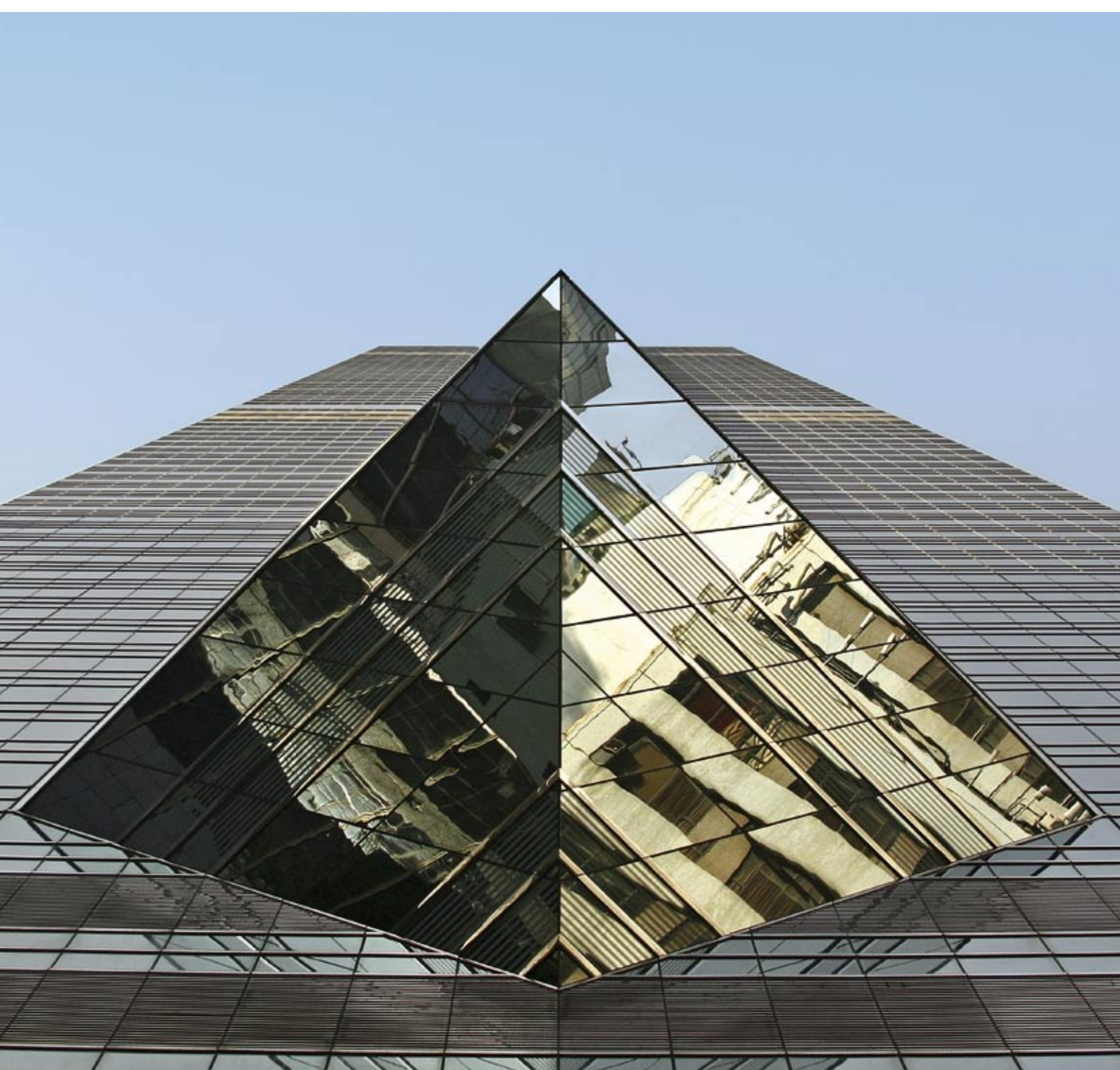


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global investment

# review



**Governance and value creation**

Our latest thinking on pension investment combines capability with three core strategies.

**Liability driven investment and liability hedging**

More and more pension funds are doing it, but what exactly is LDI?

**The price of imbalance**

General insurers should pay more attention to managing assets as well as liabilities.

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# Introduction

Life has become a lot tougher for pension funds. Their task – to provide affordable, quality pensions – is looking worryingly like ‘mission impossible’.

Those who hoped that rising equity markets in 2006 would perk up pension balance sheets have been forced to accept that there can be no short-term fixes.

As the old, conventional world of pension investing slips into history, pension funds have new issues to grapple with. The three most prominent are changing regulations, problems with the capacity of new strategies and increases to costs.

We are increasingly convinced that the key to success for pension funds is to have the right governance in place for the task ahead.

We are referring to the key elements that are required to run a fund – time, expertise and decision-making ability.

Good governance really does add value, while good ideas badly executed can have the opposite effect.

This is why pension funds need to make sure that their governance and investment strategies are aligned. There is a lot of room for improvement here because most funds do not employ the strategy that best suits their governance structure.

The long-term goal for institutional funds is value creation. Investors can seek to add value in many different ways.

