindly investing in bonds to get the certainty of a coupon suggests to me bowing down to a mechanism of doing things the way people have always done them but we are now in new territories and many pension schemes investing in bonds are guilty of reckless conservatism.”

**Bond substitutes**

Many commentators refer to growing interest in bond substitutes but none volunteer any concrete figures to support this and no one particular type of investment seems to stand-out here.

Atlanticomnium chief executive Jeremy Smouha points to “a lot of interest from European pensions” in the GAM Star Credit Opportunities Fund, which invests in the junior debt of investment grade companies. Zurich Insurance Group pension investment manager Matt Vincent, is finding opportunities within the European loan space, which are small enough to miss being adequately covered via the debt capital raising process but too large for traditional bank lending.

Mercer Investment Consulting’s Nathan Baker reports “a lot of interest in bond substitutes from across Europe”, ranging from distressed debt and emerging market bonds to private debt issued by unlisted companies. In particular he sees a growth in multi-asset credit strategies, switching between these bond substitutes over time.

But the main downside with such alternatives is that by bringing in complexity, and possibly also illiquidity, you are effectively just trading one risk for others. They can also involve high charges.

Tapper says: “What all these esoteric solutions typically have in common is a degree of risk and a higher cost. The more juice you try and squeeze out of the lemon the more likely it is the lemon will run dry. There are no magic beans out there, certainly for trustees with relatively low research budgets, so we feel European pension schemes are better off sticking to tried and trusted income generating approaches like government and corporate bonds, property and equities.”
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For decades the Austrian pensions industry has been working to build effective second and third pillar pensions provision. Yet a large majority of retirees will still rely exclusively upon the first pillar, a generous state system that will not be financially sustainable if current economic, financial and demographic trends continue. Austria has an ageing population; and although the state retirement age is supposed to be 65 and early retirement is penalised in the state system, many Austrians retire at or around 60.

**Popularity of the first pillar**

The Pensionskassen system of occupational pension provision is producing healthy returns and now holds over €20 billion of assets – but still serves only around 20 per cent of workers; about 770,000 active members and 86,000 pensioners. These numbers are growing very slowly, with only minimal tax incentives for employers or employees to use occupational or private pensions. Valida Pension AG actuary and board member Dr Hartwig Sorgoer believes this is because politicians of all stripes have little interest in boosting the second pillar at the expense of the first. “The Socialist party wants to have the first pillar because you can transfer amounts from the rich to the poor; and the Conservative party wants to protect the employers,” he says.

“Every expert will tell you that the state pension system will not work in the long term,” says Towers Watson Austria managing director Eva Salomon-Girsch. “But when you ask politicians and government they will tell you everything is fine.”

The state system is generous, with contributions of 10.25 per cent from employees and 12.55 per cent from employers. Individual benefit calculations are based on the 18 highest paid years of a career, length of contributions and retirement age. It is possible they can reach 80 per cent of average lifetime earnings, with a contribution record of at least 45 years, subject to a cap.

There have been some minor alterations in recent years and others are proposed, like a part-time pension, allowing for partial...
retirement towards the end of a career, but discouraging workers from retiring completely too soon. One important change already implemented has been the introduction of the Pensionskonto system, which allows workers to see how much income they are likely to receive from the state pension. However, this has yet to encourage many more people to start using occupational or private pensions.

**Second pillar growth**

Legislation passed in late 2012, the Pensionskassengesetz-Novelle, introduced some changes to the second pillar, including making it easier for Pensionskassen to offer different lifecycle options for members, who can now change their risk level up to three times before retirement.

Pensionskassen returns have been reasonable: the 25 year average was 5.71 per cent by the end of 2014 and 7.85 per cent during the last year. In 2013/2014 more conservative portfolios produced better returns, averaging over 11 per cent compared to 8.5 per cent for higher risk portfolios, according to figures from Mercer.

VBV-Pensionskasse CIO Günther Schiendl believes the relative youth of the system (established in 1990) and the fact that it is entirely voluntary are two key reasons why take-up remains low. The relatively low risk appetites of Austrian employers and scheme members may also be a factor. Many Pensionskassen hold around 60 per cent of investments in low risk assets, sometimes in part because of the low risk preferences of employers, while many employees clearly believe the state pension offers enough of a safe and reliable source of retirement income.

Pensionskassen have been far more successful than have other types of occupational retirement provision. Occupational collective insurance schemes (Betriebliche Kollektivversicherung) provide a guaranteed minimum return of 2.25 per cent per year, but must not be unit- or index-linked and must be paid as annuities. It is possible to transfer to one of these schemes from a Pensionskassen at 55, but the technical rate for converting pension savings to

**ONE IMPORTANT CHANGE ALREADY IMPLEMENTED HAS BEEN THE INTRODUCTION OF THE PENSIONSKONTO SYSTEM, WHICH ALLOWS WORKERS TO SEE HOW MUCH INCOME THEY ARE LIKELY TO RECEIVE FROM THE STATE PENSION**
Pensions in

Austria

annuities is significantly lower, at 1.5 per cent, than the 3 per cent rate for Pensionskassen. “It is in the interests of employers to offer these switches, but it is not clear how many will happen in reality, because it results in reduced pensions and opportunities in the future,” says Moritz Consulting managing director Gerald Moritz.

The other main occupational pension vehicles are direct insurance arrangements set up with life insurers by employers, who pay premiums to the insurer in return for benefits provided direct to the employee. About 10 per cent of individuals using occupational pension provision use this system. But although premiums are tax deductible for employers, any employee contributions over €300 per year are regarded as taxable income.

Mercer Austria managing director Josef Papousek would like to see the system similar to that in Germany, where combined employer/employee contributions of up to 4 per cent of a predefined limit plus a fixed contribution limit of €1,800 are tax deductible.

Difficulties

There is one more issue for both Austrian employers and employees to consider – and which may also be distracting pensions and insurance providers. The Betriebliche Vorsorgekassen (BVK), mandatory severance pay funds, backed by insurers, into which every company has to pay a share of each employee’s salary, have to invest conservatively, but have grown strongly over the last decade and now hold more than €8 billion. The Vorsorgekassen market is becoming more competitive as more providers independent of the Pensionskassen enter. Some in the industry suggest offering tax incentives to persuade workers to transfer these funds into pension arrangements.

Finally, there is the underdeveloped private pensions market, currently struggling in a low interest rate environment. “Because of the interest rate situation most people say ‘I can use my money better to buy a new car, because then I will get a better return’,” says Papousek.

There are some external factors that might also affect the future development of the Austrian pensions system: the Pensionskassen will seek an exemption from the proposed EU-wide financial transaction tax, on the grounds that this would render non-first pillar pensions arrangements even less profitable for providers or attractive to workers. But perhaps the most crucial factor of all will continue to be the attitudes of Austrians themselves. “People do not want to talk about social security pensions or occupational pensions,” claims Salomon-Girsch. “The typical Austrian prefers to buy land and property.”

Association of Occupational Pension Funds in Austria (FVPK) vice-president Christian Böhm highlights uninformed, negative perceptions about investing in higher risk assets such as equities. “You have a population and even a media who don’t understand that over three years it is maybe better to have one bad year and two very good years rather than three years that were just quite good,” he says. “It’s an education problem.”

“Austrians are not really interested in investing in securities or shares,” agrees Moritz. “It’s a pretty conservative country when it comes to investing – yet people need to understand that you lose money every day in the bank account if interest rates are low and inflation is high.”

Papousek hopes that the number of workers seeking to supplement state pension provision will increase in the longer term as a result of the introduction of the Pensionskonto – but is certain they would do so if more tax incentives were offered to employers and employees. He also believes it should also be possible for employers to structure their contributions based on their current financial situation. Böhm believes more use of collective multi-employer schemes would boost second pillar participation significantly, but again, without further tax incentives, development along these lines is slow.

Moritz thinks ordinary Austrians need to be more proactive to improve their own retirement incomes. “There needs to be more knowledge about the future situation and about longer term investment,” he says. “It could even involve going into schools to help spread awareness.” As in a number of other countries around Europe it appears there is a need for Austrians of all ages to understand that providing adequate pension provision is an important issue for everyone, not just those approaching retirement – and that the state may not be able to provide an effective answer on its own.
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Can you please explain a little more about the fund? What companies do you serve and how many members do you have?

We are a multi-employer pension fund, servicing more than 5,000 corporate plan sponsors with more than 280,000 plan members, out of which about 28,000 are already retired. Thus, we are the biggest Austrian pension fund in terms of members, and in terms of assets under management (€6 billion). Pension plans are predominantly defined contribution, with a few defined benefit plans. Plan sponsors range from multinationals, major Austrian banks to many smaller companies across all sectors.

What are the current challenges/issues affecting VBV?

The main challenge for us is the low/negative interest rate environment, together with annual investment return targets centred around 6 per cent. VBV’s main priority in order to keep ahead during this kind of environment is to achieve these results with a combination of good strategy (higher equity allocation, lower government bond allocation), tactical skills (short – mid-term positioning, exposure management), and new strategic investments in private debt markets.

How have your communication/engagement strategies changed over time? Have you implemented any new strategies to get members more engaged?

We have massively invested in online plan member communication. This enables us to clearly communicate with all our members individually. Not all of them are using this service at the moment, but more and more are getting accustomed to it.

Major amendments were made to the second pillar system in Austria a few years ago, including the creation of a ‘safety pension’ and the increase in workers’ choices on asset allocation. How have these new laws affected VBV?

Not wishing to sound arrogant: not much. We had a very similar ‘safety pension plan’ already in place since (which has been around since 2009). Workers’ choices of asset allocation, which we call a lifecycle system, is one of our key strategy elements and we have actively been proposing it in the amendments discussions.

The lifestyle system you just mentioned organises people into risk profiles according to their age – can you please tell me a bit about how this works and how it benefits the members?

