EVASIVE ACTION

Can European pension funds escape "the four horsemen of pension destruction"?

By Maha Khan Phillips

In February, the €300 million Dutch pension scheme for midwives, SPV, announced that it would be cutting pension rights for members after its coverage ratio fell below 85%. Industry participants point out that it is only a matter of time before other pension plans have to follow suit. At least two other large Dutch pension funds have warned that they might also have to cut payments next year if funding does not improve.

Pension funding in the Netherlands fell by as much as 4 percentage points in the first two weeks of January alone, according to Mercer, the investment consultancy. Because Dutch schemes are required to have a funding ratio of 105% to be considered solvent, and the March ratio is estimated to be 96%, their situation is challenging. But similar struggles are being played out across Europe. On an accounting basis, just over 35% of European defined-benefit pension plans have a ratio in excess of 100%, according to CREATE-Research, a global research boutique specialising in future trends and global asset management. A December 2015 paper from the Pensions Institute at Cass Business School in London reveals that one-sixth of the 6,000 defined-benefit schemes in the UK will probably not be able to pay future pensions in full to members and their dependents.

The paper, titled “The Greatest Good for the Greatest Number,” says these funds are facing “unmanageable stresses.” The pension crisis has had multiple triggers: the volatility challenges that began at the turn of the century, increasing life expectancy, increased accounting and regulatory impact, and quantitative easing (QE). QE is of particular importance because it has led to historically low gilt yields that effectively raise the cost of a promised pension.

It is the gilt yields that many schemes are struggling with particularly. “At the moment, it is all about gilt yields for trustees,” says Steve Delo, chief executive of independent trustee services firm Pan Governance and former president of the Pensions Management Institute in the UK. “Because funding strategies and funding calculations are all ultimately in some shape or form pegged to gilt yield, trustees are agonising about what to do about them. Now you have the double whammy effect of risk assets having collapsed in recent months as well. Funding is terrible, too.”

MULTI-LAYERED APPROACH

So how can pension funds address these challenges? Many schemes are changing their thinking on both asset and liability management. Two of the four worst bear markets of the past 100 years occurred in the most recent decade, according to CREATE-Research. Those bear markets have side-lined conventional wisdom on risk premia and diversification and have changed the business models of many schemes. Prior to the bear markets, 80% of portfolio returns came from intelligent asset allocation. Now, the figure has reportedly fallen to 50%, with the rest of the alpha being attributed to implementation, according to the firm’s research report *The Alpha* behind *Alpha: Rebooting the Pension Business Models*.

CREATE-Research says that pension funds now understand that good performance depends on symbiotic interaction between asset allocation, governance, and execution. "Every plan I know realises that the old dictum 'fix asset allocation and numbers will follow' no longer works—if it ever did," says Amin Rajan, chief executive at CREATE-Research.

Amin Rajan

Rajan argues that pension funds have to be savvy about governance and execution, not just asset allocation. "This was the abiding lesson learnt from their incursion into alternatives in the last decade, emulating iconic investors like Harvard and Yale endowments," says Rajan. "Subsequent losses on these investments made pension funds realise that governance is the alpha behind alpha."

GOVERNANCE

CREATE-Research surveyed 190 pension plans across Europe with combined assets under management (AUM) totalling €1.9 trillion. At least one-quarter were upgrading their governance practices: 63% proposed to bring in more clarity in plan mission and goals; 60% were pushing for more clarity in investment beliefs and time horizons; 42% were adding investment expertise to their board; 33% were bringing more clarity to the roles of the board and full-time executives; 31% were bringing in a dedicated, in-house chief investment officer; 27% were using more in-house investing; and 25% were delegating more authority to full-time executives.

The survey also found that pension funds are focusing on "softer" issues, such as mission, goals, beliefs, and time horizons. Many are adding specialist investment professionals to their trustee boards or organising sub-committees to enable faster decision making. For trustees, it is a high-wire act between delegating their authority to full-time executives and not losing control, given their own fiduciary responsibilities. But they also walk a fine line between personal accountability and career risk, and Rajan says they must be more mindful of their obligations.

