ARE TRUSTEES IN DANGER OF EXCESSIVE PRUDENCE?

Brian Delaney, Aon Hewitt

The real underlying question we should be asking is:

Are Trustees being forced into making difficult decisions that will result in poor outcomes for members?

….not by choice, but by compulsion.

The good old days….

Period	Return to an Irish Investor over a period from investing in:		Increase in CPI
	Equities* % per annum	Bonds % per annum	% per annum
1973 to 1982	12.1%	10.8%	15.8%
1983 to 1992	17.9%	14.5%	4.4%
1993 to 2002	11.8%	10.6%	2.9%
1973 to 2002	**13.9%**	**12.0%**	**7.5%**
2002 to Today	6.5%	5.1%	

**40% Irish, 60% Global*

Average Equity Return

Period	Average equity return % per annum	Range of yearly returns
1973 to 1982	12.1%	-44.6% to +107.8%
1983 to 1992	17.9%	-21.6% to +61.4%
1993 to 2002	11.8%	-30.1% to +52.7%
1973 to 2002	13.9%	-44.6% to +107.8%

Average Bond Return

Period	Average bond return % per annum	Range of yearly returns
1973 to 1982	10.8%	-18.3% to +60.0%
1983 to 1992	14.5%	+0.9% to +37.3%
1993 to 2002	10.6%	-7.9% to +34.9%
1973 to 2002	12.0%	-18.3% to 60.0%

Source: "Current Funding Issues for DB Pension Schemes", Society of Actuaries in Ireland, 2002

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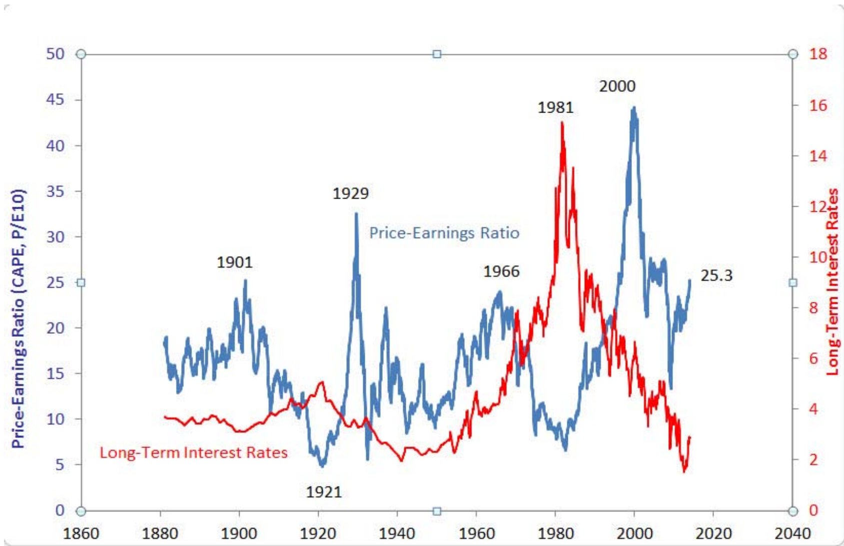
Today, stocks are expensive. The S&P 500 is trading at a P/E of 25x the average of the last 10 years of corporate earnings.