We were the first pension fund in Austria to implement this model almost 10 years ago and we have improved it over time in various ways. This helps to set us apart from other pension funds, as we offer fourth generation life cycle models when other are just starting. Today, pressure to introduce life cycle models with choices on asset allocation is increasingly coming from workers’ representatives: they see this element of potential choice – even if not used – as a very important feature of a modern pension fund. We have also reacted to the typical “complacency” of plan members regarding risk profile/asset allocation choice by offering...
a modern variant of cycle models with automatic mode, meaning according to a communicated plan, members will automatically be shifted to the next life cycle asset allocation depending on their age – no selection decision needs to be made, it will be done automatically; yet: for those plan members who don’t like the ex-ante communicated change, they just let us know that they refuse to proposed automatic change. The effect is: individual right of refusal is kept, but the majority of plan members will over their lifetime be automatically assigned to the appropriate asset allocation. This asset allocation is not static like in target date funds etc., this asset allocation will be annually optimised. For new corporate pension plans life cycle systems have become the de facto standard.

Please can you describe the fund’s investment strategy? What mix of asset classes do you invest in and are you looking to change these allocations soon?

We are an active pension fund. Starting with a refined asset liability analysis and optimisation, we set the strategic asset allocations optimising for each pension plan’s risk levels and return target. We are a global investor with a European bias that comes partially from regulation and partially from conviction. We typically have a 5-10 per cent real estate allocation and the equity allocation ranges from 0 per cent to 60 per cent depending on the plans’ risk capacities. The remainder is filled with corporate bonds, loans and government bonds. Given the interest rate environment with very low to negative yields on so many governments bonds, and given our view that this environment is here in Europe and beyond to stay for years to come, we see the private debt markets allocation to increase and governments bonds to reduce further and further.

Many European pension funds have been actively divesting from fossil fuels and have been heavily focussing on ethical investment. How does ESG fit into your investment strategy?

We have a low profile ESG approach, we don’t talk about it every day in the press. We have implemented a well thought out and structured approach in the various asset classes.

In equities, we have run external screenings on our equity funds for years. We know that those of our funds that deliver above average performance typically are those where the fund managers select companies with good governance. In effect, governance is one of our key elements in our ESG efforts and we see the focus on governance as more ‘efficient’ than the ‘ethical’ approach – in effect, what is an ethical investment is much too often in the eye of the viewer, and too often these ethical funds are too expensive in comparison.

We are a strong believer in ‘green buildings’ and we were one of Europe’s first handful of pension funds to engage in green buildings. Buildings built according to these standards safe resources and energy for a very long time, day by day.

Secondly, rental income on those buildings is higher, because of higher quality buildings, better working atmosphere, and maybe an element of trophy buildings where some corporations want to be in. So it is a financially more attractive investment as well.

We have another example where ESG fits business strategy, financials goals and scheme members’ interests. We are a significant investor in senior housing and elderly care buildings in Germany and potentially Austria; again serving societies’ needs and reaching financial income goals fit together here. ESG further means a thorough look at costs – having been the major reasons for taking the decision to exiting hedge funds (a few weeks before the CalPers decision was announced). Furthermore, we don’t invest in food commodities.

What effects is QE likely to have on VBV?

We’re likely to have a somewhat higher equity allocation – much more European equities than typical benchmarks. We’re also not buying government or corporate bonds at negative yields and intend to move into private capital markets, private debt markets and be selective as to our moves into real estate.

What are your future plans for the fund?

Being one of the intellectually leading European pension funds in terms of investment process and results, further enhancing individualised electronic communication with our all of our scheme members, contributing to sustained economic developments in European companies, societies and countries.
Jerry Moriarty joined the Irish Association of Pension Funds in 2007. As the voice of Irish pensions, the IAPF represents the interests of scheme members, trustees and sponsoring employers. Moriarty was head of compliance with the regulator, the Pensions Board for six years. Between February 1994 and October 2001 he worked as a senior manager in various pensions technical roles with Sun Life Financial of Canada in the UK. He commenced his career with Irish Life in Dublin in 1989.

Dominic Croft joined Profund Solutions Ltd in 1992. Croft is additionally the product owner for P3 Ireland, one of Profund’s pensions administration platforms. Croft’s expertise lies in the technical aspects of pensions and he is a fellow of the Pensions Management Institute (PMI) in the UK and a recently appointed fellowship network ambassador. He is also the chairman of the board of examiners for PMI’s vocational qualifications.

Jonathan Bull led the team that established the Occupational Pensions Defence Union in 1997 with the assistance of a group of independent professionals and representatives from pension schemes. He has been a director of various subsidiary businesses since 1985 and is additionally a lawyer with 37 years’ experience in insurance. Bull has also been involved with The Pensions Advice Archive Trust since its inception and was appointed a director in 2005.
Chair: What’s the current sentiment among the large Irish pension funds? And what are the key regulatory issues currently affecting the Irish pension’s landscape?

» McNally: In our industry at the moment, the main issues are around member outcomes and trying to get members engaged with their retirement savings plan. The majority of our schemes are defined contribution. We have just a few DB schemes left and of course, there are funding proposals in place for some of them. Also looming in the background is auto-enrolment and what kind of effect that would have on the construction industry if and when it does come into existence. We’re also conscious of the pension levy and hoping that it will be finished this year and that no new version of it will begin.

» Croft: As the demise of DB schemes in Ireland gathers pace, I think there will inevitably be greater focus on DC going forwards. I think auto-enrolment will happen; it’s just a question of when. We do need to learn from what’s happening in the UK though because, although it’s been generally well received, it hasn’t been perfect in every way.

» Leech: I think auto-enrolment will come eventually but at the moment I think it’s just been put out there. The issue of costs and member contributions will come after the next election sometime, so it’s a little way down the road. There is a bit more optimism around this, though, because there are more people working and there’s at least the potential there for salary increases, which would mean increased contributions, so that’s good for members and it’s good for the industry.

» McConville: Yes I agree with everything that’s been said up until now. What I’m seeing on the legal side is trustees and employers who are still nervous about where to go
from here. We’ve probably had the most contentious couple of years in pensions and we’ve seen a number of high profile cases, but there are still an awful lot of rows to be had in relation to DB schemes. They aren’t going to go away in the near future so employers remain nervous about pension provision.

» Bull: In the UK we’ve seen some of these changes, as described, and I think there has certainly been, to some extent, a sense of nervousness in going forward. As you’re probably aware, having a proactive pensions regulator in the UK has changed things and listening to people like yourselves, it seems as though you’re probably going through the same process in Ireland, which is largely why we have been approached, to provide protection to take people safely along that journey.

» Cunningham: Yes it certainly seems to be of concern that regulators may get more active and more involved in directing what schemes should be up to. We’ve certainly seen that in the UK, with a much more aggressive attitude on the regulators’ part – wanting to investigate what schemes are doing. That in itself causes a large degree of cost, disruption and uncertainty. Despite the discomfort and the cost the litigation has caused, it did at least set a framework and provided some assurance to trustees that where they do take advice, they can act reasonably on it. So it was very encouraging, even though it did highlight the risk of litigation that trustees face, because they can’t control what third parties do.

» Bull: I think trustees and sponsoring employers in the UK are quite aware that when members wake up to the fact they may not be getting what they thought they might be getting for their pension, there may be a rise in complaints as society is generally becoming more litigious. Whether they have a valid claim or not, there may well be expense incurred to deal with people who are feeling dissatisfied. So that’s the trend, regrettably, which applies equally to default funds.

» Croft: We’ve had the Budget in the UK and the Conservatives are now going to bring down the lifetime allowance from £1.25m to £1 million, which is about €1,400,000. Labour had already stated that, if they had got into power, they would have restricted the lifetime allowance to a similar amount and would have looked to reduce the annual allowance to around £30,000. Is there nervousness in Ireland that a similar sort of thing might occur? There’s also a lot of talk about tax relief in the UK and potentially restricting the amount of tax relief for higher rate tax payers or having a consistent rate of tax relief on contributions, say 30 or 33 per cent across the board. Is that something that has filtered through to Ireland yet?

» Chair: We’ve had a bit of a review of that over the last couple of years, but it’s been parked for the moment. We do have an election next year, though, and I think the concern would be that depending on who gets into power they’re going to pick that issue up again. I wouldn’t really have any personal worries about the levy not ending this year. I think it will, but I think there is a danger that the precedent has been established and the levy’s actually been implemented by what’s pretty much a right of centre party. There are a lot of very left wing parties which are running round the polls at the moment and a lot of their mantras are about taxing the wealthy, so you can imagine something like that would be right up their street and looking at the allowances and tax relief too. So we’re probably ok for now, but depending on what the election throws up, it will definitely be back on the agenda again.

» Leech: But I think the more left leaning political parties will be more likely to look at and reduce the lifetime allowance than have a levy because a levy hits everybody, whereas a reduced lifetime allowance is perceived to hit only the rich.

» Croft: Yes, that’s true. It is generally recognised that the lifetime allowance is more likely to hit the wealthier members of society. Although as it reduces further, it won’t be just the wealthy that are impacted.

» McConville: I think the resurrection of a levy is really only likely if someone challenges the double insolvency order of priority the government inserted into the Pensions Act whilst reaching a settlement with the Waterford Crystal members. It may be that somebody will come along and challenge that legislation at some point in the future. If they do, there’s a chance they might be successful. We’ve already seen from the recent Omega Pharma decision that the funding standard under the Pensions Act, on which the double insolvency order relies, is a minimum level of benefits and not necessarily an acceptable one. So whilst I would agree with Jerry [Moriarty, chair], I don’t think there’s a likelihood that the levy will continue after the end of this year, which is subject to another, future, catastrophic insolvency, which creates the problem which the courts are left to sort out and which the government maybe won’t be able to settle in the meantime.

**Investment**

» Chair: What impact does QE have on our pension schemes and how can and should schemes look to manage this?

» Leech: It’s good at the moment
for investors who hold non-euro assets, but I have a nervousness that today it’s the euro, the dollar could do it tomorrow and sterling could do it after that. So we could all be playing catch up with each other – whoever feels they want to kick-start their economy or their currencies will engage in QE. Therefore, I think it could be, in the longer term, somewhat destabilising.

» McNally: It will trigger other options for investments though – alternatives such as forestry and infrastructure as part of the investment mix for members to choose from.

» Cunningham: It does also create an additional risk for the trustees. If everyone starts piling into buying forests, does that concentrate a risk? Do people properly understand what they’re doing and will it actually deliver what people were expecting, or does that then stir up a different series of problems?

» Chair: Well, you’ve already got that to some extent with infrastructure, in that the infrastructure that really matches pension scheme liabilities – such as some of the big toll roads – are being snapped up all over the world by large Australian, Canadian and Dutch pension funds. So people are getting in there too late.

