Irish Association of Pension Funds

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Investigation of
Trends in Pension Scheme Investment

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1. Introduction

The IAPF investment committee last conducted an analysis of investment trends in 2000. Events have moved on considerably since this, and we felt that it was appropriate to revisit this topic in 2006. Previously, the analysis was carried out on the basis of a quantitative survey of pension schemes. However, this time around, the analysis is considerably more qualitative. Rather than sending a questionnaire to a large number of schemes, the committee decided to conduct one-on-one interviews with a smaller sample. These interviews were conducted between July and September 2006. In total, 10 large pension schemes, across a wide range of industries, and 5 leading pension consultancy firms were interviewed. The responses from this group have been analysed, and the trends that we have identified as significant are presented herein.

By interviewing 10 large pension schemes, several of whom run both defined benefit and defined contribution schemes, we were able to compile information on 8 defined benefit schemes, with assets of €14.5 billion, and 6 defined contribution pension schemes, with assets of over €500 million and covering more than 20,000 members, in total.

Where possible, we have indicated how this report's results vary from the results of the survey conducted in 2000. However, given the different methodologies used and topics covered, it is impossible to comment on every variation in trends since the previous survey.

We would like to thank all of the participants for giving generously of their time, and for their extreme candour. Without their help, this report would not have been feasible.

Fiona Daly, FIA
On behalf of the IAPF Investment Committee

October 2006

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2. Executive Summary

The purpose of this research report is to consider developments and trends in the investment practices of Irish pension schemes over the past number of years, and in particular since the last investigation of this topic was conducted by the IAPF Investment Committee in 2000. Our discussions with pension schemes and consultants covered a broad range of topics, and the most relevant of these are discussed in this paper. It is hoped that the results of this analysis will provide the IAPF and other relevant organisations with an insight into the views of the wider pensions community. This will facilitate relevant and targeted delivery of services to pension schemes in Ireland.

The report is divided into two main sections. The first section looks at trends in investment practices for Defined Benefit (DB) pension schemes, while the second considers Defined Contribution (DC) schemes.

The first topic discussed with regard to DB pension schemes is the setting of investment strategy. The views expressed by the participants on both asset liability modelling and liability driven investment are presented. Pension schemes have made considerable progress over the past six years in this area, with a much greater awareness of risk, and consequently an increased focus on risk budgeting, being evident. This section shows that the vast majority of DB pension schemes have determined their investment strategies with due consideration to the behaviour of the schemes' liabilities. As a result, many, but by no means all, schemes have moved away from traditional balanced mandates, in favour of bespoke investment strategies.

Trends in investment management structures are then considered. It is clear that there is a divide between the behaviour of large and small pension funds in this area. Larger funds are more likely than smaller schemes to appoint specialist, active managers for substantial portions of their asset portfolios. Smaller schemes, however, are more restricted in terms of access

to specialist managers. These schemes tend to use either a single investment manager or a multi-manager provider. Smaller schemes are also more likely to invest their entire portfolio on a passive basis.

Next, property and other alternative assets are discussed. Although Irish pension funds continue to invest in property, there is a noticeable shift towards increasing diversification in property portfolios by investing in European property. Other alternative assets, such as hedge funds, private equity and currency, remain generally unpopular with pension scheme trustees, despite their diversification benefits. These assets are seen as lacking in transparency, expensive and difficult to assess.

We also looked at the issues of trustee training and governance. Some trustee boards are well versed in most of the investment matters relevant to pension funds. However, there is an awareness that, more generally, levels of knowledge in many fiduciary bodies is suboptimal. This is not due to a lack of interest. Rather, this appears to be due to the difficulties of communicating complex issues to large groups of trustees, who have many responsibilities, are part-time and unpaid.

One suggestion for overcoming this barrier is for schemes to set up dedicated investment sub-committees, consisting of a small number of trustees and possibly a professional advisor. This smaller group can be more flexible, meet more often, spend more time dedicated to investment issues and attain a higher level of knowledge of investment issues. This sub-committee can then report back to the full trustee board on investment issues, and ensure that the wider trustee board is comfortable with the sub-committee's expertise and recommendations. Such sub-committees are considered best practice by the pensions industry; however, it appears that many pension schemes do not have investment-specific sub-committees in place.