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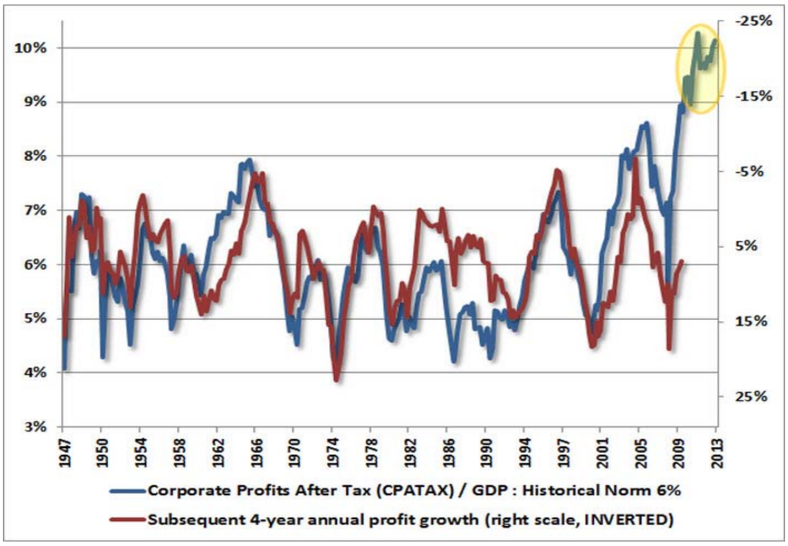
Corporate earnings are booming and have reached 10% of US GDP versus the historical of 6%.



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Where are all the bears? Investors Intelligence survey recently reported the lowest % bears on stocks in over 20 years.

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Leveraged loan issuance is surging. Banks are lending to low grade corporates and re-packaging those loans into ETF's for investors

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Bonds aren't looking too cheap either. We're turning Japanese. German 10Yr yields have fallen from 9% in 1990 to 1.5% in 2014.

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So, are trustees in danger of ***excessive*** prudence?

…….. and being forced into making difficult decisions that will result in poor outcomes for members?

AON Hewitt

Given the current investment climate, Trustees are right to adopt a prudent approach to managing risk……. and over 87% of DB Schemes today now follow a tailored approach to scheme design.

Funding Update

However, as the majority now focus on matching liabilities with long duration government bonds, ***excessive*** prudence becomes a potential problem. How big is the problem?

- Irish **DB pension scheme assets** are estimated at **€50 billion**
- 40% or **€20 billion** are invested in govt. bonds with **a duration of 12 years**
  - 70% or €14 billion have a duration of 14 years
  - 30% or €6 billion have a duration of 8 years
- Every 1% change in interest rates changes the capital value of those bonds by 12% or **€2,400,000,000**

- The majority of DB Schemes are in funding proposals today
- The majority are being forced to buy AAA bonds to match annuity prices
- The best match for annuity prices: 60% AAA 10yrs+ / 40% AAA 5ys+
  - Today: 1.8% yield (12yr duration)
  - Last decade average: 4.8% yield
- A 3% rise in AAA yields back to the long-term average would result in a **€7,200,000,000** capital loss on those safe liability matching bonds!

What happens in a worst case scenario? If a Japanese style deflationary crisis is on the cards, how bad could it get?

- Japanese 10 year yields bottomed at 0.5% in 2003 and again in 2013 following their deflationary collapse in the 1990's
- If the EU has a similar deflationary crisis, the yield on our basket of 60% AAA 10yrs+ / 40% AAA 5ys+ bonds could fall another 1.3% to 0.5%
- Maximum gain in capital value of DB bonds held: +15% (+€3.0BN)
- Maximum loss in capital value of DB bonds held:
  - at 4.8% yield: -36% (-€7.2BN)
  - at 6.8% yield: -60% (-€12.0BN)
  - at 8.8% yield: -84% (-€16.8BN)

- Pensioner liabilities of course will fall as interest rates rise, **but with only 15% upside and almost unlimited downside… why take the risk?**

So, in my opinion, perhaps the time has now come for a different approach.

- Time has come to change the focus away from "yield" and towards "return"
- Liability matching with long duration bonds may no longer be appropriate when AAA yields are plunging to multi-decade lows
- Change in focus towards low risk absolute return fixed income investing
  - 15% max. upside can be achieved in 3-4yrs. with a low risk absolute return bond strategy
- In the current investment climate, funding proposals should be modified or set aside
  - It is a nonsense to force schemes to target a 4-5% annual return and also demand them to hold 70%-100% in bonds by the end of their funding proposal
- Risk reserves are a worthy long-term goal but unrealistic in today's climate
- A dangerous precedent has been set; there is still time to change before it's too late.

Thank You.