» Bull: There’s also a tendency for trustees to be judged by hindsight, so that’s a challenge.

» Cunningham: Yes. Default options that we all thought were safe may turn out not to have been so safe, so people just end up investing in those and then finding that yields do suddenly go up and the value of their assets go down as a result. Because of that, someone is potentially going to look for someone else to blame, so it’s a big risk that people need to be conscious of.

» Chair: That leads us neatly onto risk reversing. So, from the beginning of next year the regulator will require you to hold an additional reserve in respect of any risky assets you’re holding (at the moment that is anything other than Eurozone sovereign bonds and certain Eurozone corporate bonds, cash, etc.). So most trustees are being forced into buying assets that most people are saying shouldn’t be bought at the moment. Is anybody seeing the impact of that?

» Cunningham: This is the type of regime that we have had to cope with for some time in the UK when managing insurance companies. The problem from our perspective, is the regulatory position can force you into holding assets, which actually aren’t best suited to the fund. One might regard it as ironic to describe it as de-risking if you’re concentrating everyone into buying particular types of assets. It’s actually concentrating risk, so if anything arises from it, you’ve got a very big problem that could be contagious. It’s difficult if you’re a trustee running a trust-based scheme. You know you have fiduciary duties to the beneficiaries to get the best returns as safely as you can and then you’ve got these conflicting regulatory obligations and pressure pushing you down a route that might not deliver a good outcome.

» McConville: What I’ve found over the last year or so is an increasing number of employers who are looking at exit strategies from DB. You’ve got the employer wanting to get out as fast as they can and some trustees wanting to see how far they can push the employer to make up a degree of the deficit. The trustee is wondering what will happen if the scheme winds up and meanwhile the regulator may be putting pressure on the trustee to comply with legislative funding standard requirements, whilst the trustee is just trying to buy time and reach a settlement with the employer. So I can see the risk reserve perhaps focusing minds, but not necessarily positively for defined benefit schemes. I can just see it adding to the number of reasons why employees would want to walk away from DB.

» Chair: On the DC side Frances [McNally], in terms of de-risking, how often would you look at the make-up of your funds and the level of risk people are taking?

» McNally: The trustees regularly review the different funds available and are very active on the investment side. They try to ensure that the default option they have is the best for the members who are automatically defaulted into it and review its investment mix regularly. We currently have a lifestyle strategy as part of the default multi-asset fund and we are now looking at expanding that to include an ARF lifestyle option. The trustee have an independent investment adviser and are kept aware of the various developments in the pension space and review investments on a monthly basis.

» Leech: Yes, I think in order to have a lifestyle strategy in a DC scheme, it really has to be tailored to the individual member’s circumstances.
Irish pensions Roundtable

Chair: Yes. I think this is probably one area that we’re ahead of the UK in that some providers have those individualised lifestyling options, rather than just a plain assumption that it’s tax-free cash or annuity. On the UK side, with all the changes that have taken place, I assume that’s an area people are going to have to look at as you now don’t know what a person’s going to do with their retirement fund and it’s very hard to make assumptions around that.

Croft: That’s true. At the moment, most DC schemes will have a default lifestyle fund and, generally, most members will be invested in that fund. The perception is that people invest in the default fund because they are apathetic and want someone else to make the choice for them. However, many people are in the default fund by choice. As Frances [McNally] was saying, if you get it right, then it can be the right fund for people.

Longevity

Croft: In the UK there’s a growing appetite for DB schemes to de-risk; for example, with bulk annuity exercises with insurance companies. Is that something that’s taken hold in Ireland yet?

Chair: There hasn’t been a huge amount of activity in this area. I think there’s been a lot of goodwill towards doing the very best to keep the DB scheme going, at least when it comes to employers.

Croft: Albeit potentially with lesser benefits going forwards, such as having a reduced accrual rate for future service.

Chair: Yes, there’s been a lot of work done to try and manage the liabilities, but I think there is a point where people do start to lose patience.

Leech: Once members who are ‘forced out’ of DB schemes into DC schemes realise there will be a transfer value of their accrued entitlement paid to the DC scheme, perhaps bigger contributions and the 25 per cent tax-free lump sum option, they realise it isn’t quite so bad. So, while there is always this dread and fear of DB schemes closing, there can be better outcomes for members.

Chair: Yes, although I do wonder if members understand the value relative to the value of their benefits. Transfer value can seem like a lot of money relative to what they’re going to get.

McConville: Deferred members in particular are waking up to that. Whilst there’s plenty of ways the employer can and may wish to sweeten the deal for active members, deferred members in DB schemes don’t have those advantages and are now becoming quite militant in their outlook.

Bull: I think one of the ancillary issues in the UK that we’ve seen is the tendency for there to be a separation of provision between senior personnel, the company and the rest of the employees, which has perhaps changed the pattern of the way in which pensions are managed and what is offered.

Asset allocation

Chair: What interesting asset allocation trends are we seeing by Irish pension funds?

McNally: We have seven investment options available for members at the moment, and one of them is the default multi-asset fund. All asset classes are covered in the range offered to members without over complicating the offering. In the last year or so, property, forestry and infrastructure have been added to the fund and have widened the range of options for members.

McConville: From my own experience, there does seem to be a reluctance in certain DC schemes for members to go near equities. I think there is a very great need for members to have the opportunity to attend quarterly/six monthly briefings and to be told what the options are and asked if they want to be more involved.

McNally: But where does the trustee’s responsibility end? Obviously trustees can’t give financial advice, but I think they do need to have an independent financial adviser that they can refer members to when it comes to choosing an investment strategy or discussing retirement options.

McConville: A trustee’s starting point needs to be looking at whether they are adequately protected by the trust deed to be offering member investment options. It’s also up to pensions lawyers and their legal advisors to make sure trustees are adequately protected because if they don’t, the trustee or employer could actually end up being sued directly for any investment loss suffered subsequently. So there’s an engagement to be had between the trustee and the consultant.

“Auto-enrolment will include people in a pension scheme who were never included before and it will be interesting to see what the Irish reaction will be”
Insurance

» Chair: Are our trustees doing enough to protect themselves from future liability? Do trustees always know what protection they have with them?

» Leech: No. I’ve been involved in trustee training and often they don’t realise that they’re the people ultimately responsible. I’ve always said to trustees that, if they’re good enough to become a trustee, I think the sponsoring employer at least owes it to them to pay for liability insurance.

» Bull: That was the challenge that we were presented with back in 1996, prior to the implementation in the UK of the Pensions Act 1995. It is a very specialist and complex area, which from our perspective, is quite a challenge to communicate. Policies can look quite similar, but there are differences and trustees need to be assisted in that process. If a member is dissatisfied and there’s a claim, enormous costs can be incurred by the sponsoring employer and/or the trustees in dealing with the matter regardless of the merits of the claim.

» Cunningham: It’s an even bigger issue when the scheme has been wound up and there’s no scheme assets or sponsoring employer to call on and trustees are left to defend themselves. The duties of trustees have always been broad in law, but I think the risks have increased considerably over recent years.

» Leech: Have you found that there are significant risks of this, particularly with the disposal of death benefits?

» Cunningham: We haven’t actually. There haven’t been many claims with regard to discretionary decisions. Like with all decision making, it’s very important to record the process and everything that was taken into consideration. Generally the level of governance is good and that provides protection from those sorts of claims. We see liability mainly from an isolated error where no one can really explain how they did it. With the likes of the Ombudsman, it makes it very easy for people to raise an issue, even if the issue itself is relatively small in terms of its impact on the individual who has made the claim.

» Croft: With DB, it may be that there is found to be an overpayment or an underpayment of a member’s benefits, so it tends to be isolated cases. With DC, administrators could allocate correct units to the wrong funds or they could allocate an incorrect amount of units to the right funds. You could be looking at incorrect transactions that impact thousands of people, so the ramifications for the trustees are likely to be much greater for DC. As they are ultimately responsible, it is imperative that the trustees have appropriate liability insurance in place to mitigate against possible claims.

» Bull: I think trustees are hopefully now becoming more aware. Sometimes wind ups, or potential wind ups on the agenda can trigger people’s awareness to a larger extent, but I certainly would caution people to really think about it well in advance and get insurance earlier rather than waiting for wind-up situations.

» McConville: History tells us, certainly in Ireland, that trustees have had a tendency to be reactive rather than proactive with regard to their own protection. If you look at the history of Irish pensions litigation, the noteworthy cases have tended to be based on a documentary error where the wrong impression was given or taken and trustees and employers have scrambled to try and rectify the situation retrospectively. The courts have been, on the whole, sympathetic towards trustees and employers where this has happened.

» Bull: This is where insurance can provide a great deal of comfort to the trustee and sponsoring employer, because it effectively provides retrospective cover. In pensions, no one knows what’s occurred in the past and these kind of things can come out of the woodwork many years after the decisions were taken, so trustees can be reassured by the fact they are covered by an insurance policy.

Auto-enrolment

» Chair: Moving on towards auto-enrolment, which we touched on earlier. Is it inevitable for Ireland and if not now, when? What can we learn from the UK? How do we tackle inadequacy, if it comes into effect?

» McNally: I think auto enrolment is inevitable and will come into existence at some point. We can learn a lot from the UK experience to see how they are getting on and to ascertain how successful or unsuccessful it has been. Regarding inadequacy, I think it comes down to communicating with members and sponsoring employers of schemes to make them aware of the value of saving for retirement. Auto-enrolment will include people in a pension scheme who were never included before and it will be interesting to see what the Irish reaction will be.

» Croft: Auto-enrolment has been a lot more positive in the UK than was originally envisaged. It was predicted that opt out rates would be about 30 per cent and, thus far, it’s been just under 10 per cent, which is really good. However, you have to bear in mind it is probably this way because so far it’s only affected the bigger employers and it’s generally easier for them to be compliant and promote the concept because they’ve got the resources available. Smaller employers are likely to struggle more. Also, the level of contributions are being phased in, so it’s starting
quite low and then, for the period up until October 2018, it’s gradually getting higher until it reaches 8 per cent. It will be interesting to see whether the opt-out rates continue as they are or whether they will increase as people see a bigger drop in their pay packets over time.