Our work isolates three building blocks. They can adopt a liability-driven approach to investment. Second, they can diversify their assets in a number of areas: clearly equities, but also less mainstream choices; property, private equity hedge funds, even more exotic choices such as infrastructure and timberland, which have longer-term

payoffs. Third, they can use skill-based strategies, judging that active managers will come out ahead for them after fees.

The better governance message increasingly applies to DC funds around the world. It is vital that these funds are invested as efficiently as possible so that they too can provide affordable, quality pensions in future.

Whichever way you look at it, the price of delivering retirement security to pensioners is dauntingly high. But the cost – in human terms and to corporate reputations – of *not* rising to the challenge is even higher.

Roger Urwin  
Global Head, Investment Consulting

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# Governance and value creation

## Our latest thinking on pension investment combines capability with three core strategies.

Ten years ago, pension fund investing was relatively straightforward. The key decisions were to decide the equity/bond split and then pick managers to implement that asset allocation. Managers' performance was assessed relative to a benchmark. The other questions that funds wrestled with were the number and type of managers in the line-up – whether they should be active or passive, balanced or specialist.

Greater regulation, product proliferation and competition have complicated the sorts of decisions pension funds now have to face:

- Should the fund take risk to create value or focus purely on risk minimisation?
- How much time and resource should be committed to governance and how should this effort be organised?
- What should be the balance between market risk and manager risk?
- Should the focus be on absolute or relative return?
- How much exposure should there be to mainstream assets (equities and bonds) and how much to alternatives?

We believe that now is a perfect time to take a fresh look at the investment issues facing pension funds and to structure a more joined-up approach, given today's opportunities and constraints.

### Creating value

Imagine that running a pension fund is like flying a plane, and that a successful investment strategy is similar to a flight plan.

A skilled pilot must make use of three major control levers, as well as cope with complex monitoring. To remain airborne, a pilot must control roll (keep the wings parallel with the ground), yaw (keep the nose and tail pointing towards the destination) and pitch (point the nose up to climb and down to descend).

We suggest that there are also three primary 'control levers' for investment funds. These are:

- **Effective LDI:** liability-driven investment refers to the reduction of unrewarded liability-related risks, typically using bonds and swaps.

- **Cheap beta:** this refers to packaged market exposures with the stock-specific risk taken out. By 'cheap' we mean ensuring that a fund does not overpay for the market component of return.

- **Reliable alpha:** this refers to pure skill returns. No single skill source produces consistently positive returns, so alpha must be made more 'reliable' by diversifying across a broad line-up of managers.

## Why governance matters

The investment success of investment managers is driven by the quality of their decision-making. High quality decisions will show up in high quality results. Equally important is the quality of fiduciary decision-making, or governance. It is governance that determines how the risk budget is deployed and whether this creates or destroys alpha.

Because of this, we believe that the notion of 'best practice investment' should be closely tied to the governance capabilities of each fund. This implies that there is no single best practice model that is appropriate for all investors.

All too often, we see investment solutions proposed that are technically efficient but are beyond the governance capabilities of the fiduciaries. The results are inevitably lower than expected.

Not surprisingly, the best governed funds tend to perform better than averagely governed funds. What distinguishes a high, or strong, level of governance from a low, or weak, one? We use the concept of a governance 'budget', which we see as a combination of time, expertise and organisational effectiveness.

The characteristics of leading high governance funds are worth noting. They tend to split the key functions between a board, which governs, and an executive, which implements and manages. The board appoints and supervises an investment CEO/CIO, who is involved in setting policy, has a high degree of investment expertise, and is supported by a strong research function.

We view governance as central to successful investing. Skimping on governance is likely to result in lower-than-expected performance,

and an inability to manage the conflicts of interest that abound in the investment industry.

Some investors will see merit in improving their governance arrangements by increasing the time they spend on investment issues, adding expertise, and rethinking their organisational structures.

However, it is unrealistic to suppose that all pension funds can better their arrangements to such an extent that they become high governance funds.

## Three models, three solutions

Because governance resources differ, we have identified three different investment models which correspond with funds' different levels of governance (see Figure 1).

Each one will have an 'ideal' investment solution (see Figure 2).

**Cost minimiser.** The point of running a fund in this way is to manage down all costs and to focus on easily available investment returns. This model is compatible with the lowest governance resources.

**Diversity seeker.** The diversity seeker has sufficient governance resources to pursue some value creation opportunities. The focus would be mainly on improving beta diversity, with limited active management.

**Diversity and skill exploiter.** The third model has significant diversity and a high proportion of active risk. There is greater emphasis on identifying alpha opportunities and, as a result, this model requires very strong governance.

