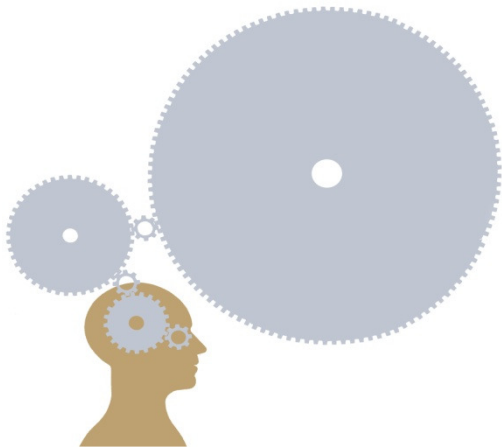


# Pension investment and financial crisis

CEE Life Insurance and Pension Funds 2010

Dr Leonie Bell, Managing Consultant

January 29th 2010



## Illustration

- two individuals with a DC pension plan that is 100% invested in UK equities. 30-year accumulation period.

|                     | Retirement date | Accumulated wealth |
|---------------------|-----------------|--------------------|
| <b>Individual A</b> | end 2006        | £160,035           |
| <b>Individual B</b> | end 2008        | £92,598            |

Notes: Based on historical parameters for real equity returns. The individuals contribute £1,000 in the first year, and contributions then grow at a rate of 2% (real) over 30 years. No tax and management fee.

Source: Oxera calculations.

⇒ 42% lower accumulated wealth as a result of retirement coinciding with financial crisis and sharp fall in equity markets

- is this outcome 'fair'?
- what are the alternatives?

## Main messages

- pension investment decisions cannot be based on the benefit of hindsight
- pension schemes are vehicles for long-term investment
  - investing in equity can deliver higher returns at comparatively low risk given the long investment horizon
  - minimum return guarantees are not a 'free lunch'
- important to avoid short-term policy overreaction to events
  - investment restrictions and other rules can be costly in the long term
- more need than ever to focus on key asset management (AM) functions and responsibilities

# Pension investment

## The cost of investing in 'safe' assets

### Simulations of impact on retirement wealth (30 years)

| Percentile    | 100% equity | 100% bonds |
|---------------|-------------|------------|
| 10th          | 44,171      | 31,443     |
| 25th          | 70,176      | 39,287     |
| 50th (median) | 120,640     | 50,383     |
| 75th          | 222,242     | 65,961     |
| 90th          | 389,224     | 84,313     |