» Bull: It depends on the nature of the industry as well, because there are challenges within companies such as supermarkets, where there are substantial numbers of part-time and casual employees and they have to go through the system and then they may leave, and the required stages of communication are inevitably lagging behind. But there’s been a lot of positive feedback from organisations such as the UK’s Nest pension scheme, who have been pleased with the low-opt out rates.

» Croft: I think if it was compulsory, it would certainly make the administration a lot easier. Although decisions cannot and should not be made on this basis, they do have compulsion in Australia and contributions over there are a lot higher. When compulsion started back in 1992, contributions were set at 3 per cent and they are now up to 9.5 per cent, and increasing over time to around 12 per cent by 2025. People have generally accepted that this is how it has to be.

» Leech: It should be easy to administer, but who would do so? Will it be individual providers, or will it be some sort of central provider? There are issues that need to be looked at and we would certainly have to look at the experience in the UK. I’m also nervous that employers who don’t want to provide good benefits, will simply provide the minimum. It didn’t happen with PRSA’s, but it’s certainly something we need to watch out for.

» McNally: My worry about auto-enrolment now is that there’s too much of a concentration on numbers. It seems as soon as people are enrolled, that’s it. But, as with the Australian system, the key is engagement. There is very high consumer engagement in the Australian system. Most people I talk to in Australia know all about their superannuation pot. They all regularly check online and are engaged as to investment performance. What worries me is that the auto-enrolment system we would be setting up is much more concerned with making sure people don’t leave than it is with actually making sure they engage with the system. I think we have to bite the bullet and go for a compulsory system. Yes it’s going to be painful, but there are ways that we can introduce it gradually as they did in Australia.

» Croft: So how would you introduce compulsion gradually? Would you make it compulsory for people entering the workforce for the first time?

» McConville: Everybody coming into the workforce for the first time, anybody changing jobs.

Communication and engagement

» Leech: It comes back to communication and how we properly engage with members.

» McNally: Yes, it’s key to communicate with members. The adequacy issue doesn’t go away just because somebody is putting money into a pension scheme. It has to be a relevant amount of money to their own personal situation with due consideration of what they would like to retire with. And so again it’s about engaging with them to make them aware of the impact of how much they put in will have on how much they want to get out at retirement.

» Bull: It’s a start though isn’t it?

» McNally: Absolutely! I agree completely, it is a good start. The people who didn’t contribute before will be contributing now, so yes, it should be encouraged.

» Croft: But there are a couple of flaws in the UK model. Auto-enrolment was set up to encourage more people to save, but the people that we’re most encouraging to save are precisely the people that still aren’t contributing because they do not earn above the threshold for when contributions kick in. So, if you’re a part-timer working a couple of days a week, there’s a good chance you’re not even going to break through that threshold. So a lot of the people who it was aimed at to start with aren’t actually contributing at all.

» Chair: Unless those people aren’t adequately being covered by the state pension, which here they probably would be.

» Croft: On the subject of communication and engagement, should we not have financial education that’s compulsory in schools? Teaching people not just on pensions, but on financial education as a whole – to get people engaged at an early age?

» Leech: Yes, people know the price of their car, they know the price of their house but they have no idea of the value of their pension.

» Bull: I totally support that the more education there is the better, but I’ve read research in the past that indicates that even financially literate people often have not taken proper interest in their pensions. So I think there has to be a balance and although the individual must now take some action there is the responsibility on others to assist them.

Administration

» Chair: Let’s go back to administration. What are the key day-to-day challenges currently facing administrators? Is technology being used to its full potential, and is enough being done to ensure that
members data if fit for purpose?

» McNally: With the number of members we have in CPAS, holding accurate member information is crucial. It is vital that we keep that information up to date and have an efficient IT system in place to hold member records, and administer benefits as correctly and efficiently as possible. The documentation that is sent to members is quite detailed and keeping that up to date is also important.

» Croft: I think the technology’s there. I’m not convinced everyone uses it to its full potential, though. For example, there are integrated systems out there that allow members to view and model their benefits online but not all trustees make use of this technology even though it is a powerful engagement tool. Also, I think administrators still rely heavily on spreadsheets or manual intervention rather than have their calculations automated. As well as being inefficient, this is prone to human error.

» Bull: Generally DB schemes have the luxury of putting things right if it’s been discovered that things weren’t quite as they should have been at the point of a member’s retirement. Of course now with DC becoming more prominent, there are transactions going on every single day, so regrettably we see money going into the wrong fund or not the right amount of money etc. So it really is essential that people check on the data, systems and benefit formula. If it’s not done properly, it can give rise to very substantial claims.

» Cunningham: Yes, we’ve had several claims where the automatic calculation of benefits has gone wrong.

» Croft: Sometimes this is not because of the automation of calculations but the quality of the actual data. In my experience, the lack of quality in data tends to be more predominant with third party administration where administrators take the data on and have no way of knowing with total certainty whether that data is accurate. If it is subsequently passed onto someone else it can become even more of a problem. In-house schemes are less at risk in this respect but again it’s by no means always perfect.

» McConville: I do have one concern in the long term and that’s the new postcode system that Ireland is putting in place now. The Irish government has opted for a unique system which operates an absolutely random postcode for each and every individual property in the state. That’s going to create a number of problems. I was talking to UK insurers at a conference last October and asked: “How are you going to be able to base your data on risk data if you’re operating in Ireland with our unique postcode system?” They said: “We can’t.” The other concern is if you have a data administration system that relies on the postcode and that postcode is entered incorrectly, there’s no way back.

» Bull: Many years ago, OPDU organised a meeting between administrators, trustees and sponsoring employers given our concerns about administration and the lack of uniformity of standards. The independent Pensions Administration Standards Association (PASA) has since been formed which has done some very good work in trying to raise the standards and provide best practice guidance to administrators and employers. I don’t know if there have been similar initiatives here in Ireland?

» Chair: Not really no. I think the regulator is trying to pull it together by publishing various documents, though. On a final note, what would we all like to see happening within a year’s time?

» McNally: From CPAS’ point of view, we’re looking forward to the advent of auto-enrolment and perhaps being in a position to be considered as the provider of auto-enrolment schemes for the construction industry. We are also concentrating on member engagement and trying to engage our members by providing access to pension consultants who can meet members regularly. We have also developed online platforms and communication methods to ensure that members are able to actively engage with their pension savings.

» Croft: For the next year, I would like to see a greater emphasis on better quality of data and better use of technology.

» Bull: I agree and I think it’s encouraging to see trustees and sponsoring employers grappling with these issues. Risk management and awareness is increasing and that has to be for the better too. Obviously from our perspective, trustees need to be secure in all that they do.

» Leech: Yes, I’d endorse all of those comments, but I’d just like to add that I do think the economic situation is better and this will feed into the pensions world. This will ultimately make it better for members and better for us. Although we’ve got a long way to go with member engagement, I’m optimistic.

» McConville: I’d like to see the policymakers get together, make the decision as to where pensions in Ireland are going to go, to communicate that, to stick to that decision and to implement that decision. We’re great at having committees, we’re great at coming up with big visions for the future, but we’ve got an awful record of implementing them. Now is the time for us to do what we say we’re going to do.

» Cunningham: And hopefully you don’t see many high profile cases of litigation against trustees over the next 12 months.
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European Pensions
It seems a long time ago that the European stock markets were spiralling downwards into turmoil. The atmosphere on the markets is distinctly more serene today – so much so that those days of frightening headlines and front page photos of brokers with their heads in their hands seem to belong to the past. “It’s quite easy to forget just how bad it all looked in 2012,” Invesco portfolio manager Stephanie Butcher says. “If you go back to the beginning of 2012, the markets were beginning to price in the European Union split. Sectors such as financials and countries in the periphery were trading at significant discounts to their long-term averages.”

Things did indeed look dark, with country after country facing credit rating downgrades and knife edge talks causing deep concerns. But things have, fortunately, moved on for the European markets. “Gone are the days where European growth was completely stagnant and negative, and we had nothing but high debt, a lack of competitiveness, political difficulties being highlighted every day in the newspapers, and awful battles between core and periphery countries,” Columbia Threadneedle European equities manager Ann Steele comments. “Seven years after the crisis, there is no doubt that Europe is looking brighter.”

The main turning point, she says, was the decision of European Central Bank president Mario Draghi. In July 2012 Draghi made a speech that would see him dubbed ‘Super Mario’ which he began, perhaps surprisingly, by comparing the euro to a buzzing insect. “The euro is like a bumblebee. This is a mystery of nature because it shouldn’t fly but instead it does. So the euro was a bumblebee that flew very well for several years. And now – and I think people ask ‘how come?’ – probably there was something in the atmosphere, in the air, that made the bumblebee fly.” The bumblebee, he said, needed to become a real bee and fly. And to get the euro to do that, Draghi made a firm statement. “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough,” he said.

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“What we are seeing at the company level is green shoots,” Steele adds. “The markets are up about 18 per cent in the first three months this year, and there is no doubt US mutual funds are yanking money out of every other asset and putting it back into European equities where they have been conspicuous by their absence.”

In January 2015, Draghi announced his quantitative easing, which was larger than anticipated. “The combined monthly purchases of public and private sector securities will amount to €60 billion,” he said at an ECB press conference. “They are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation.” The first wave began in March 2015.

Positivity
And now, Steele says, the outlook is looking positive. The euro dropped
to 11 year lows against the dollar, which is great news for European companies looking to export goods. And the fall in oil prices has also had a beneficial impact. “Lower oil prices have really cut energy and raw material costs [for companies] and raised consumer purchasing power. You can see a real difference when you fill the car up, that gives you an extra £10 in your pocket that consumers will spend,” Steele states. Furthermore, an ECB bond buying spree will also help move things along. “This is really pushing already low borrowing rates even lower. Credit conditions are evening, and that’s good for large cap, mid cap and small cap equities across Europe.”

Change is also being driven from within individual member states. Some of those countries worst hit by the crisis have had to take serious steps to get their economies back on track, and this has led to some positive developments. “What is interesting is that, if you look at some of the countries that were in the greatest trouble at the height of the crisis, the actions they have made are real and genuine and quite profound,” Butcher comments.

Spain is perhaps the clearest example, with wide-reaching labour reforms, banking consolidation, pension reforms among the changes implemented.