Finally, the DB section of the report looks at schemes' attitudes towards socially responsible investment (SRI), added value techniques (such as stock lending and directed brokerage), and pan-European pensions. Very few pension schemes impose SRI restrictions on their investment managers, believing this is beyond the scope of their mandate as trustees. However, there is some increase in demand from trustees for their investment managers to actively engage with the companies in whom they are shareholders; for example, by exercising their right to vote.

Stock lending and directed brokerage appear to be widely used by large pension funds that employ independent custodians. These activities generally produce sufficient income to offset the custodial fees of the schemes. However, it can be more difficult and less profitable for smaller schemes to engage in these activities. Almost all passive investment managers use stock lending within their portfolios in order to offset trading costs, which benefits those smaller schemes whose funds are passively managed.

Pan-European pensions have been making headlines recently, particularly with the implementation of the IORPs directive in 2005. However, the participants expressed mixed views on the benefits of such arrangements. Although there appears to be some movement towards pooling of assets on a pan-European basis, it is very difficult to amalgamate liabilities cross-border.

In the second section of the report, we look at trends in investment within Defined Contribution pension plans. Although most of the industry discussion of investment matters tends to focus on DB matters, DC schemes should not be ignored, as most new employees today are joining DC pension plans.

The range of fund choices presented to members of DC schemes has improved dramatically in recent years. Most schemes offer a range of funds that allow members to choose the level of risk appropriate to their own circumstances. However, it is clear that many members are not actively engaged in setting their investment strategies. This is despite DC schemes offering a wide

range of communication and educational tools to their memberships. The vast majority of DC members invest in the default option, which is usually either a consensus fund or an active balanced fund.

Few schemes appear to employ a lifestyling strategy. Therefore, members that are in the default option, who are getting closer retirement, will tend to remain invested in the consensus (or active balanced) fund. This may not be appropriate. However, many trustees expressed a reluctance to make assumptions regarding how members will use their retirement funds and at what age members will choose to retire. Without making these assumptions, it is difficult for trustees to put a lifestyle strategy in place. Most schemes that do not have a lifestyle strategy will write to individual members as they approach retirement, suggesting a more suitable investment strategy for these members than the default strategy.

Although pension schemes place considerable emphasis on member communication, it appears that most members of defined contribution schemes do not actively engage with the investment of their pension funds. This is directly reflected in the high proportion of members in the default option.

Most schemes offer fund information and risk projection tools via the company's intranet or their external consultants' web-tools. Members are also given booklets, annual statements and company newsletters. All of the pension schemes we spoke with offered some form of face-to-face meetings between members and investment experts on a regular basis. However, it appears that take-up of such opportunities is poor.

3 Defined Benefit Trends

3.1 Asset Liability Modelling

Asset Liability Modelling (ALM) has been in existence, in one form or another, for a considerable length of time. Traditionally, ALM involved looking at the distribution of a scheme's liabilities between active members, deferred pensioners and pensioners in payment. The theory behind this approach was to determine a mix of assets that was deemed acceptable in terms of a risk-reward profile as assessed over a very long-term time horizon. One problem with this method, however, appears to have been a lack of clarity on the best way to handle conflicting objectives. On the one hand, schemes were looking to match their long-term liabilities; on the other, maximising returns was often paramount. Initially, this did not seem to create significant problems, as "everyone knew" that equities produced the best returns over the long term.

However, when the equity market crashed in 2000, trustees realised that in trying to maximise the performance of their schemes' assets, the ALM had often overlooked the essential, but conflicting, objective of matching the scheme's liabilities. "Matching" involves investing in assets that behave in the same way as the liabilities, in response to a variety of factors, such as interest rate changes, inflation, economic growth, and so forth. As equity markets continued to decline, many central banks cut interest rates aggressively in order to stimulate economic growth. This created unprecedented difficulties for defined benefit pension schemes. As the values of schemes' assets were falling in response to events in equity markets, the values of the liabilities were increasing rapidly in response to interest rate cuts.

