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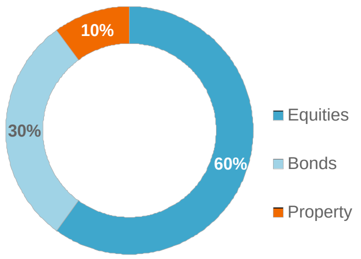
Current Issues in Pensions

INNOVATIVE ADVICE DELIVERING SOUND SOLUTIONS

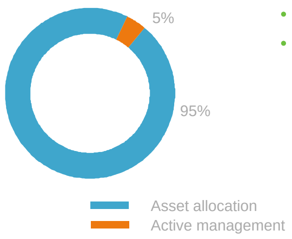
Changing investment landscapes

- New products and practices
- Characteristics and expected return
- How are investment banks fitting into the industry?
- Allowing for new approaches when setting valuation bases

What a typical scheme had



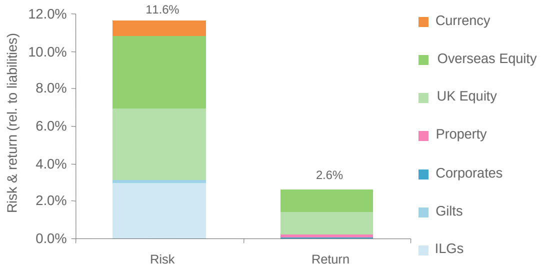
Contribution to risk



- Traditional model
- New focus on sources of risk / return

Asset allocation dominates risk, active return ignored

Risk / return comparison



60% equity / 10% property / 30% bonds

What happened?

- Equity bear market
- Low inflation, low interest rates
- Longevity
- ‘One size fits all’ has not worked
- Regulation / legislation
- Better understanding of risk

What are a pension scheme's main risks?

- Unavoidable risk
  - longevity
- Uncompensated risk
  - interest rate risk
  - inflation risk
- Intended risk
  - equity risk (market) – 'beta'
  - manager risk (skill) – 'alpha'

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New products and practices

INNOVATIVE ADVICE DELIVERING SOUND SOLUTIONS

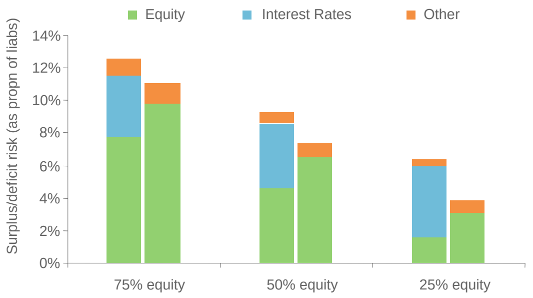
New products and practices

- LDI (liability driven investment)
  - interest rate risk
  - inflation risk
- Diversification
  - alternative assets
  - 'alpha' and 'beta'
  - absolute return (hedge funds, TRFs)
- Portable alpha

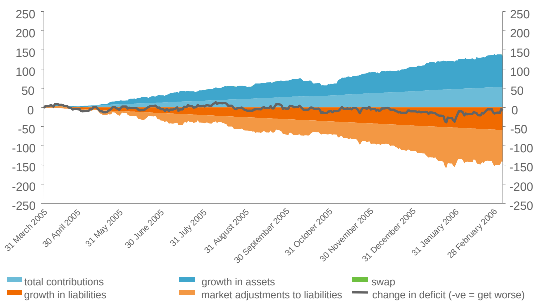
Liability Driven Investment (LDI)

- Not a product – a different approach
- Risk management
- Benchmark is scheme's unique cash flows
- Use swaps to reduce risk (duration, inflation)
- Not just liability matching
- Can seek to outperform liabilities