Figure 1 | Three levels of governance

Limited	<b>Single board</b> <ul style="list-style-type: none"> <li>resources constrained by expertise and time</li> <li>overall cost likely to fall in range under \$1m</li> </ul>
Middle-range	<b>Investment committee</b> <ul style="list-style-type: none"> <li>resources increased by experts and greater time</li> <li>overall cost likely to fall in range from \$1m to \$5m</li> </ul>
Advanced	<b>CIO and investment team</b> <ul style="list-style-type: none"> <li>use of investment experts with support of strong investment committee</li> <li>overall cost likely to fall in range above \$5m</li> </ul>

Figure 2 | Three investment models

	Asset allocation	Managers
Cost minimiser	<b>Mainly equities and bonds</b> (say 60% equities, 40% bonds)	<b>Mainly passive</b>
Diversity seeker	<b>Diversity &gt; 15% outside equities and bonds</b> (say 40% equities, 20% diversity assets, 40% bonds)	<b>Passive and active</b>
Diversity and skill exploiter	<b>Diversity &gt; 30% outside equities and bonds</b> (say 20% equities, 40% diversity assets, 40% bonds)	<b>Very active: active risk above 20% of total risk</b>

We think that these three models give a glimpse of how the three 'control levers' (LDI, cheap beta, and reliable alpha) can be better used, given funds' different governance budgets.

We believe that current practice is overly ambitious in terms of trying to identify successful active managers. Few funds have sufficient governance in place to fully exploit both diversity and manager skill effectively. In other words, many funds aspire to a model that is too complex for their resources.

### What the future holds

Provided that governance is up to the job, we see three big investment opportunities becoming available:

- **Wider diversity of betas and benchmarks.** The trend of diversifying away from equity risk appears well established. Going forward, we see opportunities for some investors with higher governance to do better with different betas.

“ We believe that current practice is overly ambitious in terms of trying to identify successful active managers. ”

- **Optimised risk allocations.** With the use of leverage and 'porting' (or moving around the different components of return within the portfolio), risk allocations can be more flexible, and less tied to capital. If we want, we can have more exposure to the alphas than the underlying capital would suggest, and more scope

to separate the alpha and beta decisions.

- **More long-term investment.** Short-termism has come to be seen as a 'bad thing' because it introduces unnecessary costs. New opportunities to do more and better long-term investment are requiring fiduciaries to make longer-term decisions, and creating demand for long-term products. Among these, we see continued growth in long-term absolute return investing, and in real estate and infrastructure opportunities through globalisation.

At the same time, we believe that future mandates will need to:

- **Increase the transparency of the return drivers.** For example, many hedge funds get a large portion of their returns from diversified traditional betas, but they charge alpha-type fees to investors.
- **Be more explicit about timeframes.** There is nothing wrong with a short time horizon if it is appropriate for the mandate.
- **Reduce benchmark constraints.** Allow active managers more freedom to apply their skill. As this idea catches on, relative return mandates will need higher risk tolerances, or they are likely to be replaced by absolute return or long-short mandates.
- **Charge a fairer fee for the value added.** We believe that both traditional relative return and absolute return mandates charge inappropriate fees for beta.

All of this could have implications for investment organisations. Growth is typically easier in new areas, and this is already leading to a convergence of organisation types.

Alongside these changes, we suggest that the next five years may well see significant growth in the use of liability-driven investment, diverse benchmarks and leverage, and a decline in traditional low-risk long-only mandates.

One further big opportunity available to pension funds and other institutional investors is to recognise the direct link between governance and performance. This recognition should lead to a strengthening of internal governance, with funds spending more time on strategic issues and less on investment products.

A more integrated approach to pension fund management is the way forward.

For the full report, please see the separate publication *Flight Plan*, Watson Wyatt, November 2006.

### **Not everyone can exploit alpha**

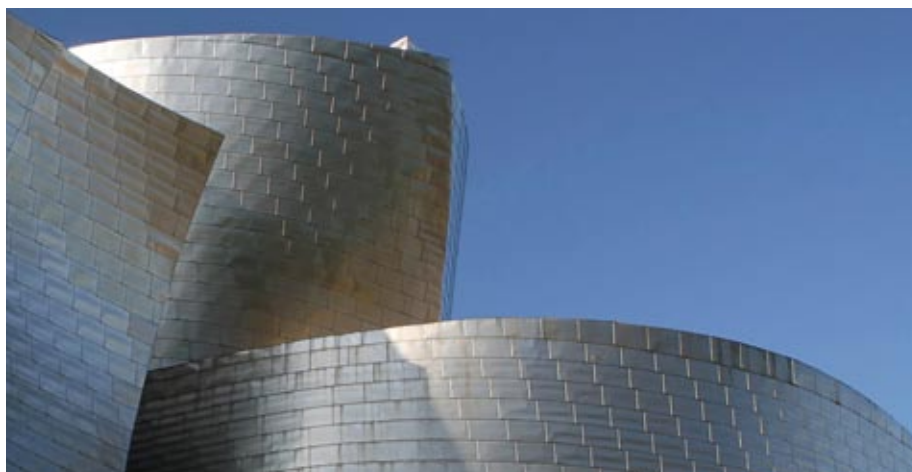
We believe that the use of active management should be reserved for those funds with the highest governance. This suggestion may seem startling, but there is a growing body of evidence to suggest that institutional investors are generally unsuccessful at selecting and terminating active managers.

For UK pension funds, the evidence can be traced back to 1996, when The WM Company published its first report on this subject. This is complemented by a major study of manager hiring and firing decisions by US institutions<sup>1</sup>.

Both studies suggest that institutional investors often select managers based on the comfort of a good track record. Disappointment follows when the newly hired managers fail to outperform. Meanwhile, managers tend to be terminated after underperforming, but their subsequent performance tends to improve.