In this environment of short-term pain and greater short-term accounting volatility, pension schemes and the consultants who advise them realised that the traditional approach to ALM needed to evolve into an approach that more closely pinpointed various short-term risks, and

allowed these risks to be evaluated as separate decisions. In the intervening years, techniques have been significantly improved. Rather than emphasising a long-term time horizon, schemes are more focused one one-year and other short-term risk measures relative to the liabilities. The introduction of new accounting standards such as FRS17 accelerated this process, as sponsoring employers became more concerned about pension fund asset volatility being reflected on the company's balance sheet.

Of the DB pension schemes interviewed, 88% have conducted (or are currently conducting) asset liability studies since 2000. The consultants that we interviewed confirmed that the traditional emphasis on long-term liabilities and returns, without sufficient emphasis on short-term risks, is no longer appropriate. Much work has been conducted to improve on the traditional model, moving to one which focuses on risk budgeting. In most cases, this involves initially determining the least-risk portfolio; that is, the portfolio of assets which most closely mirrors the liabilities. From this point, consultants and pension schemes work together to determine the level of risk that should be taken in moving away from the leastrisk portfolio, and how best to allocate this risk. Trustees and consultants are therefore highly conscious of the level of any mismatch between a scheme's assets and liabilities, and how this mismatch will affect the funding position. Such focus has led to an increasing use of more sophisticated investment strategies. This form of ALM now appears to be used extensively. However, at the time of the last investment trends survey in 2000, only 14% of DB schemes had ever undertaken any form of asset liability study.

3.2 Liability Driven Investing

Liability Driven Investing (LDI) has been making headlines for the past several years. At its highest level, LDI is a mind-set that promotes an approach to investment and investment decision-making, which focuses on the performance of assets relative to liabilities, rather than relative to the market. Since their introduction, ALM exercises usually indicated that pensioner liabilities should be matched by very long-dated bonds. However, such bonds were not available. In recent years, many investment banks and fund managers have begun offering very long-dated "synthetic" bonds, often created using swaps. These allow pension schemes to match their expected pensions cashflow very closely. This is important, as it is these long-dated pension liabilities that are the most volatile element of any pension scheme. Once pension liabilities have been better matched, schemes can focus on how best to utilise their risk budget. Other products have also come onto the pensions market, such as absolute or target return funds, which use a variety of techniques to deliver a less volatile, real return (relative to the liabilities) on the return-seeking assets of the fund.

By using a combination of the above investment instruments, pension schemes should strive to achieve more consistent returns on their assets relative to their liabilites; thereby minimising the level of volatility in the funding position.

During our discussions on this topic, it became clear that there are a wide range of views on LDI. The lack of consensus on the value of LDI suggests that this is a topic which will need to be revisited frequently over the next few years, and that increasing understanding of LDI will be a difficult, but worthwhile, challenge.

None of the pension schemes interviewed have adopted what they viewed as an LDI approach to setting their

investment strategy. However, most schemes had actively considered and rejected this option. Several reasons were given for this. Many schemes are concerned about the perceived high bond weightings associated with LDI strategies, particularly given the high cost of bonds at the current time. Even if long-dated bonds were affordable, the loss of potential future returns was a matter of concern, particularly for schemes with deficits or weak employer covenants. Several schemes expressed the view that LDI would generally be appropriate in the event of a pension scheme having very mature liabilities and a strong funding position, or where a sponsoring employer was concerned about balance sheet volatility and prepared to accept the higher cost of funding the pension scheme in return for stability. There seems to be a lack of awareness among pension schemes that LDI could simply be used to help trustees to address, and decide upon, strategy and structure by focusing on return and volatility relative to liability measures, rather than "buying a product". Trustees appear to view LDI as leading to a very high bond weighting, which increases the cost of funding and eliminates the potential for higher returns. However, the consultant community regards LDI more as an approach to assessing an individual scheme's interest rate, inflation and equity risks, and using this assessment to set a strategy with both risks and rewards consciously evaluated. This may lead to part, but not necessarily all, of the portfolio being used to close off some of these "unrewarded" risks, possibly using bonds.