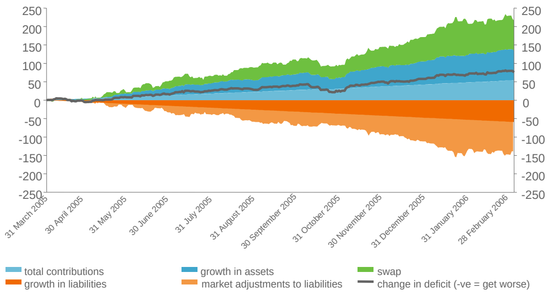
Impact of hedging liability risk



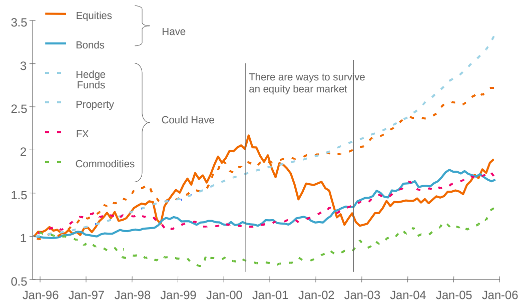
Growth in assets and liabilities



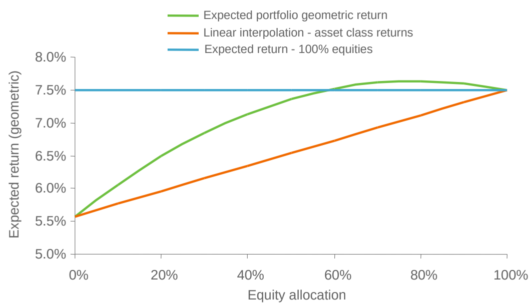
With swap



Diversification – asset class performance



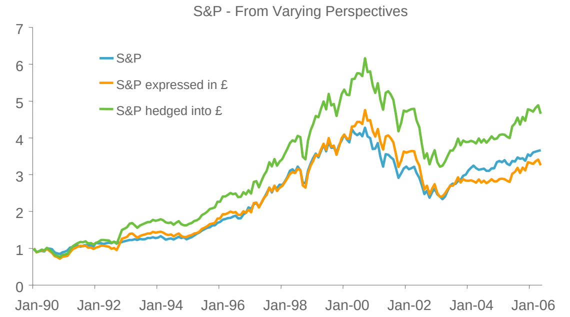
Diversification – a free lunch?



Range of alternatives

Asset classes (beta)	Active management approaches (alpha)
Property	Currency
Private Equity	Hedge Funds
Commodities	Tactical Asset Allocation
High Yield Debt	Unconstrained Equity
Emerging Market Debt	Long/short equity

Currency - why bother?



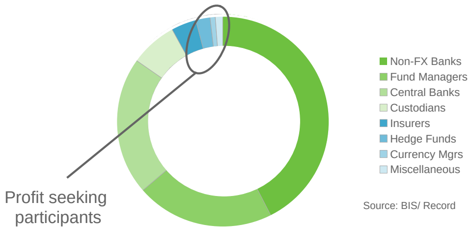
Equity Market Volatility

Volatility of equity market in local currency and Sterling terms

Volatilities (% p.a.)	1970-2006		1990-2006	
	Sterling	Local	Sterling	Local
UK	20.5	20.5	14.3	14.3
North Am	15.0	18.1	14.1	17.4
Europe	15.4	16.4	17.5	17.6
Japan	18.4	22.0	20.0	23.4
Pacific	21.1	24.3	17.7	21.7

Hedging currency should reduce risk
…. and sometimes you get paid to do it!

Active Management Opportunities

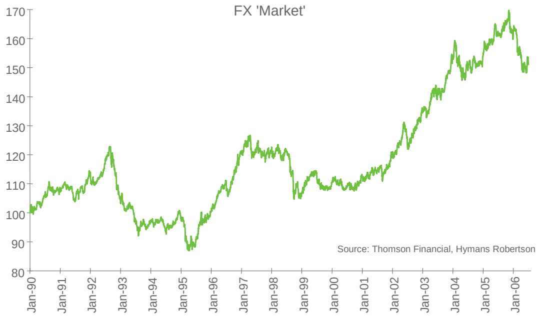


- currency market acts as global clearing house
- few "pure profit motivated" players
- opportunity for active currency managers

FX 'Carry' – Market '*beta*'

- In theory, the interest rate carried would be equal and opposite to the future change in fx rate
- In equilibrium, what you gain on interest, you lose on capital
- But, equilibrium is a myth
  - Many more factors at play
- Yield or Carry gained has persistently exceeded capital lost
  - Remember, has favoured £ based investors who hedge

…and here it is!



Hedge fund strategies

Strategy	Long position	Short position
Equity long / short	Favoured equity	Unloved equity
Merger arbitrage	Acquisition target	Acquirer
Global macro	Favoured currencies etc.	Unloved currencies etc.
Index arbitrage	Index entrants	Index departures

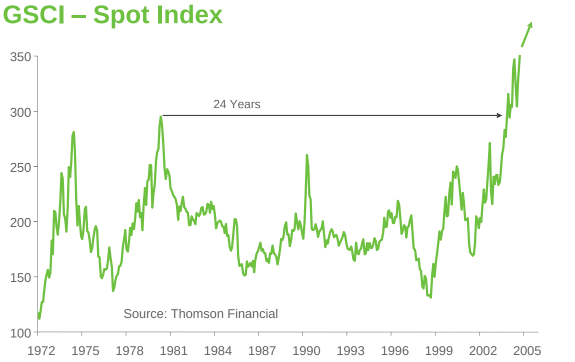
Characteristics of hedge funds

- Skill-based
- Often market neutral (not always)
- Arguably expensive
- Alpha is portable
- Aligned with scheme objectives
- But alpha is a nil sum game?