“The seeds are being sown for an economy that will be much better, on a longer-term basis, than had the crisis not happened. It has a much more balanced economy, it is more competitive, more productive and so on, and I think the same goes for Ireland and Portugal,” Butcher says. Some countries, of course, have been slower to make changes, but Butcher says Italy is beginning to move in similar directions.

As for France: “It’s not a secret that France is lagging in terms of structural reforms. I think they are beginning to get that and some of the political changes there are good,” Butcher states. “But it is easier to make changes when your back is against the wall than if your economy is sort of doing OK, which is the case in France.”

**SOME OF THOSE COUNTRIES WORST HIT BY THE CRISIS HAVE HAD TO TAKE SERIOUS STEPS TO GET THEIR ECONOMIES BACK ON TRACK, AND THIS HAS LED TO SOME POSITIVE DEVELOPMENTS**

**Company changes**

But it’s not all been about political reform – changes within companies have also been hugely significant, Steele argues. “There is no doubt that the real heroes have been the very astute finance directors. They have been very prudent, they have managed their costs very efficiently and they have been survivors ... You can see in car companies in Germany, for example, there are continued cost cutting efficiencies being announced by these companies and I think we will go on seeing this, so the good disciplines that we have seen as a result of these are something I hope will carry us into the future.”

But Europe does not exist in a vacuum; for all the efforts of the ECB, member states and individual companies, positive external influences are essential to a robust recovery too. “We are at the stage now where three-fifths of the sales of the large cap companies in Germany, France, Italy and Spain are outside their home market,” Steele adds. And one of the key factors is the US.

“History shows that as an equity market, Europe is playing second fiddle to the US,” Heptagon Capital portfolio manager Christian Dieb underlines. “I believe that the rationale is simple. The US is the only economy in the world that ultimately has the ability to meaningfully move the needle as far as global economic activity is concerned. The key reason is that the US is a consumption-led economy. Hence, once US households decide to start spending, Europe (and Asia) are in positions to export their way back to recovery.”

With the green shoots and improved growth forecasts – the European commission increased its forecast from 1.1 per cent to 1.3 per cent for 2015, and 1.9 per cent in 2016 instead of the previously forecast 1.7 per cent - the picture is looking rosier than it has in a while, and pension funds in other regions, as well as Europe itself, have been taking more of an interest. “It’s an area the Americans have started to reinvest in, and we have seen a lot of requests from Asian and Latin American pension funds as well as Europe domestically,” Steele says.

Nonetheless, Europe still causes jitters – although pension funds are arguably best placed to look at the long term and absorb fluctuations, the prospect of high volatility can be off-putting. “It is a region that people are always quite shy of for that reason,” Butcher emphasises. “But if you look at the whole sovereign debt crisis from a currency point of view, the euro remained remarkably stable, and from a stock market point of view, by not investing in Europe in 2013 you missed out enormously, and 2014 was also decent.” It is, says Butcher, too big and too important a region to leave out of a portfolio. “If you are looking at the sorts of businesses you want to invest in – high quality, strong balance sheets, potential to grow – Europe genuinely stacks up on that basis.” ■
A critical selection

Pension funds across Europe have traditionally had very small investment allocations to quoted small-cap equities. Lynn Strongin Dodds looks at whether now is the right time for small cap investors to flourish and whether small cap can outperform its mid to big cap counterparts.

It has been well documented that small stocks outperform their larger brethren on a risk-adjusted basis over the long term. However, the ride over the past few years has been bumpy, causing investors to be wary. Easing monetary policy and an improved economic picture in Europe has sparked renewed interest but institutions are advised to do their homework and be patient.

Small cap interest
For example, the European small stock contingency had a patchy 2014 but this year has gotten off to a promising start with the Stoxx Europe Small 200 index gaining 16.5 per cent year-to-date. Meanwhile, the European Central Bank (ECB), which started injecting around €1.1 trillion into the eurozone economy, recently raised its forecast for the region to 1.5 per cent, up from its previous 1 per cent. Analysts also followed suit, increasing their estimates for company earnings this year and next.

This is in contrast to the last three years, according to Standard Life Investment’s European small cap fund manager Andrew Paisley. Typically, analysts have made downgrades as the year progressed but in 2015 we are seeing them make upgrades. This is due to the quantitative easing and the weakening effect it has had on the euro – driving it down versus other currencies - as well as lower oil prices.”

J.P. Morgan Asset Management European small cap manager Francesco Conte agrees, adding: “Oil prices and the weaker euro are now massive tailwinds where they used to be headwinds. They should accelerate growth in Europe and we believe that small caps will benefit more than large caps because many have greater exposure to the domestic economy.”

The other factor is that the potential exit of Greece from the eurozone is not casting the same shadow over the periphery that it did three years ago when the country’s deep rooted problems first surfaced. Although it only accounts for 2 per cent of the eurozone’s GDP - not much bigger than that of Madrid or Milan - the prospect of Greece leaving not only terrified financial markets but threatened to break-up the union. Today, there are still fears over the systemic consequences, but ECB president Mario Draghi recently noted that the region was better equipped than it had been in the past to deal with a new Greek crisis, although it warned of “uncharted waters” if the situation were to deteriorate badly.

“If Greece leaves the eurozone there will be problems but they are likely to be more confined to the country itself,” Russell Investments senior portfolio manager, European equities, Ronnie Sabel says. “There is less concern than in 2012 over contagion to the periphery markets because they will not be as impacted today. Spain and Italy are showing signs of recovery and the bond markets are not reflecting the Greek problems.”

Perhaps what is more uncertain is the soundness of an economic upturn in Europe. “I do think small caps are well positioned to benefit from a pick-up in the economic growth because they are more sensitive to cycles and also their indices have a greater weight to the industrial sector,” Carmignac Gestion portfolio adviser and member of the investment committee Jean Medicin says.

“However, the question investors have to ask is whether the support from the weaker euro and lower oil prices are temporary factors and how this can translate into a sustainable recovery and structural reform.”

Large vs small
Large caps have a better chance of weathering a storm because their operations and revenue streams are more diversified and global. By contrast, their smaller counterparts are not household names and are often low down or not even present on an analysts’ radar screen.

Research from J.P. Morgan Asset Management shows each European large cap stock has on average 17 analysts compared to the average small cap European stock that is followed by only four analysts. This lower level of coverage though provides an opportunity for active investors to add value by selecting the most attractive opportunities.
from a broad universe of over 1,500 European small cap stocks. Skill is required though to not only to identify the successes but also to avoid the failures.

Approaches
This perhaps explains why fund managers typically prefer a more dynamic approach and rely on sound fundamental bottom-up research to select stocks.

“I believe that investors get a better risk-adjusted return profile from individual stocks than from investing on a sector basis,” Hermes Investment Management head of small and mid-cap investment team Hamish Galpin comments.

“In general, the classic reason that investors like small caps is that they grow faster and are nimbler than a large conglomerate. They still offer value today, although they are not as cheap as they were, in that they are trading above their long-term average price to earnings, but they are not excessively expensive either. At the moment specific companies in the defensive sectors such as breweries, drinks and utilities have done well but I think going forward high quality cycicals, particularly in the US, will make a comeback as the Federal Reserve raises rates.”

Conte believes there is a sweet spot in the €1 billion to €2 billion camp. “In the less than €500 million space there is a lot of upside potential but there is risk from a liquidity point of view, while above €2 billion there are also good opportunities but I think the best place to be is in the middle. We look for companies who are global leaders in niche areas, with significant potential to grow their market share. For example, in Europe, we like a company called Brembo, which is a world leader in the brakes for sports and high-end cars.”

Other companies on the JPAM list include Duerr, a world leader in paint systems for car manufacturing as well as a beneficiary of stronger consumer demand for autos, digital hearing aids group GN Store Nord, dental implants firm Straumann and German manufacturer Rational, a leader in steam and convection heating with a 60 per cent global market share.

Paisley on the other hand, identifies “change situations and companies where there is not a consensus view”. “This includes Swedish-quoted Loomis, which is a cash management and transit specialist in Europe. We believe in putting a small cap allocation squarely into an equities portfolio because it will deliver the alpha a pension fund needs.”

Despite the preference for stock picking, there are a few themes being played out. For example, European-based exporters, which are the largest section of the small cap universe, as well as industrials, are popular choices because they are benefiting from the currency depreciation and more bullish outlook. Companies that are reasonably priced and have strong competitive positions are also appealing because they may be on a takeover list. Last year saw a spate of deals including Glencore Xstrata’s $1.35 billion acquisition of Caracal Energy at a 61 per cent premium, Cirrus Logic’s £291 million purchase of Wolfson Microelectronics at over a 70 per cent premium to its trading price and Nordic Capital’s $370 million purchase of real-time graphic firm Virzt at a 32 per cent premium to its closing price.

F&C European Small Cap fund manager Sam Cosh believes that investors need to look at the ‘bigger picture’. “Valuation multiples can be blunt tools and do not necessarily take account of the potential profit growth that smaller companies can offer were we to see a recovery in Europe. The growth that smaller companies have delivered historically is after all one of the main reasons why the asset class has beaten its larger counterparts over the long term,” Cosh explains.

There are several studies that support this. For example, since the market bottomed in March 2009, the Russell Top 50 index of the largest US companies has gained 111 per cent compared to the Russell 1000, which is up 150 per cent. Meanwhile, Russell 2000, the most widely used benchmark for the performance of small-cap stocks, has climbed 197 per cent.
Global equities roundtable: EXPLORING THE LANDSCAPE

Panel:

CHETAN GHOSH
Chief Investment Officer, Centrica
Chetan is the chief investment officer for Centrica’s pension scheme arrangements within a Common Investment Fund and has held an in-house role for the last five years. He is responsible for providing support to the directors of the Investment Committee. His role covers investment strategy considerations, asset class and manager research, and the liaison with the investment advisers.

SUZANNE LUBBE
Researcher, Mercer equity boutique
Based in London, Suzanne focuses on global and global ex-US equity managers and is co-lead researcher. She joined Mercer in June 2011 from Investment Solutions, a multi-manager, where she spent five years. Suzanne was the portfolio manager of Investment Solutions’ UK and Global equity funds and was responsible for all UK and global equity research. She previously consulted to pension schemes in South Africa.