A number of schemes expressed scepticism about the entire LDI concept. These schemes felt that investment banks had fuelled the debate about LDI in order to gain access to the lucrative pensions market.

Generally, the consensus view among the consultants was that the discussions about LDI have had a positive impact on trustees' level of understanding and awareness of the risks inherent in running pension schemes with mismatched investment strategies. The increased focus on risk is seen as a welcome development.

However, most of the consultants interviewed agreed that the idea of LDI is not entirely new. Both LDI and more recent ALM models aim to develop an investment strategy that reduces the level of risk in a pension scheme, and to use the best tools and products available to match liabilities while targeting risk budgets appropriately. While ALM has always been designed to measure risk, an increased focus on short-term risks, rather than long-term risks, has led to the development of the LDI approach, and an evolution of ALM techniques to focus more on the shorter-term risk measures around which LDI is based.

3.3 Investment Management

At the time of the 2000 investment trends survey, only 29% of schemes had adopted nonbalanced investment strategies. Overall, 84% of schemes had at least a portion of their assets in balanced mandates at that time. Furthermore, 64% of schemes employed a single investment manager, in respect of all of their assets, in 2000.

In the intervening six years, there has been a noticeable shift away from traditional balanced investment managers. Most DB schemes have now conducted ALM exercises. In most cases, this has resulted in schemes adopting scheme-specific, investment strategies. Some schemes have maintained a balanced investment strategy following an ALM exercise, as such a strategy continued to be appropriate. In those cases where schemes decided to move away from a balanced mandate, most of the schemes interviewed have appointed specialist investment managers. While many schemes have appointed some overseas managers, Irish managers appear to be holding their own and retaining or successfully winning assets to be managed against bespoke mandates. All of the pension schemes we interviewed had a bias towards active investment management. Of the schemes interviewed, 88% had some passive exposure (averaging around 25%) with the remainder of the assets being actively managed. Interestingly, this reflects the findings of the

IAPF's 2005 Asset Allocation Survey, which found that 25% of all Irish pension scheme assets were passively invested.

The consultants interviewed concurred with the view expressed by the participating pension schemes that, in many cases, the traditional balanced approach was no longer appropriate for defined benefit plans. However, some schemes have found that the investment strategy implied by examination of their liabilities is in line with that employed by balanced funds. They also agreed that larger pension funds tended to appoint a range of specialist investment managers, on the basis that an individual manager is likely to excel at managing one, rather than all, asset classes. However, for smaller schemes, this option is not usually available - either for cost or accessibility reasons. The consultants we spoke to were divided on what offered the best solution for these smaller schemes. Several held the view that multi-manager (or manager-of-manager) funds offered small schemes access to a range of specialist managers, thereby enhancing returns. Others felt that using a single investment manager to manage all assets against a bespoke benchmark was more appropriate, due to lower fees, less separation between trustees and fund manager, and the ability to add value through active asset allocation.

All of the consultants also agreed that the least-risk approach to investment management for pension schemes was to adopt passive mandates, and that this should be the starting position for all investment decisions. It appears that smaller pension schemes often favour a passive approach, due to the removal of manager selection risk and lower fees. In general, consultants felt that larger schemes were more likely to appoint active managers. Some of the consultants felt that the best approach would be to invest a substantial portion of a scheme's assets passively, with the remainder being invested in highly active, high return-targeting strategies, in order to target the use of the scheme's risk budget effectively.

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3.4 Property and Alternative Assets

Although property is technically an alternative asset class, Irish pension schemes have long held significant weightings in this asset. Therefore, most trustees do not view property as “alternative”, reserving this definition for assets such as hedge funds, private equity, commodities and currency funds.

Property

Property remains very popular with pension schemes. 38% of the schemes interviewed are actively increasing their property weightings, while one scheme with a very large exposure to property is looking to reduce this. 88% of the schemes have moved, or are considering moving, a proportion of their property weighting into European property. This is mainly seen as a way to improve diversification, rather than enhancing returns. The consultants interviewed agreed that this appears to be a common trend.