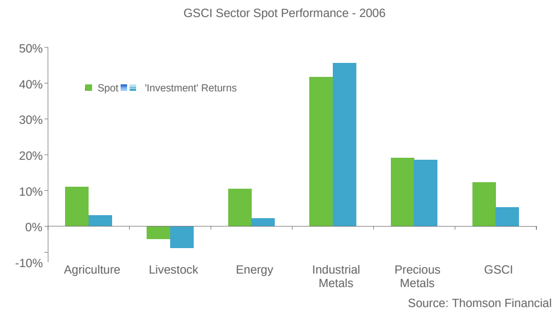
Commodity types

Sectors	Examples
Energy	Oil, Gas
Industrial Metals	Aluminium, Copper, Lead …
Precious Metals	Gold, Silver
Agriculture	Cocoa, Coffee, Sugar (softs) … Red Wheat, Corn (grains) …
Livestock	Live Cattle, Lean Hogs …

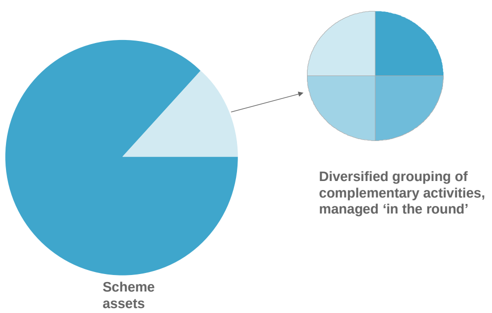
GSCI – Spot Index



Commodities
– What you see is not what you get!



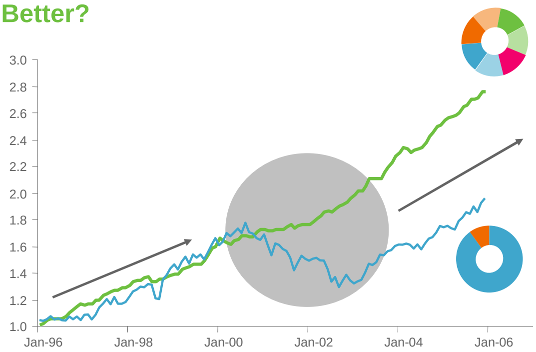
Complementary Activities



An '*Alternative*' Array

- Currency
- Commodities
- Hedge Funds / TRFs
  - natural Long/short, macro
  - 'un-natural' variety of arbitrage, event, CTA
- HYD / EMD
- Infrastructure

Better?



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Investment banks

Investment banks

- Trading experts
- Generally paid on trading activity
- ‘Free’ advice
- ISDAs
- Fund managers – gatekeeper
- Simplifies process
- Range of counterparties
- Protects anonymity

How are they fitting in?

- Brought new skills to party
- Enhanced range of solutions
- Still some distrust?
- Banks recruiting ex-consultants ….
- …. who are recruiting ex-bankers!
- Advice vs execution

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Characteristics and expected returns

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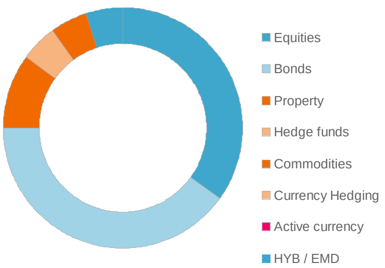
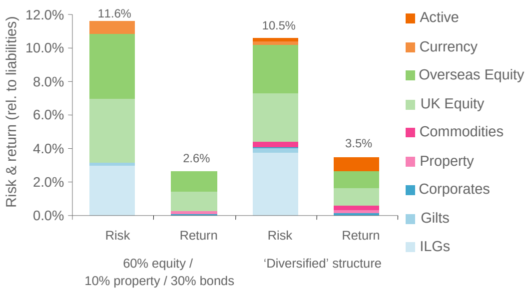
What a scheme might have now



Risk / return comparison – before and after



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What does this mean for valuations?

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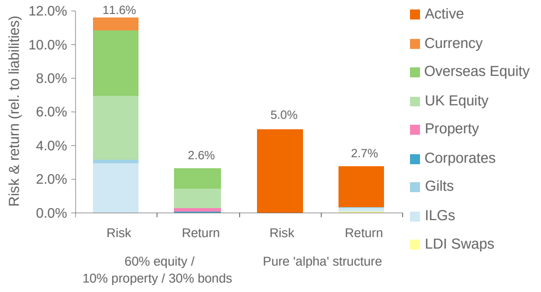
Valuation bases

- Pre / post retirement discounting
- Historically – no allowance for alpha
- Now – reliance on ‘skill-based’ solutions
- Sometimes no allocation of capital
- What can actuaries do?

Pure ‘alpha’ structure

- 50% bonds, 50% hedge funds
- Hedge funds target cash plus 4%
- Ported onto liabilities using swaps
- Target is liabilities plus 2%
- GTAA (incl currency) overlay
- Target net return 0.5%
- All alpha, no (or limited) beta

Pure ‘alpha’ structure



Ignore alpha?

- Nil sum game ….
- …. less costs!
- Return will come out in the wash

But…..

- No advance credit = higher contributions
- Trustees bombarded with alpha ideas
- May want to take advance credit

And…..

- What about risk?

Solution

- Split requirement …
- … between cash contributions and
- asset returns
- Agnostic on sources of returns
- Need to deal with disappointments

Advance credit for alpha?

- Difficult to reconcile
- Economic justification?
- How much to allow for?
- Trustee decision
- Need to deal with disappointments

Conclusions

- Historic bias to return
- LDI – better understanding of risk
- Liabilities plus is the future
- New players, changing roles
- AVR becoming commoditised?

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APPENDIX

INNOVATIVE ADVICE DELIVERING SOUND SOLUTIONS

General risk warning

Please note that the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance