



DC PENSION PLANS – DESPERATELY SEEKING ALTERNATIVES?

The defined contribution pensions market keeps growing as does the pace of innovation in investment, administration and communication platforms, Irish Pensions will be publishing a series of features that will examine developments in the defined contribution pensions. In this first article, Eunice Dreelan considers the scope and benefit of additional diversification across the standard range of Defined Contribution fund choices.

The defined contribution pensions market keeps growing as does the pace of innovation in investment, administration and communication platforms, Irish Pensions will be publishing a series of features that will examine developments in the defined contribution

pensions. In this first article, Eunice Dreelan considers the scope and benefit of additional diversification across the standard range of Defined Contribution fund choices.

Most pension practitioners would agree that

despite the growth of Defined Contribution (DC) pension plans, the majority of recent investment research and developments concentrate substantially on the challenges facing Defined Benefit (DB) plans. To address the problems facing DB plans, progressive investment managers and advisers, in consultation with trustees and company sponsors, have developed complex investment solutions incorporating, liability driven strategies, implemented consulting and alternative asset classes. These defined benefit investment solutions are designed with de-risking in mind (closer matching of assets and liabilities and greater diversification) and therefore serve to better manage volatility and return objectives.

In many respects the challenges facing individual DC pension plan members are very similar, though historically costs and accessibility have limited the range of available solutions. Clearly, DC members share the ambition to grow their pension funds and to protect themselves, in so far as possible, from stock market volatility, interest rate movements and longevity risks. The challenge for providers is to deliver innovative solutions which are simple in structure (for ease of communication) and sufficiently robust in design to deliver reliable performance and consistency.

STANDARD FUNDS

Traditionally, the investment choices offered to members of DC pension plans have been via standard managed funds (with a relatively high equity allocation and diversification through bonds, cash and property). A large proportion of schemes now offer a range of funds between which members are encouraged to select. For younger members with greater appetite for risk the standard recommendation has traditionally been an all equity fund and for older members who want to manage risk as they approach retirement the recommendation is almost invariably bond or cash funds. Typically the default fund will be a managed fund invested on a passive basis.

This article proposes that the standard ranges and choices can usefully be expanded to take advantage of developments in asset management generally. We examine how some of the research and solutions developed for large defined benefit schemes can be applied for Irish defined contribution schemes.

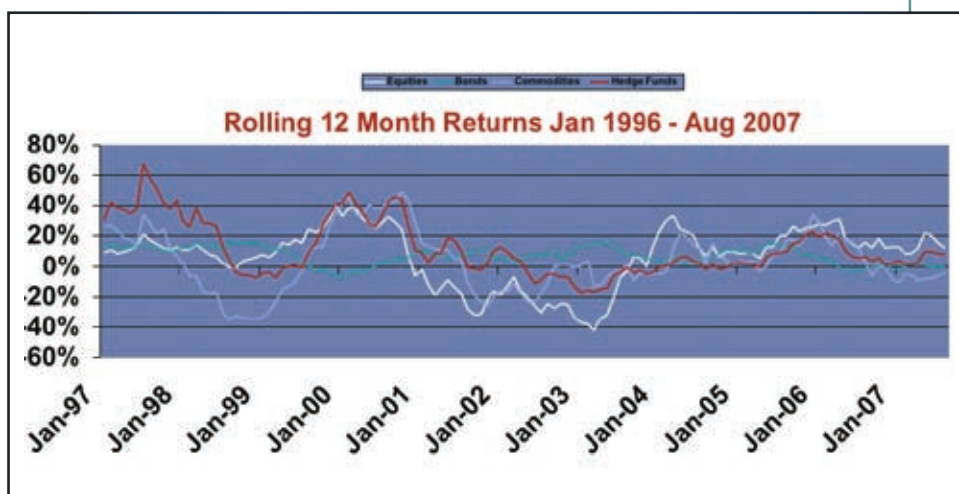
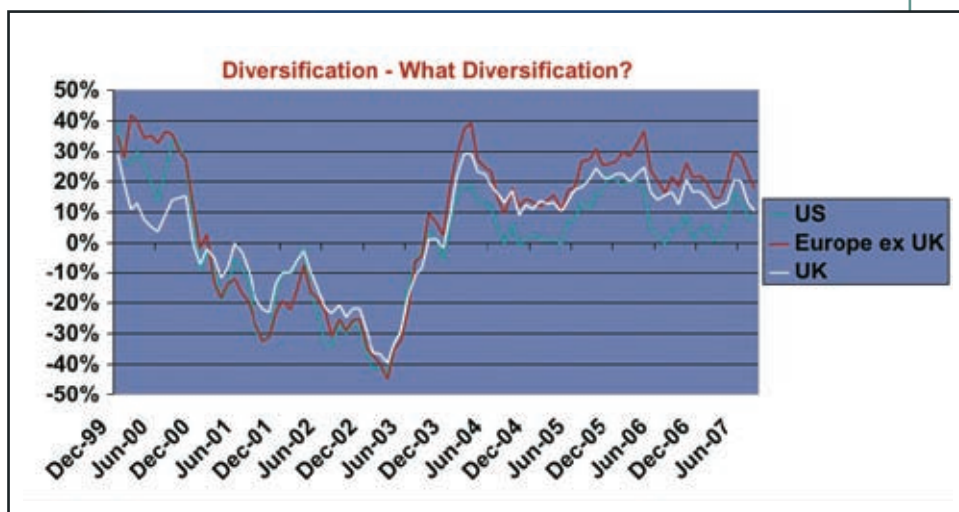
As a first step it is interesting to consider the diversification agenda which has been driving DB schemes globally. Diversification has been the by-word of risk management for as long as most schemes have been in existence. However, its significance continues to develop over time as assets and markets which might previously have offered greater diversification have become more closely correlated. For example, while a global equity fund is composed of a broad range of regional equity indices it is arguable that, due to globalisation and open economies, the regions within such a fund offer less diversification benefits. The graph below illustrates the increased correlation between US, UK, European and Japanese equity markets i.e. the developed world equity markets.

Our traditional managed funds offer a significant allocation to equities, typically between 65%- 80% with bonds, cash and property added for diversification. While cash does not protect against inflation and generally holds a very low weighting it does provide nominal value security and can assist in enabling tactical allocation decisions. Similarly, bonds offer good diversification advantages when combined with equities. However, an overweight position in bonds will result in a significant performance drag that for a younger member may represent too great a cost relative to the benefit being sought. Property is also a good diversifier but, primarily due to liquidity, allocations are generally at a low level. Consequently, overall managed fund volatility is predominantly attributable to equity (and to a lesser extent bond) allocations.

In recognition of these factors, and driven by the need to reduce volatility, more and more DB schemes are seeking to diversify by blending alternative asset classes into their asset allocation decisions. While DC members are not impacted by the same Funding and Accounting standards which influence defined benefit investment strategies the advantages of diversification in managing risk still hold true.

MANAGE VOLATILITY

The aim of introducing alternative asset classes into the pension fund mix is to manage volatility better while continuing to deliver on specified return objectives. Naturally different asset classes within the broad family of diversified alternatives will



have different risk and return characteristics. When mixed with developed market equities and other alternatives each blend will deliver a distinct composite risk and return characteristic. This allows providers and advisers, who have efficient access to alternative asset classes, to model "new balanced" funds targeting specific risk and return profiles.

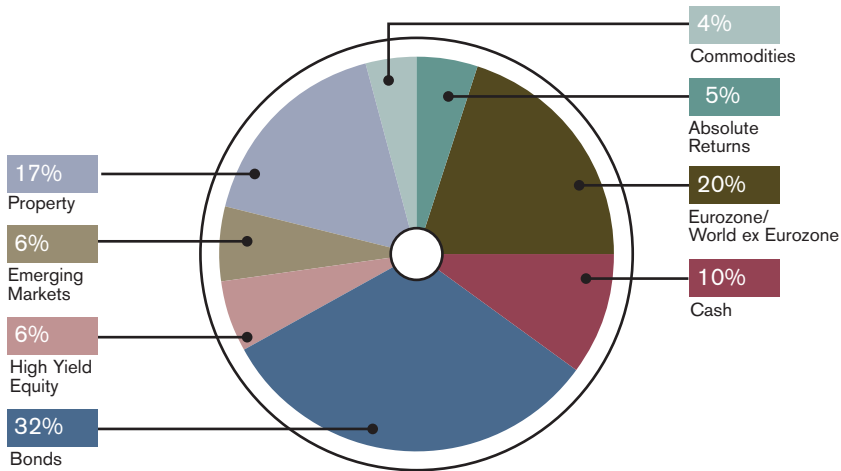
The real life impact of blending different asset classes can be seen below starting initially with a comparison of experiences in equity and bond markets relative to that of commodity markets. History would suggest that bonds, equities and commodities perform best at different stages of economic cycles. The historic effects of the economic cycle are illustrated in the chart below, where 12 month rolling returns are plotted for equities, bonds and commodities. Each market has its own peaks and troughs and at every point in time, at least one, and generally two, markets are in the black. So even this limited allocation illustrates the advantages of diversification during the sample periods.

Unsurprisingly, analysis of other asset classes and their relative risk and return characteristics delivers similar results to varying degrees.

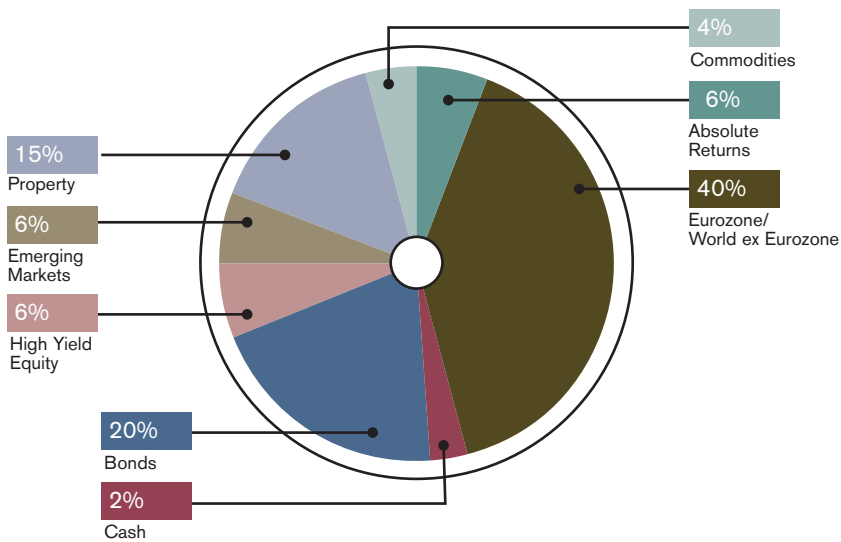
The bottom line is that a properly blended basket of alternative assets will be less volatile than a basket of regional equities and when a strategic allocation towards alternative assets is introduced into a traditional equity/bond portfolio the impact on risk can be substantial. Modelling undertaken by Irish Life Investment Managers when developing their suite of Diversified Funds has shown that, based on a sample experience from January 1999 to June 2007 a typical regional equity fund illustrates in excess of 50% excess volatility over that of a selected basket of alternative assets.

Whether the risk/return objective of a DC member is for capital/purchasing power protection, consolidation or aggressive growth the accessibility and development of alternative asset classes offer significant opportunity to target defined return characteristics with reduced volatility

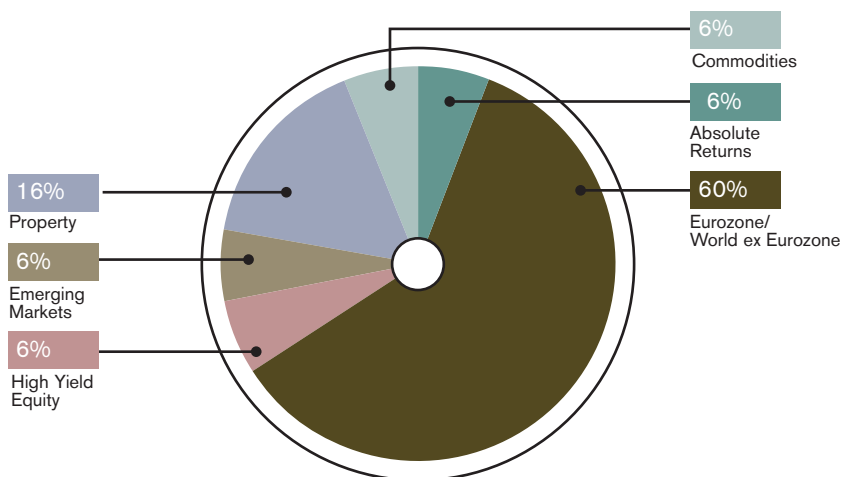
A: DIVERSIFIED CAUTIOUS



B: DIVERSIFIED BALANCED



C: DIVERSIFIED GROWTH



alternative asset classes (with different risk/return profiles) have been developed specifically for the DC market over recent years and are now available in the market place delivering sophisticated solutions in a simple packaged format. Broadly speaking these funds incorporate traditional developed world equities and alternative asset classes such as high yield equities, emerging market equities, commodities, hedge fund of funds, Irish and European property and a mixture of traditional bonds and inflation linked bonds (some sample allocations are illustrated in the piecharts to the left).

As with everything in the defined contribution market place, the greatest challenge will be the communications agenda. Similar developments are taking root globally and experience in Ireland to date shows a willingness on the part of trustees and consultancies, as a first step, to broaden DC fund choice to include "new balanced" funds for member selection. Given the simplicity of the message surrounding diversified funds member appetite seems to be strong.

It should be expected that the success of these solutions (in terms of reliability and performance) will support the continued efforts of those committed to defined contribution schemes and will support the further development of innovative solutions for their trustees and members.

Eunice Dreelan is Head of DC Portfolio Management at Irish Life Investment Management



Eunice Dreelan