Hedge Funds

88%of the pension schemes who contributed to this report had investigated the possibility of investing in hedge funds, but decided not to proceed. Reasons for this decision included the level of due diligence required, the high level of fees, the distortion of historic returns caused by survivorship bias and a perception that there is too much money chasing deals at the moment. Industry data indicates that there is some take-up of hedge funds by pension schemes; however, it seems that their use is still peripheral.

Private Equity

Most Irish pension schemes have some legacy exposure to venture capital, the most highrisk form of private equity investment. Poor returns on these holdings have put many schemes off investing in private equity. However, pension funds seem less negative on private equity than on hedge

funds. Several of the schemes interviewed are considering investing in private equity, while two are already doing so. 38% of the schemes had recently considered private equity investment, but had decided not to proceed. As with hedge funds, due diligence, high fees, difficulties in assessing performance and the amount of money in the market were the main reasons for not investing in private equity.

Currency

While hedging non-Euro currency exposure appears to be fairly common, direct investment in currencies appears to be less so. Most of the schemes interviewed were not currently interested in currency investment, although some were considering it. Only one scheme has invested in a currency fund to date, although the amount involved was very small.

Global Tactical Asset Allocation (GTAA)

A quarter of the schemes who participated have GTAA in place. Several others are currently investigating the possibility of allocating to GTAA, although concerns were raised about the complexity of this type of investment.

Consultants' View

Most of the consultants interviewed agreed that there was currently little demand for alternative assets. Some clients have looked at structured products or swaps, but not many. Interest in private equity may increase as a result of the NPRF's decision to allocate to this asset class. However, several of the consultants felt that the multiple levels of fees charged within funds-of-funds offset any potential benefits from diversification. Some consultants felt that trustees need to avoid having too many small, complex investments. In general, it was felt that there may be some role for alternative assets in terms of either reducing risk or increasing return, for diversification reasons or as part of LDI strategies.

3.5 Trustee Training

All of the consultants interviewed agreed that, although some trustee boards are well versed in most of the investment matters relevant to pension funds, generally levels of knowledge in many fiduciary bodies is sub-optimal. Although most of the consultants offer intensive training courses in investment, the majority of trustees prefer to receive training as part of their regular trustee meetings. Most of the consultants recommend that new trustees should attend a formal, introductory, trustee training course. Demand for trustee investment training varies widely across schemes of all sizes.

Most of the pension funds we talked to agreed that they generally covered investment issues at their regular trustee meeting. Usually they would ask their investment consultant to conduct this, except for those schemes that had dedicated pensions professionals on staff. Many schemes expect the trustees to attend seminars, hosted by the pensions and investment industries, a couple of times a year as part of their continuing professional development. However, the unpaid and part-time nature of the trustee role can make it difficult for trustees to devote too much time to this issue. Nevertheless, it appears that most pension schemes do, at least, send newly appointed trustees on a formal, introductory, trustee training course.

3.6 Governance

According to almost all of the consultants who participated in the survey, it was felt that it was best practice for schemes to set up an investment sub-committee. This would allow a smaller group of trustees, perhaps with additional members from the scheme's advisors, to focus on investment issues. It would be easier for this small group to achieve a higher level of investment knowledge, and spend more time investigating investment issues, than could be achieved by

the wider trustee board. Investment sub-committees are usually less formal and meet more frequently than the full trustee boards, which can facilitate quicker decision making, and faster responses to market developments. It is generally the remit of the subcommittee to investigate investment matters, and present their conclusions to the full trustee board. This reduces the amount of time the main trustee body need to devote to the detail of such matters. Despite these benefits, consultants reported that the majority of the schemes with whom they work do not have dedicated investment sub-committees. However, such sub-committees are often set up for the duration of specific projects.

Half of the pension funds we talked with have dedicated investment sub-committees in place, and agreed with the consultants' view that these facilitate better knowledge and quicker decision making. Two schemes had set-up investment sub-committees on a temporary basis in the past; for example, while the scheme conducted an ALM or manager review exercise. However, since the pension funds who participated in the survey were generally very large, their behaviour in this regard does not necessarily reflect the practice of pension funds in general.

3.7 Socially Responsible Investing (SRI)

None of the trustees we spoke to had placed any SRI restrictions on their investment managers. Most felt that this was outside of their purview as trustees. However, several indicated that they did expect their investment managers to actively engage with investee companies, particularly with regard to exercising their right to vote.

The consultants agreed that there was very little demand for SRI mandates in Ireland at present. On the other hand, this is becoming a larger consideration globally, particularly with several large international schemes recently signing up to the UN Principles on Responsible Investment.

3.8 Added Value Techniques

All of the schemes participating in the survey are very large schemes, and most employ an independent custodian. This allows these schemes access to added value techniques that many smaller schemes might be unable to employ.

88% of the interviewed schemes use stock lending within their portfolios to boost returns. 75% use, or are considering using, directed brokerage as well. Most felt that these strategies had been profitable and more than covered their custodian's fees. However, some trustees felt that the level of work involved in setting up such programmes was disproportionate to the level of return.

The consultants agreed that stock lending and directed brokerage were popular with larger pension schemes. However, some felt that such arrangements distracted trustees from more important issues. Stock lending plays an important role in passive funds, allowing passive investment managers to reduce their trading costs. This was the most common way for smaller schemes to benefit from such strategies.

3.9 Pan-European Pensions

Only four of the schemes interviewed have offices overseas. Two of these have already set up, or are definitely setting up, pan-European scheme structures. The other schemes felt that pan-European arrangements were attractive, but currently unworkable.

4 Defined Contribution Trends

4.1 Fund Offerings

Historically, schemes tended to offer a single balanced fund, possibly adding a single bond fund and a single cash fund in response to members getting closer to retirement. Indeed, at the time of the last investment trends survey, schemes offered 3 fund options on average. This has changed significantly in recent years. Most pension funds now offer members a choice of 6 to 8 fund options. These usually reflect a range of risk levels, from equity funds through balanced funds to cash and bond funds. Most schemes use a single provider for these fund offerings, although some used more than one. It appears that, where the investment manager also carries out the administration of the scheme, a single provider is used. However, if the administration is conducted by a third-party administrator, the trustees are more likely to appoint a number of investment managers. In general, appointing any more than two managers appears to be counter-productive, both in terms of higher costs and increased confusion on the part of members offered too many choices.

In general, members are offered one equity, one bond and one cash fund. These may be either actively or passively managed. However, almost all schemes offer more than one balanced fund. Usually a passively managed balanced (consensus) fund will be offered alongside an actively managed balanced fund. Several schemes are also offering multimanager (manager-of-manager) balanced funds, which combine active and passive elements. All participants felt that it was difficult to strike a balance between offering members a wide enough range of fund options, without creating undue confusion amongst members.

Very few defined contribution schemes offer property funds. In addition to the high costs associated with such funds, the

recent IORPs directive's restrictions on investment in unregulated markets has made offering property funds unattractive.

None of the schemes interviewed offer ethical funds, or access to alternative assets. Ethical funds were generally not offered because there appears to be little demand for such funds from members. Given the complexity, cost and range of alternative assets, and the lack of pooled vehicles through which to invest in them, trustees did not feel these were a practical option for defined contribution schemes at present.

Some consultants expressed the view that trustees should make ethical funds available on request, in order to avoid potential difficulties from members denied access to such funds. However, they felt that if the trustees were to offer an ethical fund as standard, this would not necessarily avoid such problems, as different members might have different ethical standards.

4.2 Default Funds and Lifestyling

All of the pension schemes we spoke to have a default investment strategy in place. The most popular default fund, by far, was a passively managed balanced (consensus) fund. This concurs with the information given to us by the consultants interviewed. In 2000, only 56% of DC plans offered a default option. At that time, 58% of these had an actively managed balanced fund as their default, with 25% choosing consensus funds and 17% offering with-profits vehicles. In general, it appears that the vast majority of defined contribution members invest in the default fund.

