New Pension Guide Helps Prudent Planners

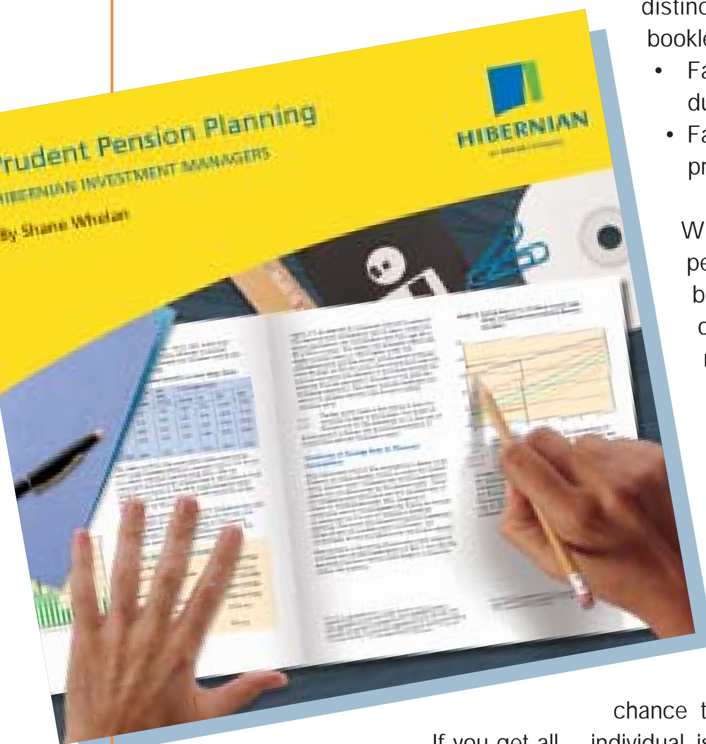
Let's start with a quick quiz: (answers at the end of the article)

1. What group in Ireland got the highest wage increases over the 20th Century?

2. Who won the Nobel Prize for Economics for pricing investment risk only to lose all their prize money – with many dollars more – on risky investments?

3. What investment tip in the Bible, well-heeded before the 17th century, was expensively learned again by investors in the 20th century?

4. In what calendar year (after 1900) did Irish equities post their worst performance?
5. What is the biggest myth about equities widespread in the pension industry?



If you get all five correct then you probably don't need to read *Prudent Pension Planning*, the latest investment booklet from Hibernian Investment Managers, written by Shane Whelan, which covers five millennia of capital market history, delves into the mysteries of compound interest, and, with a sprinkling of economics, anecdotes and pictures, aims to repay the reader with just enough knowledge to enable them to plan a pension in a prudent manner.

The booklet targets Irish workers who must be self-reliant when it comes to providing for their old age. At present, three out of every five are not covered by occupational pensions and, even for those with occupational pensions, one-third are members of defined contribution arrangements, so are made to shoulder the risk of markets doing poorly. This majority lie outside the warm embrace of the defined benefit scheme and must either provide for themselves and invest wisely or adjust their lifestyle to live on the basic state pension.

This group face two related but distinct risks, according to the booklet:

- Failure to set aside enough during their working life
- Failure to invest savings prudently.

While trustees of defined benefit pension schemes can claim to be saddled with the same onerous risks, they can rely more on the law of averages with the larger numbers and longer time-frame involved.

It is not possible to answer the two questions, how much to save and in what to invest - with anything like the certainty demanded by the pension saver. With so much at stake and no chance to learn by trial-and-error, the individual is required to have something approaching the wisdom of the entire pension industry to pull off this feat. While it doesn't supply all the answers, this booklet does treat all the major topics without oversimplifying the issues or pretending certainty when there is none.

Prudent Pension Planning is divided into two sections. The first section attempts to answer the question of how much to save. This question, in another guise, is simply what return can be expected above wage or price inflation on suitable investments over the long-term.

The Irish courts are daily faced with this assessment when they rule on the lump sum award that, suitably invested, will reproduce a stream of lost income in the future. In line with the Irish courts, and after a review of interest rates through several thousand years, the author argues that a real return of 3%-4% per annum seems reasonable to project on a well-diversified portfolio over the long term. The pension saver is then encouraged to formulate a saving plan that, on the basis of a 3% or so real return per annum, will produce the required nest egg come retirement.

While the 3% assumed real rate is the best estimate based on our current knowledge, there is an inherent wide margin of error around this estimate. The impact of uncertainty on the pension plan is controlled by periodically reviewing the actual accumulated fund versus the expected size of the fund under the savings plan.

If there is a shortfall in the size of the actual fund versus the expected then the future savings rate is adjusted upward and vice versa. This review may be not more frequently than once every five years when retirement is a decade or more away, reducing to once every three years and then, with five years to go, every year. At this frequency of review, the changes to the savings rate proposed tend to be small as whatever shortfall or excess tends to be insignificant in comparison with the value of expected future savings.
The second risk is that the individual fails to invest the accumulated savings

prudently. This risk manifests itself in different ways over the long and short term. An investment strategy that is too cautious over the long-term can be expected to reduce the return on assets and thereby increase the saving rate to produce the same pension at the end of the day.

On the other hand, an investment strategy that is too aggressive in the few years approaching retirement can create a sudden and large deficit in the fund that can only be righted by a dramatic increase in the savings rate over the remaining few years. The trick is, as discussed in the book, to pursue an unconstrained investment strategy with more than a decade to go to retirement then to gradually adopt a more risk averse strategy.

What might constitute a suitable investment strategy is fully discussed, with a few statistical studies on the outcome of suggested investment strategies. Tables give a unique and invaluable guide to the performance of Irish capital markets, each year, over the entire 20th century, together with wage escalation and inflation rates. Use is made of these historic return and risk figures to inform expectations of the likely outcomes of different investment strategies.

Copies of Prudent Pension Planning by Shane Whelan, are available from Hibernian Investment Managers (01 670 0950).

Answers to the quiz:

1. *Irish Politicians (who record an infinite increase over the 20th Century).*

2. *Robert Merton & Myron Scholes.*

3. *"Lend not to him who is mightier than thou." Ecclesiastes (VIII:13) – not heeded by gilt investors in the 20th century who saw the real return from their investments fall as Governments pursued inflationary policies.*

4. *1974 was the worse return in both nominal and real terms at –45% and –54% respectively.*

5. *Equity returns are a hedge against wage or price inflation. This is demonstrated not to be the case when studied across 26 equity markets capturing more than 60% of the capitalisation world equities over the period 1947-1979*

- *[Gultekin, N.B. (1983) Stock Market Returns and Inflation: Evidence from Other Countries. Journal of Finance, 38,1,49-65].*