"At a time when asset prices are so distorted by central bank action, trustees have understandably become ultra risk adverse," he argues. "But risk aversion carries its own risk. Trustees should think more about portfolio risk and less about career risk. Trustees now agonise and [become] paralysed about every good idea, in case it's a bad idea."

WEEDING-OUT COSTS

One way to help ease the pressure is to bring down costs, and pension fund trustees have been applying more scrutiny to both internal and external charges. Many have rethought their hedge fund allocations as a result, citing high fees, disappointing performance, and complexity as some of their concerns. In the UK, the £22 billion railway workers plan RPMI was the first to divest. In the Netherlands, three schemes have all chosen to at least partially walk away from hedge funds: PMT (the €63 billion industry scheme

A Focus on Risk Premia, Not Assets

RPMI Railpen, manager of the assets of the UK's £22 billion Railways Pension Scheme, launched its investment transformation program three years ago in an effort to take a more forensic approach with its asset management process. The pension scheme's trustee board decided to disband its investment committee and replace it with the Railpen Investment Board, delegating to this new entity responsibility and the ability to invest assets to meet scheme requirements. Four external directors were also added to the board.

RPMI has also changed its investment strategy, with the majority of funds moving from single asset to multi-asset. Fourteen of its pooled funds were consolidated into five funds (and five sub-funds focusing on risk premia) rather than just assets. Those five funds include its existing flagship growth fund and its private equity fund. New funds include its illiquid growth fund; a long-term income fund; and a de-risking fund platform, which includes sub-funds in government and corporate bonds, cash, index-linked assets, and liability-driven investing.

The fund also has a team of analysts who spend all their time modelling factors of return. Based on this analysis, the fund has moved 50% of their public equities portfolio into products designed to access risk premia systematically and cost efficiently and has allocated to low volatility, value, and income equity strategies.

As part of its investment transformation program, Railpen looked at the fees it paid its managers. Its revelation that the underlying fees charged by its managers were just a fifth of total fees sent shockwaves through the investment industry. Railpen found that additional underlying fees charged by its managers were around 300%–400% of the £70 million upfront fees it paid.

As a result, the fund decided to go back to basics and pull out of many asset manager relationships, particularly with hedge funds. It has also expanded its back- and middle-office functions.

"We've always had a very active private markets programme, and we've had good returns from private equity in particular, but as a result we used to pay less attention to the level of fees that were implicit inside the funds we were investing in. In a low-return environment, we have to pay attention to everything," says Chris Hitchen, Railpen's chief executive.

Hitchen says that he is prepared to pay for true skill, however. "To me, there's a lot wrong with the investment value chain; there are too many places where value leaks between the member and the portfolio, but fund managers shouldn't really be the problem—they are the solution."

for Dutch metalworkers), PME (another Dutch metalworkers' fund, with assets of €41.5 billion), and PFZW (the €178 billion health and welfare sector scheme).

Austria's €6 billion VBV scheme was also one of the first to decide that hedge funds didn't add value. "Since Autumn 2015, we no longer subscribe to the belief that hedge fund managers will be able to deliver relevant positive returns in a somewhat consistent way," explains Günther Schiendl, the scheme's chief investment officer. Schiendl also says that "traditional" fixed income, like government bonds, is "by and large dead." Instead, the fund has dynamic, separate corporate bond investments in European, US, and emerging market high-yield bonds. "'Dynamic' means we can vary between zero and strategic allocation within a few weeks or so," he explains.

The plan's major new strategy is an allocation to private markets. As Schiendl explains, "By this we mean that we invest in funds run by specialists who invest in corporate loans—project and infrastructure finance. We will invest into the full spectrum of capital structure, from equity, mezzanine, to senior-secured debt."