JEFF MUNROE
Investment Leader, Global equities, Newton
Jeff is investment leader of the global equities team, and manages a range of global equities portfolios. He also chairs both the global model group and the global ex US equity model group, and is a member of the Newton Board. Prior to his current role, Jeff was CIO at Newton from 2001 to January 2012. Jeff has completed an MBA, and is a CFA charterholder and a member of the UK Society of Investment Professionals.
Chair: How positive are people feeling about global equities in the current climate?

» Subjally: If one looks back, the last six to eight years have been great for equity markets. MSCI World is up 150 per cent, so it has been a fantastic time to be invested. But it is very hard to make the case that the next several years are going to be as good as that. In that sense, the easy money has been made. Now, we can get into talking about equities’ valuation relative to other asset classes but I think there is still a lot going on in equities. One can talk about whether valuations are expecting recovery and future growth, but at the same time we are witnessing a lot of change within equity markets and within the real economy. That creates opportunities. So I think one, as ever, should take a long-term view and this leads to a reasonably attractive outlook.

» Richardson: I think people are reasonably positive. For the long-term investor, depending on the profile of the scheme that you are investing on behalf of, it is positive but there is this question mark building up on valuations because of that 150 per cent rise of MSCI World index. Schemes have to weigh up carefully what their risk tolerance is. How are they modelling their percentile risks for their assets and liabilities? There are alternatives for diversification but it is not an endless list of alternatives. Most schemes feel fairly positive about maintaining their equity profile and perhaps gradually downsizing as the scheme matures.

» Munroe: There is so much you can say about today’s environment that is truly extraordinary, especially surrounding the whole investment backdrop and the involvement of central banks. There are a significant number of distortions because of the policy involvement of the authorities...
and there is a real quest for yield globally as people are looking for income. Bonds all of a sudden are not yielding very much and record numbers of bond markets globally are offering negative yields. Against the context of being more highly valued, equities are attractive but my argument is that you need to be really selective. I think there is also a lot of technological change going on with a lot of business models being destroyed, and a lot of newer business models that seem to be in the ascendency.

» Lubbe: We can’t ignore the fact that markets have risen, probably more strongly than any of us expected. In light of that, beta is less easy to play and we are focusing more on alpha generation and being selective in opportunities pursued.

» Ghosh: In terms of what others have said, I slightly dull down the level of positivity that we have. Certainly not negative, but I think we are in a position where we just about feel ok with our equity holding. Given that we are a long-term investor, we have mainly focused on valuations and trying to shift the balance of probabilities into our favour. Valuations currently do not look fantastic. That said, against a backdrop where you have very low interest rates, low oil prices, corporates that have generally repaired balance sheets and typically not doing stupid things with their capital and finally where people are in the hunt for yield, you can think of quite a few tailwinds for holding onto equities. We are very cognisant of the counters to that, which is the six year bull run. We have mentioned what the MSCI has done and indeed the S&P has done 200 per cent plus in that time. There is also a lot of macro uncertainty across Russia, Greece and the emerging markets which means there is seems to be a constant cloud hanging over equity investment. Putting that all together, we are just about getting comfortable with keeping hold of our equities, but we are thinking about how we can protect ourselves if there is an unexpected downturn in markets, possibly by rotating from higher beta managers to lower beta. Can we put in any other types of equity strategies that have better downside protection? That is where our thinking is going at the moment.

» Chair: There seem to have been some pretty big idiosyncratic shocks that have potentially really upset people. Abenomics had a huge impact, as did Draghi in Europe, while the US has confounded many people for five years now. If I look at attribution reports that are coming through from managers, it seems to be that the US is a drag on performance. Can people actually pick stocks? Can people add value?

» Ghosh: We tend to favour global unconstrained managers when allocating our equity capital. The theory is that they should be able to pick all of these macro and micro trends. What you find is that while they do to some extent, they probably don’t do it in a way that fully expresses their conviction. So actually, if they think that the US is expensive they might dull down their weighting from 50 per cent to 40 per cent but they actually won’t stay away completely. It is difficult to get that pure expression of genuine alpha from managers. That said we do philosophically believe that it is best to hand over those sets of decisions to our fund managers, provided we can find the fund managers skilful enough to take advantage of it.

» Lubbe: If we look at 2014, a manager’s weighting in the US was a big component of their performance. There are portfolios with less than 20 per cent in the US. In our view, it is about taking risk but being aware of that risk and over the long term, we do think that the managers who are picking best ideas and are putting that together in a sensible portfolio should add alpha.

» Munroe: I think geographies are pretty important. I don’t know that we have any geography that is in some senses a lot better than any of the others. Ultimately we are still in a dollar standard world, and I think the way that the US creates liquidity globally is very important. I think global liquidity ebbs and flows and I think that is a big feature and currencies are also key. The current environment favours us to be a little bit more allocated to the developed world.

» Richardson: This is where you want to use your advisers and your managers because the trustee board is not normally the best place to be determining geographical allocation. It is better to use people who are looking at that full time. I wonder if the panel think there is a difference between European equities and other regions, because the regions may have their different prospects based on economic fundamentals or demography, but in Europe part of the performance is driven by the dysfunctional monetary union without fiscal union and therefore that carries the uncertainty of when or if that may be sorted out. I can see Europe as being potentially, if anything, a higher risk, because it has got a monetary union dysfunctionality.

» Subjally: This regional question is becoming less and less relevant. For instance, just look at the UK and the proportion of the FTSE’s profits that come from abroad. One has to become more granular and look at it by industry or company. Structuring things by region is not helpful as it constrains investment choices. I would say the same thing about emerging markets.
Chair: Clearly it has been a disappointing few years in the emerging market world and people are losing faith. Where will emerging markets be in 10 years time?

Subjally: Expectations got very high. In the aftermath of the financial crisis you had significant stimulus from countries like China and emerging markets rode a resources and energy boom that was further magnified because of a lack of liquidity. Now that the stimulus is over there has been a lull and expectations have had to be adjusted downwards. Emerging markets are more and more connected with the rest of the global economy and so have faced political and economic headwinds from the slowdown in developed markets. Other factors such as global liquidity and the small cap effect have also impacted emerging market returns.

Chair: Emerging market managers have generally been struggling; while there have been a few exceptions, there are consistent themes of underperformance.

Lubbe: Within emerging markets, the countries are so diverse and there is such a divergence of performance and a divergence of valuations. Over the long term, we still think that emerging markets offer an attractive opportunity, as this is where growth will come from. As investors we always need to be careful that we don’t just ignore the risk. I think often people think that emerging markets are wonderful, let’s pile in, but actually they are classified as emerging markets because they still have levels of volatility and risk attached to them. That is something that we too easily ignore when returns are good.

Chair: You have a period of time when, in the developed world, every single stock is highly correlated with each other and we are told managers can’t generate any performance in that context. There are big discrepancies between countries within emerging markets and sectors. Again, emerging market managers are really struggling to generate performance. What is the pension fund view on this?

Ghosh: Looking to the long term there is an incredible structural tailwind. We are talking about a marketplace that probably houses half the world’s population. There will invariably be good company stories over that time, as technology saturates these households. Indeed, there is a growth opportunity to be exploited. I think in terms of the most recent period of stock market return weakness we have picked up “Emerging markets are more and more connected with the rest of the global economy and so have faced political and economic headwinds from the slowdown in developed markets” that the index for the emerging markets has been skewed towards the state-owned enterprises and actually if you dig below that there has been fairly healthy performance. It again comes back to whether the managers are actually doing what you want from them in terms of looking at the idiosyncratic opportunities rather than being slaves to the benchmark. While we have a great level of negativity about the emerging markets, it might just be a good time to start thinking about having greater allocations. History shows us that if you have that contrarian approach then it might well pay dividends for a long-term investor.

Subjally: There is growth in emerging markets and equity investors tend to follow growth. However we believe that equity markets are driven by profitability rather than just growth. I think that is why a lot of managers make mistakes by diving in looking for growth. What we have observed in emerging markets is that while there may be huge growth in demand, quite often there is a bigger growth in supply. So if we look at the Chinese beer market, or iron ore, there has been a huge growth in demand but supply has quickly outstripped it. The growth in demand can be quite seductive and dangerous. We believe that one has to be quite specific and granular in investing in emerging markets and one must be disciplined about looking at profitability because that is what drives value.

Munroe: We are in an era of terrific opportunity in the emerging world for a whole range of reasons. There are some great demographics out there but you can go through periods of time where capital gets misallocated. Returns on capital are the important thing for me. China used to be quite small but it is now 18 per cent of global GDP so these areas are increasingly important for long term investors. We will probably look back and ask ourselves, why were we so worried about emerging markets?

Chair: As a pension fund, how can you best access the global equities asset class?

Ghosh: In our approach we have a balance of passive and active with the majority skewed towards active investment. We hold passive because it helps a lot with our operational processes like rebalancing, automatic de-risking mechanism and currency hedging. What we have learnt is that active management is probably a luxury item for pension schemes if you have the resource to investigate
it well. You also need an emotional robustness to deal with under-performance and because we have a decent amount of in-house resource we feel equipped to deal with the emotional and workflow aspects of an actively managed program. We would typically employ active management to fulfil strategic purposes that we seek from our equity portfolio, so we very much focus on risk and return. We might happily accept an active manager that is level with the benchmark but would deliver a 20 to 30 per cent volatility saving. Being able to give us that boost in a severe downturn is quite valuable. We try to engage with these managers so we get the best expression of their skill and their ideas. Typically, we don’t set our managers’ benchmarks, but we understand how they like to invest and we back that. Furthermore, we will try to give our managers the widest universe to make those relative value judgements. We used to have 55 per cent of our equities domiciled in three countries. That was too much. Spreading the balance between countries is important and I think the Swiss currency and equity market movements this year is fresh in our minds. Even if you think everything is globalised, you can have country specific impacts and so making sure that you force diversification in your equity portfolio has been quite important.

Richardson: Generally speaking, this asset class can be accessed through outside experts and through investment consultants. Even if you have a sophisticated trustee board or investment subcommittee, the largest consultancies would tend to argue that their fiduciary management offering is the best way to access different classes, in particular equities. There is a lot of sense in that subject to reasonable cost. Pension funds have a bit of a herd instinct regarding allocations of all types and they seem to just follow trends of other pension funds. This has a poor history. Pension funds are directed so much towards short-term measurements, whether they be accounting measurements or discontinuing measurements vis-a-vis their overall strategy that they have less time to consider the specifics of how best to access the equity market.