On average, the sad conclusion has to be that many fiduciaries have tended to subtract value by chasing active return.

<sup>1</sup>Source: *The selection and termination of investment management firms by plan sponsors*, by Amit Goyal and Sunil Wahal of the Goizueta Business School, Atlanta, May 2005.





# Liability driven investment and liability hedging

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## More and more pension funds are doing it, but what exactly is LDI?

The pensions world has recently started to buzz with talk of LDI, or Liability Driven Investment. More and more funds are using LDI techniques to help close the gap between their assets and liabilities. Rising costs and inflation expectations are making plan sponsors increasingly aware of this risk, and making them more inclined to do something about it.

Crucially, they now have access to financial instruments that can help them.

But what do we mean by 'Liability Driven Investment'? We thought it would be useful to explore what lies behind the concept, and what it means for pension funds.

### So what exactly is LDI?

This is not an easy question to answer as it depends on whom you ask, but generically LDI refers to setting a fund's investment policy with a closer eye on its liabilities. Despite the 'buzz', Watson Wyatt's clients have been doing this for some time already and the aspect that typically differentiates LDI is the specific consideration of 'liability hedging'.

Liability hedging seeks to better align a pension fund's assets with its liabilities. On a more technical level, it means using bonds and (more often) swaps to mitigate the inflation and interest rate risk posed by a pension fund's liabilities.

### But haven't pension funds always been aware of their liabilities?

Pension funds have traditionally invested with their liabilities in mind, but until the turn of the millennium, they had more of an asset-focus towards setting investment policy.

### So this is about making up for lower equity returns, right?

Not exactly. At the same time that equity markets turned south, pension deficits appeared more transparently on corporate balance sheets, courtesy of new mark-to-market accounting measures. Calls from plan fiduciaries for larger contributions posed a further threat to corporate P&Ls. Other factors such as improved longevity were also adding to sponsors' pension fund burdens.

The result has been closer collaboration between plan fiduciaries and sponsors with a view to reducing pension fund risk relative to liabilities.

### Which risks are we talking about here?

Think of pension fund risk as comprising both 'good' and 'bad' risks. Funds taking 'good' risks – such as equity, credit, or liquidity risk – expect to be compensated with a higher expected return (although they still need to consider whether the risks are appropriate for their own circumstances).

'Bad' risks are not generally rewarded via a risk premium that offers higher expected returns. Examples include lack of investment diversification, interest rate (duration) risk, inflation risk, and longevity. These risks should be

minimised if the costs of doing so are attractive.

### **OK, you hedge. But where do the liabilities come in?**

This is where it gets interesting. We are talking about hedging out interest rate and inflation risks within the pension fund's liabilities. This can be done in a number of ways.

The cheapest and simplest approach is often to buy bonds with the appropriate duration, though interest rate and inflation swaps will in most cases achieve a closer match than buying physical bonds. The most complex and sophisticated solution is full liability cashflow matching using swaps.

### **I like the idea of swaps. I heard about them at a recent Watson Wyatt conference. What happens next?**

Before you make any decisions, first you need to establish what your liabilities are.

Pension fund liabilities are subject to a lot of uncertainties, such as early retirements and salary increases. Therefore, you need a good understanding of the liabilities you want to hedge, and their sensitivity to changes in interest and inflation rates.

Bear in mind that although liabilities are 'bond-like', they are not bonds, and that most pension fund benefits are complex and not a straightforward stream of cashflows.

If the idea of entering into a swaps contract still seems appropriate given your fund's liability profile and sensitivities, it is essential to get impartial advice before you go any further.

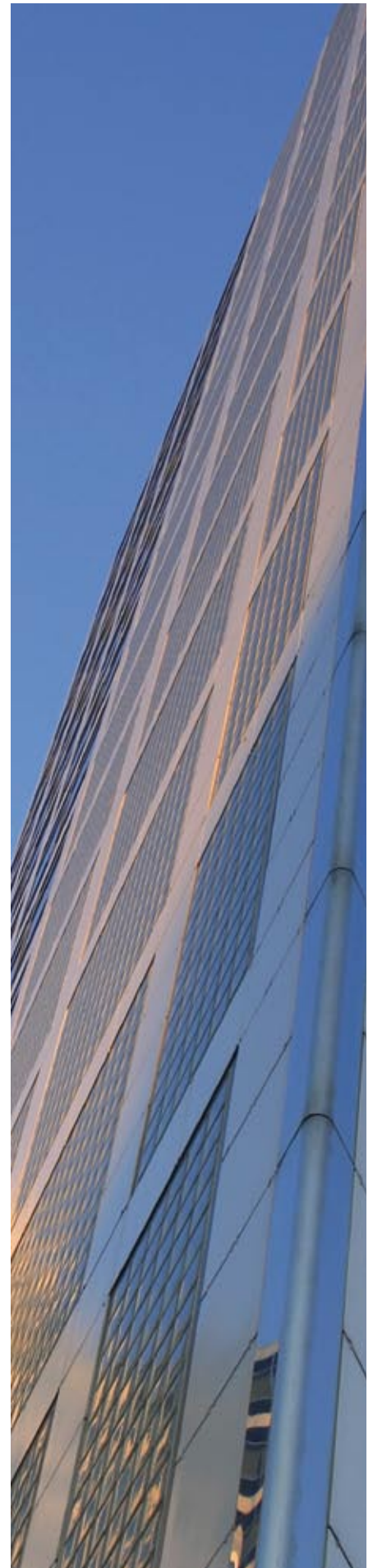
### **Why? What are the drawbacks?**

Buyer beware. It can be very difficult to assess whether inflation swap deals are fairly priced. Pension funds must tread wisely in order to achieve 'best execution' when transacting inflation swaps.

The pension fund is also exposed to counterparty risk – in other words, the risk of the bank not being able to meet its side of swap commitments.

Counterparty risk can be reduced by a process known as 'collateralisation'. The bank or fund posts cash or securities equal to the market value of the swap to the other party. Of course, this requires frequent marking-to-market of the collateral, which must also be managed.

**“ Pension funds have traditionally invested with their liabilities in mind, but until the turn of the millennium, they had more of an asset-focus towards setting investment policy. ”**



### **How much will all this cost me?**

There is a series of 'one off' costs including the transaction costs paid to the bank, legal and tax advice fees, consultant fees, and the set-up and execution fees to the pension fund's swap execution agent. There are also ongoing asset management fees, plus increased custodian charges and fees for monitoring and performance measurement services.

### **What if I don't like current yield levels?**

Once you do the deal, you are locked in at the agreed rate with the agreed counterparty. If you don't like current yield levels, you could wait for more favourable terms (although there is no guarantee that yield levels will not subsequently move against you). Alternatively, you can consider using options.

### **How will I know if my liability hedging assets are performing?**

This is probably the wrong question to ask. The right questions are closer to: how has the value of my assets changed compared with the value of my liabilities? What were the major contributors to this change? Have my liability-hedging assets behaved as

expected and improved the match between my assets and liabilities? Is my return-seeking portfolio delivering the returns that were expected and at appropriate risk levels?

### **Let's get back to basics. Is liability hedging the 'magic bullet' to cure all pension fund ills?**

Liability hedging on its own is rarely a cure-all solution. However, if it is combined with a review of funding/contribution policy and appropriate changes to investment strategy, it could be a step in the right direction.

Although more and more funds are turning to liability hedging, it is not appropriate at present for all pension funds. The complexities of the different solutions – and their true costs – may be difficult to ascertain, and the whole process requires managing and monitoring. This means that trustees will need to allocate a lot of time, effort and resources to liability hedging.

There are also many risks that liability hedging (at present) cannot address.

Remember, liability hedging is only one aspect of a fund's investment strategy and should not be considered in isolation.

“ **Liability hedging on its own is rarely a cure-all solution.** ”



# The Global Alternatives 99 ranking

According to our annual survey, some \$200 billion flowed into alternative assets in 2005.

Alternative assets managed by leading fund managers grew by about 20 per cent to \$1.26 trillion, during 2005, according to Watson Wyatt research. The Global Alternatives 99 ranking, conducted together with *Global Alternatives* magazine, shows that funds of hedge funds (FOHFs) continue to be the most popular alternative asset class for investors, followed by real estate and private equity funds of funds (FOFs). Commodities rank a distant fourth in popularity\*.

Altogether, around \$200 billion flowed into alternative assets in 2005, according to the survey, which is based on responses from 142 fund managers. Pension funds continue to be the largest source of new money, pumping some \$77 billion into these assets in 2005, a 24 per cent increase over 2004's inflow. But pension funds differ from other investor groups in their choice of assets. Real estate remains by far their favourite asset class, although FOHFs are rapidly gaining in popularity. Pension fund allocations to FOHFs rose from 13 per cent in 2004 to 21 per cent in 2005, and pension funds poured nearly as much into FOHFs in 2005 (\$26 billion) as they did into real estate (\$27 billion).

Pension funds are also increasing their commodities exposure in their search for alternative sources of return (see also page 18). However, allocations to commodities are still relatively small, accounting for only 1 per cent of pension funds' total investment in alternatives, and 6 per cent of inflows in 2005.

According to the survey, the largest alternatives manager at the end of 2005 was RREEF (previously Deutsche Real Estate) with \$62.2 billion under management. Within the commodities sector, Allianz tops the table with \$13.7 billion under management.

For a full listing of the Global Alternatives 99 ranking, please email [globalinvestmentreview@watsonwyatt.com](mailto:globalinvestmentreview@watsonwyatt.com)

Figure 1 | Top 15 alternatives managers 2006

Rank	Name of parent	Country of domicile	Asset class	Total worldwide assets \$bn
1	RREEF	US	Real estate	62,183
2	ING Real Estate Investment Management	Netherlands	Real estate	55,646
3	Hamilton Lane Advisors, LLC	US	Private equity	48,793
4	Man Investments	UK	Fund of hedge funds	45,800
5	Morley Fund Management	UK	Real estate	38,314
6	AXA Real-Estate Investment Managers	Pan European	Real estate	36,600
7	UBS AG/UBS Global Asset Management	US	Real estate	30,608
8	LaSalle Investment Management	US	Real estate	30,503
9	JPMorgan Investment Management Inc.	US	Real estate	29,700
10	Prudential M&G	UK	Real estate	29,500
11	Union Bancaire Privee Asset Management, LLC (UBPAM)	US	Fund of hedge funds	25,000
12	Alternative Investment Solutions	US	Fund of hedge funds	24,944
13	Pacific Corporate Group, LLC	US	Private equity	23,000
14	Credit Suisse	US	Real estate	22,508
15	Permal Group	US	Fund of hedge funds	21,304

Source: Watson Wyatt/Global Investor

\*Note – Watson Wyatt conducted this survey for the year to December 2005 to determine the alternative assets under management of fund management firms around the world and to determine investment trends in this area. Two hundred fund managers were approached for this survey and 142 responded – 17 more than last year and comprising 65 funds of hedge funds, 31 private equity funds of funds, 37 real estate managers and nine commodities managers. In the private equity and hedge fund space, this ranking is focused purely on funds of funds, which are of most interest to institutional investors. For real estate and commodities, direct managers are included. The real estate ranking is dominated by European respondents.



# DC – decisions on autopilot

Automating key DC decisions would increase members' retirement income and give sponsors a competitive edge.

The growth of Defined Contribution (DC) pension plans around the world has led to widespread unease about the DC model.

The key concern is that DC members lack both the will and the skill to manage their DC investments, and so suffer from inertia. To make matters worse, the savings shortfall created by inadequate contributions is being compounded by inefficient investing.

DC has also introduced a lot of uncertainty into retirement planning. Nearly two-thirds of DC plan members surveyed by Watson Wyatt said they had 'no idea' or only a 'vague idea' of their likely retirement income, whereas less than one-third of Defined Benefit (DB) plan members surveyed gave this response.

These are worrying trends, because there is, naturally, a public interest in seeing that future generations of workers are financially secure when they retire. What can be done to fix the problems?

## An automated approach

Most DC members find the role they are cast in – CIO of their own pension fund – fairly daunting. It is generally up

to the individual to decide whether to enrol in the scheme, how much to contribute, and how to invest the money. Should it be the default strategy, or a pick-and-mix choice of different funds?

So far, the industry has struggled to come up with ways to support decision making cost effectively for millions of individual members.

We think the solution lies in automation – to be more precise, making decisions on autopilot.

Nearly a century ago, Lawrence Sperry invented the aircraft autopilot to automate the pilot's response to varied conditions (today, more than 99 per cent of commercial aircraft miles are piloted by computer). The same concept can be applied in DC to support the three main aspects of decision making:

- auto-enrolment in DC plans
- auto-contribution programmes
- auto-investment strategies.

Some plans already use the first two 'auto' programmes to improve DC take-up and, help members build up benefits to appropriate levels.

Auto-investment strategies are far more complex. A simplistic version of this approach has already existed for nearly 20 years in the form of life cycle strategies, which allocate assets according to the member's age. Younger members get more equities to match their higher risk tolerance; older members have higher bond allocations.

But this is a 'one-size fits all' solution. Auto-approaches need to be more flexible and dynamic, to reflect people's different risk tolerances and life circumstances – such as their assets, expenditure and future earning potential – as well as their age.

This may seem challenging, but in fact only two multi asset funds would be needed to meet the investment needs of most individuals. These are safe assets (cash, bonds and other low risk investments), and a growth fund that would invest in equities and a wide array of other global assets, including alternatives. This diversified approach is critical to success in a long-term growth fund. DC investment is currently far too concentrated in equities, particularly domestic equities.

“ **Nearly two-thirds of DC plan members surveyed by Watson Wyatt said they had ‘no idea’ or only a ‘vague idea’ of their likely retirement income.** ”

Each individual would invest in an ideal mix of ‘safe’ and ‘growth’ assets that would change over time, not only with age but also with life circumstances. This risk-based allocation is probably the single most important element in DC success.

The drawback is that no DC plan has yet created a flexible process for determining it because of the immense technical challenge. To achieve this goal we need improved technology to capture life circumstances efficiently, more research into how risk affects members’ thinking, and streamlined fund design.

Post-retirement investing also deserves more attention. Buying an annuity can ruin all the good work achieved in building a pension, by allocating the money to bond-like investments that are inappropriate, given that average longevity for many

retirees exceeds 20 years. We see this as a form of ‘reckless conservatism’.

Combining post-retirement life cycle investing with mortality pooling<sup>†</sup> can give a mix of assets that are far more likely to deliver attractive income streams than are classic annuity solutions.

For many individuals, the time will come when purchasing an annuity is a sensible answer – but typically not until several years after retirement.

### Where next?

DC investment design currently scores only two or three out of 10 for efficiency. Companies could do much more to improve their DC plans, and for reasons that make sound business sense. We believe that companies with effective DC plans stand to gain a significant competitive edge because of their enhanced ability to attract and retain talent.

At present, sadly, our suggestions represent more of a future vision than a practical DIY kit for DC design\*. However, we are convinced that the industry will eventually combine ingenuity with technological advances to boost the DC investment design score. This is urgently needed for our pensions system to play its vital part in the vibrant economy of tomorrow.

<sup>†</sup>Mortality pooling aims to provide most of the benefits of an annuity by sharing the mortality risk in a pooled fund, but without the obvious cost. Increasing longevity makes it particularly attractive.