Only one-third of the schemes who participated in the survey use, or are planning to use, a lifestyle investment strategy as their default option. Most of the others indicated that members are contacted directly as they approach retirement, to highlight the fact that the default strategy may no longer be appropriate for their needs.

Several of the consultants held the view that schemes should employ a lifestyle strategy as their default option, in order to minimise potential difficulties that trustees might face as their schemes mature.

One of the reasons given by both schemes and consultants for not favouring a lifestyle approach was that trustees do not feel comfortable making assumptions about how members will wish to use their retirement funds, or at what age members may choose to retire.

4.3 Member Communication

Although pension schemes place considerable emphasis on member communication, it appears that most members of defined contribution schemes do not actively engage with the investment of their pension funds. This is directly reflected in the high proportion of members in the default option.

According to the results of the previous investment trends survey, 57% of those schemes who provided information on fund options to their members did so via a combination of written materials, staff presentations and the internet. Of the other 43%, 35% of schemes only provided members with written information on their fund choices, 8% relied exclusively on staff presentations, and none communicated with members solely via intranet or internet

Currently, most schemes offer fund information and risk projection tools via the company's intranet or their external consultants' web-tools. Members are also given booklets, annual statements and company newsletters. All of the pension schemes we spoke with offered some form of face-to-face meetings between members and investment experts on a regular basis. However, it appears that take-up of such opportunities is poor. Feedback from consultants offered a similar view.

4.4 Pan European Pensions

In general, it appears that defined contribution schemes are less likely to become part of a pan-European arrangement than defined benefit schemes. One of the main reasons for this appears to be the desire to offer Irish balanced fund options, which are not available overseas.

5 Conclusions

It is clear that pension trustees have changed how they view the relationship between their scheme's assets and liabilities in recent years. Almost all DB pension plans are now setting their investment strategy with regard to the scheme's liability profile, and with considerable attention to the level and allocation of risk. This is a very welcome development. The range of solutions falling under the LDI banner may bring an extra dimension to this process. However, there remains a considerable amount of work to be done by the pensions industry to improve understanding of LDI. Over the next few years, schemes will hopefully see their funding positions improve considerably. In this event, LDI may be more attractive to schemes as a means of protecting these improved positions. The intervening period offers substantial opportunities for trustees to learn more about LDI and how it may be of benefit to their schemes.

Another, related, issue highlighted by this investigation is the generally sub-optimal level of trustee knowledge of complex investment issues. We feel that this is another area which should be addressed by the industry as a whole. Trustees do not feel comfortable with adopting sophisticated investment strategies, which often utilise derivatives and alternative assets, due to this knowledge gap. One approach to addressing this issue is to encourage the setting up of dedicated investment sub-committees. This is seen as best practice by the consultant community. Feedback from pension schemes that already have such subcommittees supports the argument that these can achieve higher levels of expertise and comfort with investment matters.

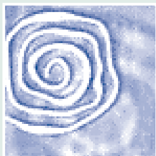
Defined contribution schemes represent a large and growing proportion of pension scheme members in Ireland. In these schemes, members are given power to set their own investment strategy with regard to their own particular circumstances. However, it is clear from discussions with trustees and consultants that many DC members do not feel comfortable making such

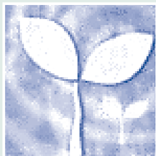
decisions, or are not interested enough to do so. Again, it can be argued that this is a result of a lack of understanding of investment and risk concepts among the general population. Alternatively, it may be the case that by offering a default option in the first place the trustees are implicitly sending out the message to their membership that this is the most appropriate investment strategy for the majority of members. Therefore, careful consideration should be given to the design of any default strategy. Given the projected levels of adequacy for most members who choose default options, a move out of equities as these members approach retirement is usually appropriate. Members who have specific intentions regarding the use of their retirement funds will be able to select their own funds and strategies.

Given the ongoing public debate surrounding the so-called pensions crisis and the adequacy of private pension provision, improving the level of interest in, and understanding of, investment issues among the wider population is an area that should be proactively addressed – by employers, the pensions industry and the State.

Fiona Daly, FIA
On behalf of the IAPF Investment Committee

October 2006





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