Other costs that both pension funds and regulators are scrutinising include the implicit costs embedded in transactions, which are not always transparent and harder to quantify. These include broker research costs, custodian ticket fees, stamp duty, turnover costs, and market impact and spread. But the information on these costs is hard to come by, and regulation is still being developed to provide specific disclosure requirements. Industry participants point out that sometimes pension funds will miss the big picture by focusing on the minutiae. They also believe that such efforts may not bear fruit.

"It's useful to understand and get transparency around costs like transaction costs, but there's a downside to the approach—and that's that some of the costs and difficulty associated with getting that transparency outweigh the benefits of doing it," explains Mark Austin, senior vice president of corporate and institutional services at Northern Trust. Austin heads a team of relationship managers and is also a trustee of Northern Trust's combined defined-benefit and defined-contribution scheme.

Austin believes that pension sponsors need to get people out of defined-benefit schemes as much as possible. "Pension schemes are entering the decumulation phase," he says. "That will speed up and up. This will become a real problem when trying to deal with the deficits they have."

Austin continues, "It is a bit like a farmer being asked to grow more food while selling land. Pension funds can either make their assets grow faster or they can make their liabilities shrink in some way—or from a corporate standpoint, preferably [do] both. But addressing the liability side of the question is the one that gives you the most potential uplift. On the asset side, you can drive down some costs, but you're really spending time with the pension scheme money flowing out rather than in, so this becomes a more difficult proposition without significant deficit repair payments from the sponsor."

Mark Austin

There are key areas to target, however. "The four horsemen of pension destruction are interest rates, inflation, longevity, and market performance," says Austin. "Those are the four things that can really hurt pension schemes. So, looking at those things is where pension schemes are investing their efforts, by using longevity swaps and looking at interest rate protection, for example, or using LDI [liability-driven investment] mandates."

PORTFOLIO CONSTRUCTION

Pension funds also have to rethink portfolio construction, according to Nico Marais, CFA, global head of multi-asset investing and portfolio solutions at Schroders Investment Management. "Most pension funds have most of their resources allocated to picking managers rather than focusing on strengthening the overall outcome of the fund through improved portfolio construction and downside risk management," he says. "For many, portfolio construction and fund exposures are still being done in dollars and pounds rather than in the risk space. Many investors are still managing in terms of a 60/40 split between equities and bonds, with asset classes rather than the more granular and precise risk premia as building blocks. There are some relatively easy wins simply shifting from a capital-based to a risk-based approach."

For the approach taken by Schroders, a focus on risk premia is essential. "We have forty-five people who just look at risk premia," says Marais. "You could say that treasuries are expensive or not expensive, but that's a very simple and unsatisfactory analysis. If you can break a treasury into a term premium, a liquidity premium, an inflation premium, and even (for certain countries) a political premium, then suddenly your toolbox is that much more robust."

Pension funds are also turning to low-cost solutions. Mercer's *European Asset Allocation Survey 2015* reveals that the use of passive management within traditional equity and bond portfolios has increased at the same time that average performance targets for alternative allocations, as well as the size of those allocations, have risen. "This suggests that investors increasingly prefer to seek returns from manager skill (or 'alpha') within alternatives mandates, whilst harvesting cheap 'beta' in the core equity and bond portfolios," suggests the firm.

But nothing can replace skill, according to Nathan Gelber, chief investment officer and founder of Stamford Associates. "There are really no new paradigms in the investment world," he says. "There may be a proliferation of new strategies, but from where we are, the identification of superior

A Focus on Sustainability

Last year, the €178 billion Dutch health and welfare sector scheme Pensioenfonds Zorg en Welzijn (PFZW) overhauled its investments after an 18-month process. Its new investment framework, the "White Sheet of Paper Project," came about because PFZW's board wanted to think afresh about its investment principles after the Global Financial Crisis. The board interviewed more than 30 external experts, peers, and consultants to discuss how the scheme could "invest in a way (1) suited to the financial ambitions of our plan participants, (2) in which sustainability is fully integrated, and (3) that is intelligible and controllable."

The fund decided to think in terms of a limited number of sources of return and reduce the complexity of its investment solution. It also decided to recognise the time variance of risk premia, to be prepared to change its policy if necessary, and to assume responsibility for both the economic and the sustainable footprint that it leaves.

PFZW decided to focus on four sources of return: interest rates, liquidity, equity, and inflation, and the specific implementation of each. It has increased its allocation to alternative public market strategies and is looking at ways to increase efficiency, avoid portfolio overlap, and cut costs. The scheme hopes to do all of this while also increasing its positive sustainability footprint fourfold by 2020 (e.g., through impact investing) and reducing its negative sustainability footprint twofold. It has also decided to shift more of its allocation to its domestic market of the Netherlands.

For PFZW's asset manager, PGGM, there are many challenges to address in terms of investments. Jaap van Dam, director of investment strategy, says that pension fund managers have to take some responsibility for their current predicament. "In the long run, especially in equity and return-generating assets, the available returns and the quality and stability are at least partly a function of the quality of the capital allocation process," he says. "There is a broad agreement between companies and asset owners that, in the current setup, the orientation of capital markets is too much tilted to the short term in order to generate optimal long horizon and wealth generation. In past decades, asset owners and pension funds have operated more as price takers, in the confidence that the 'invisible hand,' which is central to efficient market theory, magically will lead to maximum long-horizon wealth creation, both for them and for society at large. In a certain sense, we have all been free riders of the markets."

He says the fund needs to rethink its role as an asset owner and the roles of all of its agents—external managers, for example, who are in general "not well aligned." The fund also needs to rethink the way it invests with regards to the long term.

investment talent remains at the focus of our efforts, because we believe individuals who are particularly skilful have a better chance to add value. These exceptional people are extremely hard to find."

He says funds have to be conscious of the "art of the possible" when it comes to portfolio construction (taking into account risk tolerance and time horizons), rely on fundamentals to assert themselves over time, and apply a clearly defined rebalancing discipline. "A well-considered allocation linked to a rebalancing discipline, to us, represents a superior approach, because it realises profits and puts additional capital into areas that have recently done poorly," he argues.

FIDUCIARY MANAGEMENT

Pension funds can, of course, outsource the pain to a fiduciary manager. Aon Hewitt's survey of defined-benefit schemes in the UK with total AUM of £181 billion revealed that take-up rates rose from 18% in 2011 to 46% in 2015. The strong growth in the 2014–2015 period was from schemes with more than £1 billion in assets. However, the firm says that full fiduciary management remains more common among pension schemes with assets of £500 million or less, while partial fiduciary management is more frequently found among schemes with assets of £1 billion or more.

Jeffrey Levi, a partner at asset management consultants Casey Quirk, suggests that this is a tale of two trends. "There is a trend towards outsourcing, and in the other extreme, in reverse, is the trend towards in-sourcing for larger institutions [that] decide that they can find and attract skilled people to do things for themselves."

According to Levi, illiquid investments remain quite interesting for a lot of well-funded defined-benefit plans (given their illiquidity premium) because mark-to-market rules tend to benefit reporting asset values and there isn't much volatility in the portfolio.

"Frankly, the performance of illiquids has been better than a lot of liquid asset classes," says Levi.

He also points out that many funds are starting to collaborate and cooperate more. Last year, the £5.5 billion Lancashire County Pension Fund announced that it was joining hands with the London Pension Fund Authority to form a £10 billion asset liability management partnership covering all aspects of pension fund management, from jointly managed administration to pooled asset and liability management activities. The combined Lancashire and London Pensions Partnership (LLPP) hopes to have more negotiating power as well as to bring in cost reductions and more effective liability management.

Ultimately, there are no easy solutions to any aspect of the challenges European pension funds face, but pension funds are tackling the crisis in a multitude of different ways.

KEEP GOING

"Fees and Ticks," *CFA Institute Magazine* (July/August 2015) [www.cfapubs.org]

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