Lubbe: We sat down and thought about how an equity portfolio should be structured from a client perspective, considering what has worked in equities, why do equities go up, and what is driving that? We have broken it down into a number of different factors. How the clients access these factors depends on the client and differs from one client to another. Some may prefer a passive route or fundamental indexation type routes or through active management.

Subjally: When I look at the equity market at any point in time, I see some good businesses that are growing, that have a future, are creating value and are relevant to the next 10 to 20 years; for example, Google or Roche. I also see some bad businesses that are in gradual decline and will be worth substantially less in five to 10 years’ time. Then there are businesses that are undervalued and there are businesses that are overvalued. As an owner of businesses, we are really only interested in very few – just those that have a future and are undervalued. I do not understand why one would want to own bad or overvalued businesses, but this is exactly what one is doing if one is a passive investor and buys the whole market.

Owning businesses means taking a long-term view and being prepared to be wrong for a while. One has to be emotionally robust and learn from mistakes. The other issue is diversification. As a stock-picker, unintentionally loading onto one group of factors can be dangerous so one has to diversify. It is important to focus on idiosyncratic risk and this means you are not doing the same thing as everyone else.

Munroe: It is pretty challenging setting out an asset allocation. It has to start with the structure and demands of the liabilities. Investment ultimately is about security selection and preserving your purchasing power. We live in a dynamic, fast-changing world. The big problem today in some senses is the power that we have under our desks, in terms of the ability to analyse,
compare and measure, which means we are always very focused on the immediate. The real opportunities come by being able to look at things a bit longer term but sometimes our desire to measure and evaluate shortens the focus a lot.

Ghosh: European pension funds can best access this asset class by investing when it’s cheap and staying away when valuations are expensive.

Lubbe: The difficulty comes in around emotional robustness because many investors find it hard to go in when the markets are cheaper because often they are cheaper for a reason and this takes some courage.

Chair: The overwhelming range of different opportunities and the ways you can build equity exposure today is staggering, yet at the same time the complexity you can end up with is off the charts.

Ghosh: The building blocks that pension schemes now have is unprecedented. There is a fabulous opportunity set. Pension funds should go through a process of actually thinking about what factor exposures and systemic biases they want in their equity portfolio. If you don’t have the time budget to go and select active managers you can still do a lot with actually making those strategic decisions about what you want to get out of equities.

Chair: Looking at alpha, can we actually find it and can we as consultants help clients choose it? Part of the context for that is the selection process, where the trustee board will often be given the shortlisted three of four managers to choose from.

Lubbe: Alpha is scarce. We have nearly 1,000 global equity strategies in our core universe. It doesn’t even touch on strategies focusing on low volatility or value or growth – purely core. There are many in that universe that are not going to generate alpha for clients and that is something we are very aware of, which is why we support clients accessing their exposure to certain factors passively.

Chair: I agree that alpha is scarce, but how do you make the case for alpha in global equities?

Lubbe: As more clients move passively I think that creates greater inefficiencies in the market because not everybody is looking at the stocks and modelling them. It creates more opportunities for active management. I believe there are managers out there that can add alpha over and above their beta decisions. I also recognise that for some clients that is not appropriate, where they might not have the governance budget and the alternative is to invest passively. The amount of client capital I think has been destroyed by clients going from an underperforming manager into an outperforming manager only for that to become an underperforming manager is heartbreaking.

Munroe: I have great sympathy with the desire for people who want to access the returns of the asset class. Clearly equities over the last 15 or 20 years have pretty volatile. In the S&P500 we have had two 50 per cent declines since 2000. That volatility has been tough for people, especially for people who have an obligation as a trustee to look after other peoples’ money. Since 1980, we have had money getting steadily cheaper, in some senses equities getting steadily more expensive with some big drawdowns between big bull market environments. Passive makes great sense in big bull markets but I think when you get into different kinds of environments security selection really plays an important role. Active should work keep going forward. I do believe we have to be quite selective and get away from the benchmark and back our own views about how we see the world changing. There is clearly a huge amount of competition out there and equities offer a lot of opportunity.

Ghosh: There is another dimension in our thinking when it comes to the pursuit of alpha, and that is capacity. Not just at a manager level but of the market as a whole. We try to think about what is the level of active money out there relative to the whole opportunity set. If too much money seeks active return in too short a time then that can just kill the alpha across the board for the whole industry. We saw it in active currency five to 10 years ago, we saw it in local currency EMD a few years ago where managers across the board had track records of 3 per cent alpha and since a £200 billion swamping of money into that asset class, they have mostly gone to negative alpha across the board. We try to think about can the market cope with the level of money out there? Systemically within equities, I think we are seeing a trend where institutions are net sellers of equity, certainly insurers, and a lot of pension schemes. The DC schemes that are coming on board, it is half and half whether they are going active or passive but certainly in the UK a lot of the DC money goes passive. All this could create alpha opportunities in the future.

Chair: A lot of people are thinking that some of the things dressed up as alpha are actually smart beta. It might be a bit easier to access with more capacity.

Subjally: There is alpha available in equity markets and we as an industry need to find new ways of harvesting that alpha and delivering it in an efficient manner. First there is alpha generation. The source of alpha generation as I see it is investing in great businesses at the right price. Research and analysis of the
Global equities

Roundtable

past is easy to do, but forecasting the future is much harder. We have to think differently and have to look for new alphas sources. Non-traditional areas such as corporate culture and ESG, are new sources of alpha. Then there is capturing this alpha via portfolio construction. It is very easy for us as stock pickers to come up with our 30 or 40 best ideas, but as a portfolio it could have significant unintended biases. You could have a small cap bias, an energy bias, a volatility bias, or a beta bias. All these biases can creep in and significantly impact returns for several years. Risk only gives a positive long-term return when it is combined with skill, but taking unintended biases has nothing to do with stock-picking skill. So knowing how to measure, monitor and manage those risks in a portfolio is very important as it means that your returns are then driven by your idiosyncratic alpha.

» Richardson: The process whereby trustee boards may have a shortlist of managers is really bad. Gradually people are moving away from that style of process, just because if you have not got the governance budget to properly do it then it doesn’t work. Most trustee boards cannot really monitor that.

» Chair: Can ESG be considered an alpha generator?

» Richardson: It is developing and is a hot topic. I think it is too early days to say and when you are making calls whether the time is right, it is important to take into account the risks involved and governmental factors.

» Ghosh: We would all love to believe the story or theory that ESG can be a source of alpha. The difficulty is actually does that bear out in practice. The way we come at it is that if you narrow your universe so that you are only going to go after companies that are ESG compliant, we have to justify that narrowing of the universe in terms of the best interests of our membership by getting outsized returns. If we cannot have a high probability that will happen, then we feel slightly torn about narrowing our universe. We have looked at ethical funds over the years and we are yet to find one that has sustainably outperformed.

» Chair: They are probably coming in after the outperformance has already driven things up.

» Lubbe: We have a responsible investing team and on our global equity team we have someone who sits with one foot in both. ESG is something we look at. Every manager that we assess we will also assess on ESG. Most managers will look at governance but less will look at environmental and social. We have not seen any evidence that ESG is an alpha generator, but we recognise it is a risk mitigator. Reality is that, the economy has to be diverse and we cannot only have socially responsible industries.

» Subjally: It is important to look at how ESG is approached. If it is implemented as an overlay, that someone comes and tells you that you cannot buy three particular stocks for your portfolio, then there is definitely an alpha degradation as a result of that because you are narrowing your universe. But if you integrate ESG into your investment process and you think like an owner of a business, then ESG analysis can be considered as an alpha source. Fully integrating ESG into the process means that the person making the investment decision is in possession of all the facts, can determine how they impact the investment case, including valuation, and is in a position to engage with the managers of the business representing the interests of asset owners. Engagement is a vital aspect of ownership. Representing the owners’ interests through engagement is not only a duty, but is also potentially beneficial for the owners’ wealth. There are three reasons for this. First, it ensures good stewardship of the asset owners’ original capital. Second, actively engaging with a business increases knowledge and understanding. This helps the investor form a more accurate assessment of the firm’s risks and opportunities. Third, engagement can effect corporate change and improve businesses.

» Chair: What is your perspective on smart beta and what do we feel about it as a potential halfway house between beta and alpha?

» Ghosh: I think it opens up dramatically the options for pension schemes to structure how they want to access equities and that can only be a positive development for the investors involved. Being able to access those factors at a better price is also a key attraction in itself. The only thing I’d say is don’t go into whatever option one chooses in the smart beta space without actually giving it due thought first as you might find there are unintended outcomes. If you believe that actually low volatility equities are a free lunch and they give you extra return with less volatility, well yes that is an observation over recent history but is it the case that will necessarily persist? I always get scared when people backfill economic rationale as to why this should happen.

» Lubbe: There are a lot of active managers out there who are just actually providing beta but charging active fees. That is not helpful to clients and there needs to be a greater awareness of what clients are getting for the fees they pay.

» Subjally: I think that smart beta is a big step forward for the industry. If you really want factor exposure, for example small cap value with a certain dividend yield, then that is
very efficiently delivered by quantitative techniques, whether you call it smart beta or something else. For us as stock pickers, it is about minimising all the factor exposures in a portfolio and focusing on the idiosyncratic return. We use multiple risk models to do the opposite of smart beta.

» Munroe: The availability of data is the big transformation really. Now that you can create a different index based on profits or other metrics, is an improvement. If that enables people to get something that better suits their needs that is probably good but I suspect that in some senses the enemy of investing is complexity. Trying to blend things like large cap value, small cap growth etc, it can get more challenging to get the right kind of end result. Complexity is not great, we need to try and keep things simple but to the extent that these create better tools for investors.

» Ghosh: Can you do better than blindly following the market cap and our conclusion was yes. In part, many others have reached that same conclusion and that has been a big driver as to why this market has developed.

» Munroe: Baltimore Technologies is a great example. It became a FTSE 100 company in 1999. Where is it today?

» Chair: Looking ahead, what is your outlook for the asset class?

» Richardson: I don’t know whether we are near the end of the bull market or not. There is a building concern about the bond market in my personal view and that in the end will lead to bigger concern in the equity market. I don’t think we are at that point yet though. I think if you compare the current valuations with the 1999 valuations we are on a higher dividend yield now than at that time. There is scope for growth yet. Europe has still got a long way to go before it can function efficiently. If you take the impact of monetary union on southern Europe versus northern Europe it is quite extremely different so that is a major problem. Personally, I don’t find much favour in European markets.