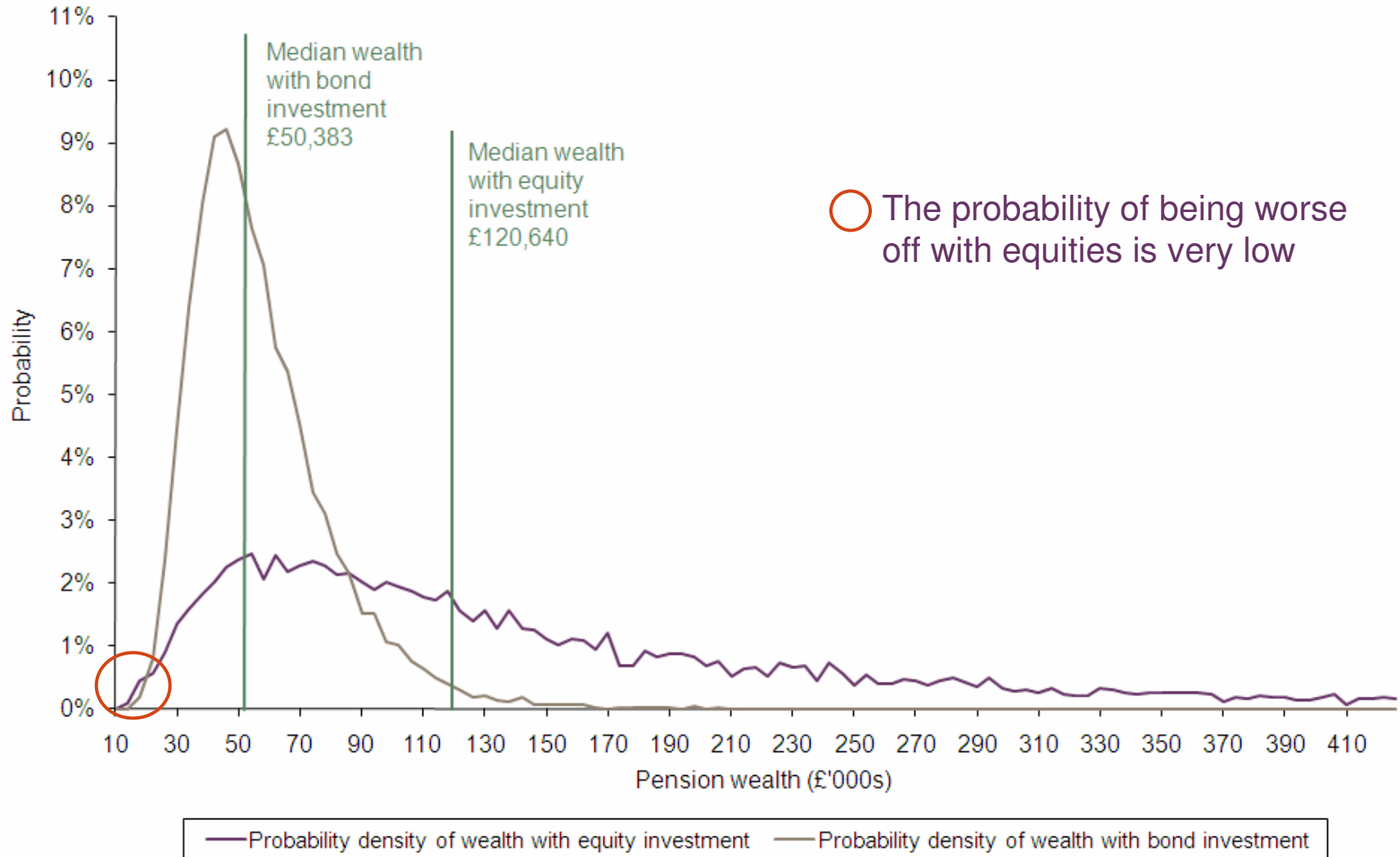
Notes: Simulations for 10,000 individual accounts, based on historical risk-return parameters for real government bond and equity returns for the UK from 1950 to November 2009 (1950 to 2008 data obtained from Barclays Equity Gilt Study 2009; 2009 data obtained from Datastream). The individual contributes £1,000 in the first year, and contributions then grow at a rate of 2% (real) over 30 years. No tax and management fee.

Source: Oxera modelling.

- diversifying into equity can deliver higher returns at comparatively low risk given the long time horizon for pension investment
  - based on simulations of historical returns for 30-year horizons

# Pension investment

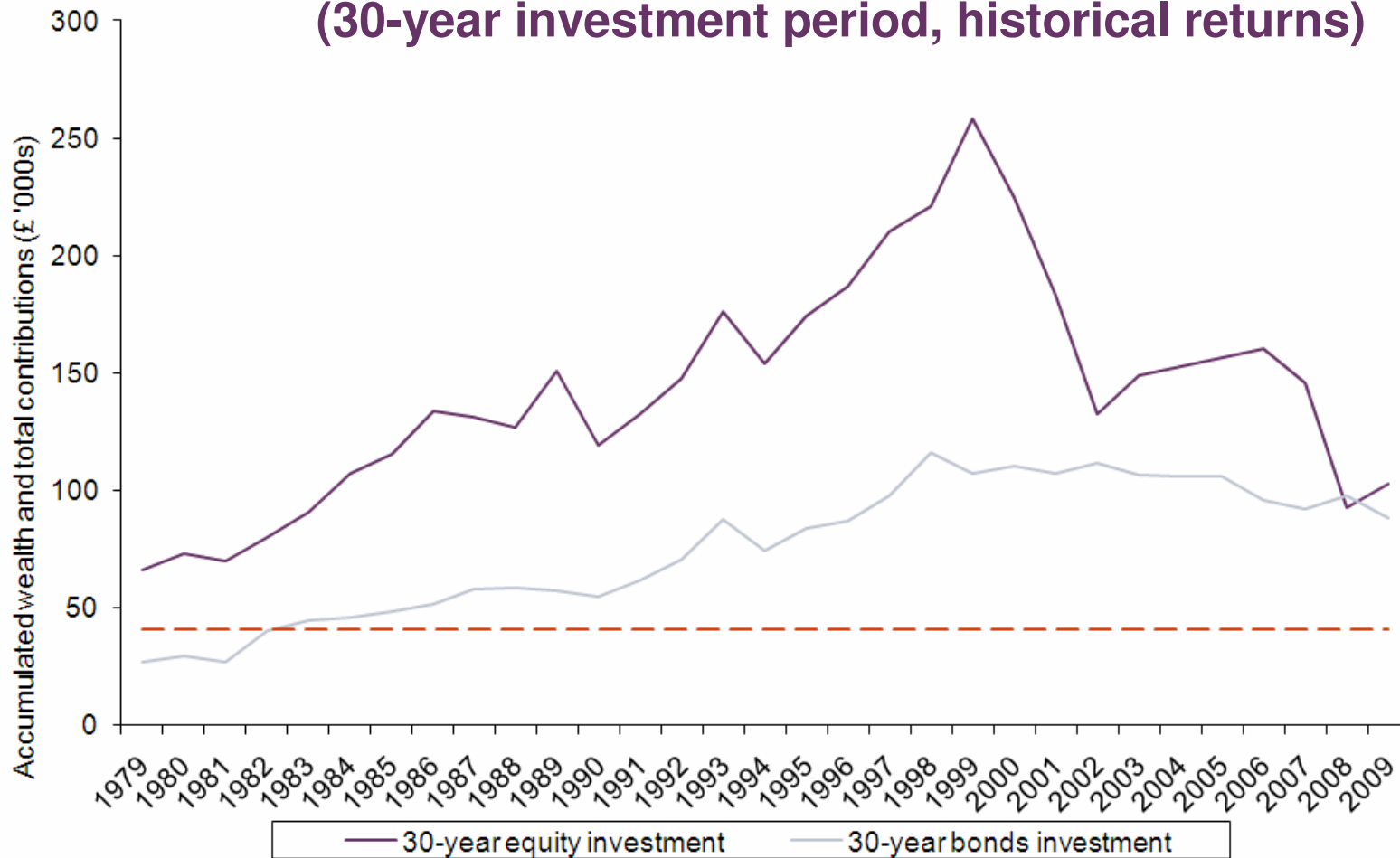
## Simulations of impact on retirement wealth (30 years)