\* See Watson Wyatt’s *Achieving the Goals of DC Members – The Forward Thinking Company DC Pension Plan*.



# Picking tomorrow's winning managers

## How a well-structured business contributes to success.

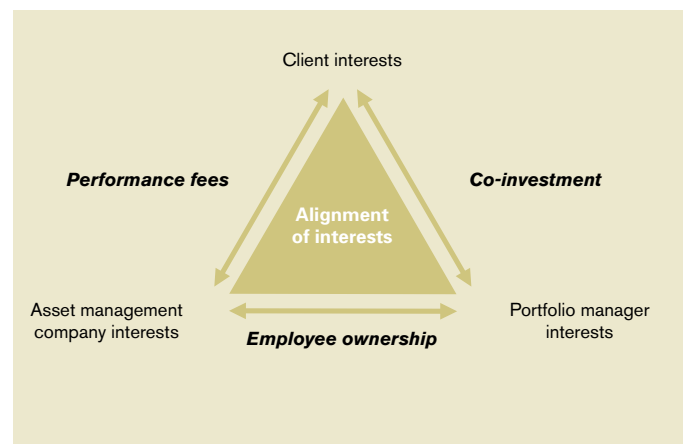
At Watson Wyatt, we devote significant resources to manager research. In a recent series of articles, we have tried to demystify what we do and how we pick tomorrow's winning managers without simply relying on past performance numbers.

In our research, we identify three key areas that we believe are critical to a manager's future success – these are business, people, and investment process. While much has been written about the advantages of recruiting top talent and maintaining a superior investment strategy, there has been comparatively little focus on the 'business' factors that can help to generate sustainable strong performance in the future.

Most investment firms look well structured from the outside. Our research attempts to dig deeper into the realities behind this facade.

Figure 1 illustrates two business factors, alignment of interests, and the ideal organisational structure, and explores how they are critical to an asset management firm's success.

Figure 1 | Alignment of interests



### Alignment of interests

Critics have noted that the asset management industry is almost unique in the way that the fees paid by clients, and the remuneration structures, tend to favour the asset management firms rather than their clients.

We believe that firms will find it increasingly difficult to survive in this manner. To remain competitive, they will need to align their interests with those of their clients and their employees (primarily analysts and portfolio managers).

How might they go about doing this? The obvious way to align the interests of a firm with its employees is to give them equity in the business. In a small boutique firm, direct equity ownership can be a powerful attraction but, unfortunately, few asset management firms are in this position.

Most firms have multiple product lines, so giving portfolio managers equity in the business is not a great motivator because it will not reflect their direct contribution to the bottom line. The incentive will be even more diluted if the equity is in a corporate parent.

One way of tackling the problem is by giving employees ownership of their own products through some form of revenue or profit-sharing. Some large firms have built a series of 'boutiques' to make this possible.

The next side of the triangle is 'co-investment'. To align interests with clients, we like portfolio managers to invest their own money alongside client assets. The easiest way of doing this is by locking up deferred bonuses in the product for a certain period of time. It is fair to say that co-investment works best in absolute return products, because that is how most managers want to see their own assets invested.

It also works best where all client portfolios are managed in an identical fashion, so that the manager is not tempted to give preferential treatment to the vehicle where his own money is invested.

The third side of the triangle is performance fees. These seem ideally suited to the asset management business because they allow the firm that produces the performance to share in any gain – or pain – that it has produced for the client. They also act as a disincentive to 'asset gathering' which could affect returns negatively. The firm is more likely to act in the best interests of its clients and close a product early, before capacity becomes an issue.

A word of caution: badly designed performance fees cause more problems than not having them at all. Most tend to be too short-term in focus, and short-term performance is more an indicator of luck than of skill.

We also look for well-designed compensation structures, because these can be a key differentiating factor in attracting and retaining talent. But we are generally suspicious of long-term deferred

compensation (lock-ins) for senior people for two main reasons.

Firstly, if they are poorly structured they can result in a lot of people leaving at the same time. Secondly, they can lead to people staying for the wrong reasons. People need to be passionate about their work, and not simply be holding on for a payout in two years' time.

### **The ideal business structure**

The ownership structure of a firm is one of the most important factors in determining its culture. It provides us with an important early signal as to what motivates the leaders of the business.

The merger fever that gripped the investment industry during the late 1990s bull market created a sharp divide between large organisations and their smaller competitors. Investors came to see large brand name firms with global reach as superior to less well-resourced niche firms. But this view is changing as large managers continue to see an exodus of their talent to smaller houses, and as specialist mandates grow in popularity. Larger firms are responding with innovative solutions, such as the boutique structure mentioned earlier.

Asset management is not a capital intensive business, and so there is little reason why such a firm should not be majority employee-owned. In fact, portfolio managers tend to be believers in capitalism and want to own their firm.