» Munroe: We started in the 1980 environment where we had equities yielding 6 per cent on 8 times earnings and we are in a very different place today. Bond yields were at that time 18 per cent in the US. It has been a huge glide path. I am overwhelmed by the abundance in our world today. In the 1800s we went through very, very long deflationary surges and I can see bond yields staying lower giving our demographics and the abundance we have created. I think that equities have a great future as I don’t see an imminent increase in price of money. It comes back to finding the right kind of businesses and the right kind of management who can drive those businesses all within a valuation context that makes some sense. The ESG point is interesting. We try to embed ESG analysis into all of our holdings. We want to be with quality companies, so you want to be encouraging companies to make the right decisions.

» Lubbe: Over the longer term, we remain optimistic on the outlook for global equities but recognise that the risk premium for equities may possibly be structurally lower as we have lower growth across the globe. The risk we are concerned about is valuation at a top level and that clients rush into the next investment trend without considering its suitability.

» Subjally: What does really excite me about the equity market is the degree of change, the behavioural change in the way we consume, the way we communicate etc. There is a huge amount of value creation and productivity improvement that is taking place. There are winners and losers which makes it a very exciting time to be investing right now.

» Ghosh: Over the long term we are proponents of equities. I’d be mindful of the dynamic within UK pension schemes where there is a systemic de-risking. They will be owners of less and less equities over time. It becomes more difficult when you are in that de-risked mode to hold a volatile asset. Over the coming nears, we are proceeding with caution. We will look to valuations. From a personal view, in terms of what might trigger the next major downturn I can’t help but feel it will be the interest rate rises. There is some quite good analysis out there showing the correlation between recessions and rising interest rate cycles.
When it comes to choosing between active and passive management, the Global trends in DC and DB plans report by Vanguard Asset Management found 57 per cent of respondents prefer to use a mix of active and passive strategies. Despite the applause for active management from asset management companies themselves, just 5 per cent of the funds would prefer an all-active portfolio. However, only 38 per cent of the pension funds surveyed would opt for an all-passive approach.

Northern Trust Asset Management found in their 2013 investor survey that 20 per cent of respondents had increased their allocation to actively managed strategies over the past five years, while almost double, 39 per cent, increased their use of passively managed strategies.

A switch to passive
If the figures are to be believed, there is a definite movement away from active towards passive strategies within pension funds. This is reinforced by Irish Pension Funds Authority CEO Jerry Moriarty who has noted a trend towards passive investment within Ireland, although this is more on the defined benefit side.

“All evidence would indicate that it is very difficult to pick consistently outperforming active managers. The trend towards more passive management is therefore understandable. However, there will still be cases where trustees feel active management is appropriate for some asset classes or particular portfolios,” he says.

Mercer head of research Richard Dell also notes that they have seen clients who have had disappointing experiences with active managers and have switched their assets to passive. He says this is because they get much lower costs and don’t have to worry about the regrets of picking an active manager who underperforms. However, he adds that this has always happened and is to some extent cyclical.

Globally, passively managed assets have been performing well, the most recent Towers Watson World 500 Survey found that since 2003, assets managed by the leading passive managers have grown by an average of 12 per cent each year. In 2013, this figure was 16 per cent, which saw assets reach a record $10 trillion, up from $3 trillion a decade ago.

Charles Stanley Pan Asset chairman of the investment strategy committee John Redwood says their research in 2013 and 2014 found that a portfolio of passive funds outperformed a portfolio of active funds by 4.7 per cent in the year to April 2014 and 6.5 per cent in the year to June 2013 on average.

He says indexing makes a lot of
sense for a core portfolio of shares in the major markets, and for more esoteric markets where it is difficult to find good quality investment expertise at an affordable price.

He even goes as far as to say that there is a good case for pension funds to have core holdings or entirely passive portfolios to keep costs down. He explains that most active managers end up owning many of the leading shares in the market, as they do not wish to distort their portfolios too much compared to the index they are trying to beat.

“There is therefore a case for holding a substantial investment in tracking funds, even if you wish to see if you can beat the index through superior management by taking different risks with a portion of the portfolio. What does not make sense is to pay higher fees for active management, but to end up with a large portfolio much like the index,” he concludes.

However, Redwood adds that a successful fund needs the best of active and the best of passive. He states that while the “odds are not great” for active managers beating the index there are managers out there who will outperform the index over the next few years.

A case for active?

Dell says that Mercer strongly believes that active management has a key role to play in the growth of a client’s portfolio. The key to success, he says, is a “robust and well-structured research process” that can help identify managers that have an above average chance of outperforming over the future”.

He adds that there are areas of the market where active management is more productive than others, such as the mid and small cap end of developed markets, emerging markets and frontier markets, whereas the US large cap market is more challenging.

Tobam president Yves Choueifaty defends the poor performance of active managers, highlighting that most do not beat the benchmark, simply because they implement tracking error metric strategies.

“When you are under the dictatorship of tracking error it’s really difficult to beat the benchmark because in a way you will be forced systematically to cut your bets at the worst moments. Remember all value active managers were fired in 2000. At the peak of the tech bubble they were all fired, when it was exactly the worst moment to fire them,” he explains.

One of the main reasons behind the switch to passive has been the poor performance of active managers and the high opaque fees. However, according to Unigestion head of equities Alexei Jourovski, there has been some reconsideration for active mandates due to the pressure on costs across Europe. He says in the Nordics, a pension fund has to publish its average management expense, which has created competition amongst pension funds on who is the cheapest.

“I believe it has introduced additional pressure on active managers to reduce costs or at least show a decent outperformance net of management fees,” he says.

Of his clients, he says most do still have “quite a big allocation to active managers” and still consider this as a critical component of their allocation. However, he states that active managers need careful choice and pension funds need to carry out due diligence checks on them to make sure they are comfortable with the strategy.

Jourovski also says that across Europe, pension fund management is not integrated, especially when it concerns active management mandates. For example, he says in France the market still considers regional mandates and it is very typical for a French pension fund to have allocation to Europe separate to that of the USA, Japan and so on.

However, he explains, Scandinavia and the UK are moving towards global mandates. He says global mandates give active managers a better chance of beating the index because it gives them the opportunity to provide diversification.

Despite the trend towards passive investment, it does have its downsides. Robeco head of quantitative equities research David Blitz states that passive investment focuses solely on the market risk premium, and “simply ignores proven factor premiums such as low volatility, momentum and value”.

Furthermore, Choueifaty openly criticises passive management as one of the most bizarre expressions he has ever heard, describing it as a “perfect oxymoron”. “How can you be passive and manage, how can you manage and be passive, so passive management is something that, in fact...does not exist,” he says.

Clearly there are cases for both sides, which is why the Vanguard report found a majority of pension funds would prefer to use a mix of active and passive strategies. Dell says that he sees DC schemes, where there is a more transparent focus on costs, use low cost pure passive or market cap passive solutions combined with active management.

Choueifaty also notes that his clients tend to allocate into three buckets, smart beta, passive and active. However, he says this is not because people are convinced with passive but because smart beta is a new innovation that will take time to get used to, but that is another story.
In their own words...

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

On the outlook for investing in European equities

“Gone are the days where European growth was completely stagnant and negative, and we had nothing but high debt, a lack of competitiveness, political difficulties being highlighted every day in the newspapers, and awful battles between core and periphery countries. Seven years after the crisis, there is no doubt that Europe is looking brighter.”

Columbia Threadneedle European equities manager Ann Steele

On the need to monitor the employer covenant

“You can have the best business in the world, trading really well - but if you have a pension scheme that is 10 times the size and volatile and running risky investments, then you can have weak covenant supported by a strong business. There are many examples of this where the deficits are also bigger than that actual scheme itself.”

Lincoln International chief executive Darren Redmayne

On whether it is now the right time to increase allocations to small caps

JEAN MEDICIN
Carmignac Gestion portfolio adviser
“I do think small caps are well positioned to benefit from a pick-up in the economic growth because they are more sensitive to cycles and also their indices have a greater weight to the industrial sector. However, the question investors have to ask is whether the support from the weaker euro and lower oil prices are temporary factors and how this can translate into a sustainable recovery and structural reform.”

HAMISH GALPIN
Hermes Investment Management head of small and mid-cap investment
“In general, the classic reason that investors like small caps is that they grow faster and are nimbler than a large conglomerate. They still offer value today, although they are not as cheap as they were, in that they are trading above their long-term average price to earnings, but they are not excessively expensive either. At the moment specific companies in the defensive sectors such as breweries, drinks and utilities have done well but I think going forward high quality cyclicals, particularly in the US, will make a comeback as the Federal Reserve raises rates.”
On the difficulties Austria faces in improving its second and third pillar provision

CHRISTIAN BÖHM
Association of Occupational Pension Funds in Austria (FVPK) vice-president
“You have a population and even a media who don’t understand that over three years it is maybe better to have one bad year and two very good years rather than three years that were just quite good. It’s an education problem.”

EVA SALOMON-GIRSCH
Towers Watson Austria managing director
“Every expert will tell you that the state pension system will not work in the long term. But when you ask politicians and government they will tell you everything is fine.”

On the proposal for a pan-European pension product

EFAMA
“The choice between different types of pension products and providers remains limited, the portability of pension savings across borders is almost impossible, and the cost of pension products is high. There is indeed a trade-off between the protection offered by professional advice and the costs associated with the provision of advice. EFAMA therefore encourages EIOPA to develop an EU framework for a standardised European Personal Pension (EPP) to reduce distribution costs and in this way encourage more consumers to save for retirement.”

On active versus passive

“All evidence would indicate that it is very difficult to pick consistently outperforming active managers. The trend towards more passive management is therefore understandable. However, there will still be cases where trustees feel active management is appropriate for some asset classes or particular portfolios.”

Irish Pension Funds Authority CEO Jerry Moriarty

“Because of the interest rate situation most people say ‘I can use my money better to buy a new car, because then I will get a better return.’”

Mercer Austria managing director Josef Papousek
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* As of 31st March 2014. Figures include assets under management and advice for Cairn Capital and its affiliate, Cairn Capital North America Inc.
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