Notes: Based on assumptions described in previous slide.

# Market volatility and DC pension outcomes (I)

## Illustration of retirement wealth by year of retirement (30-year investment period, historical returns)



Notes: Shows accumulated wealth, at the end of a 30-year period ending in the year shown on the horizontal axis, based on actual historical UK equity and gilt real returns, and assuming same contribution pattern as in the previous slides. Source: Oxera calculations, based on data as before.

## Market volatility and DC pension outcomes (II)

- market volatility implies lower DC pension wealth for those retiring during a downturn, and higher wealth for those retiring in a boom
  - whether this is fair or not is a political question
  - but what is the alternative?
    - shift back to public pensions funded on a pay-as-you-go basis?
    - conservative investment strategy, minimum return guarantees?
- ⇒ reduced investment risk for individual members, but alternatives come at a cost

## Policy responses

### Shifts back to public pensions

- political risk for funded mandatory private pension systems in CEE countries
  - scale back contribution rates—eg, Lithuania, Latvia
  - allow switch back to public pension system—eg, Poland, Slovakia
- may reduce short-term budgetary problems, but wrong economics
  - no 'free money' in the system
  - intergenerational transfers
  - unsustainable public finances

## Policy responses

### Investment restrictions and minimum return guarantees

- mandatory pension funds in CEE often subject to tight investment restrictions
    - impedes efficient portfolio diversification
    - adverse effect on long-term pension accumulation
  - political pressure for more conservative investment strategy (eg, Poland) and guaranteed returns (eg, Slovakia)
    - limits short-term volatility, but can result in more costly pensions in longer term
  - cross-border investment restrictions that are inadequate in small national capital markets
- ⇒ avoid short-term political reactions and policies that can be costly in the long run

## The role of asset managers

- losses of consumer confidence in capital markets and intermediaries
  - more need than ever to focus on key AM functions
    - manage investment risk and return
    - develop product solutions to meet individual needs and preferences
    - promote advice and financial education
- ⇒ contributes to restoring confidence and facilitating a growing market for private savings and investment

## AM pension product solutions

- pension investment solutions have emerged in the market
  - life-cycle funds
  - target-outcome funds
  - diversified funds
  - structured products
- but further initiatives required
  - what are suitable and pre-defined investment strategies?
  - how to educate people about the risk-return trade-offs?

## Summary

- short-term crisis in capital markets has damaging effects

but

- pension schemes are vehicles for long-term investment
- investing in equity can deliver higher returns at comparatively low risk given the long investment horizon
- important to avoid short-term policy overreaction to events
  - investment restrictions and other rules can be costly in the long term
- more need than ever to focus on key AM functions and responsibilities



Oxera

[www.oxera.com](http://www.oxera.com)

Contact:

Dr Leonie Bell

+32 (0)2 535 7808

[leonie.bell@oxera.com](mailto:leonie.bell@oxera.com)