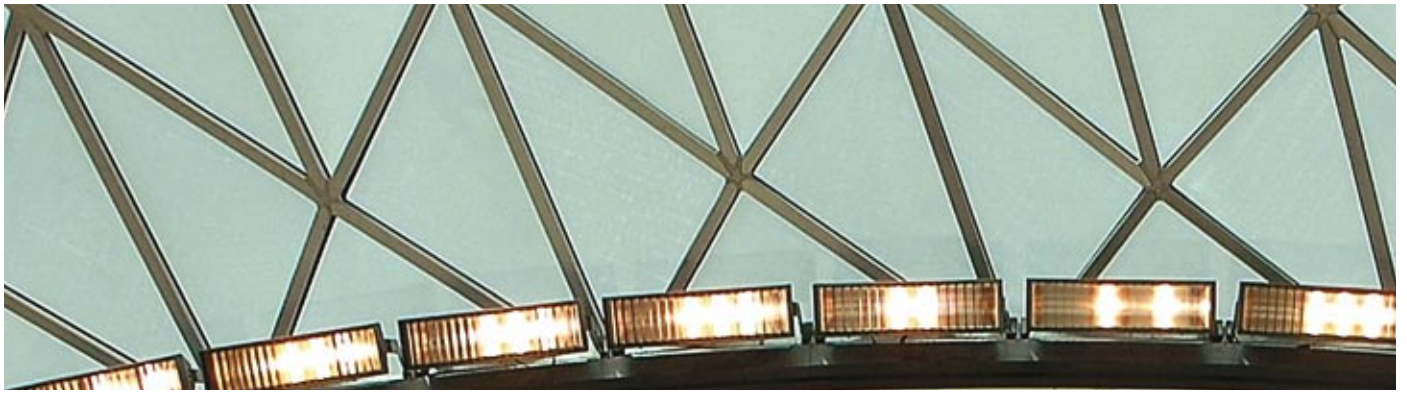
We see two reasons why asset management firms either seek a public listing or sell out. They either want to provide a short-term exit route for senior staff or to raise cash for an acquisition. Neither of these is in the interests of existing clients.

But smaller is not always better. Good portfolio managers do not always make good business managers. This means that we need to look very carefully at the way some of the smaller firms are run as businesses, especially in their early years, when pressing business issues can distract the top people from focusing on managing clients' portfolios.

'Big' has its benefits as well, and being part of a large organisation does offer 'synergies' with other parts of the business, multiple distribution channels and a diversified revenue stream. However, experience tells us that it is often difficult for firms to capitalise on these advantages. And because asset management is not a capital intensive business, being able to dig into a parent's deep pockets is not as crucial as is often believed. For instance, back office functions can now be outsourced, and buying in new IT today is much cheaper than trying to update legacy systems.

We have identified 10 different types of business models that commonly exist in the asset management world, ranging from private companies that are wholly owned by their employees or founders, to publicly quoted companies, and organisations belonging to banks or insurers.

All of these have their advantages and disadvantages, but it is clear that the successful asset managers of the future will be those that can win the 'war for talent'. From this perspective, niche firms that focus on their key strength are finding it easier to attract top people. In contrast, firms that are part of a larger organisation whose core business is not asset management will have a harder task ahead of them.



# The price of imbalance

General insurers should pay more attention to managing assets as well as liabilities.

Every balance sheet has two sides, and both of them require skilful management. In our client work, we often see organisations that throw their energies into managing liabilities rather than assets. The result can be disappointing.

Among organisations that focus their resources almost entirely on managing the liability side are general insurers. Many of them are expert at measuring and managing their liability exposures (which is, after all, their core business), but few of them seem as capable of managing their investment risk.

This matters, because they often have substantial assets to invest and because there is a hidden cost to inefficient investment.

In other words, general insurers (and reinsurers) could be achieving higher returns for the level of risk they are taking in their investment portfolios. This is simpler than it sounds. In our view, if these companies made just a small increase in resources applied to the investment side, they would see a relatively large financial improvement.

## Imbalance sheet

As risk-taking financial businesses, general insurers naturally seek a close relationship between the risks

that they accept and the rewards that they expect from risk-taking. The main job of management is to maximise the insurer's expected rewards based on an acceptable level of risk, or 'risk budget'.

This concept should apply to both sides of the balance sheet – to investment risks as well as to underwriting risks.

So far, however, few general insurers look at their investments in this way, despite having a large amount of invested assets. Typically, there is a huge imbalance in the resources that they apply to the two sides.

Some insurers employ hundreds of people to measure and manage insurance risk (which is natural as this is their core business). By contrast, often there is no-one at all with the relevant skills and full-time responsibility to oversee investment assets that can top \$1 billion or more.

Instead, general insurers typically spend just a few hours a year on investment issues, and although those responsible may be very capable executives with a keen interest in investment, their specialist skills lie in other fields.

## Counting the cost

As general insurers run larger and larger investment portfolios, the hidden cost of their inefficient investing strategies is mounting.

An example may help to put this into perspective. Take the difference in expected returns between a \$1 billion portfolio invested efficiently (that is, it generates a higher return for a given level of investment risk) and the same portfolio invested less efficiently (producing a lower return for the same level of risk).

Even if you choose to invest only in short duration bonds, there are good and bad ways of doing so and the difference could easily amount to 0.1 per cent or \$1 million a year. A more diversified approach, using genuinely active

management, could increase returns by 0.5 per cent or \$5 million a year.

Clearly, these are not insignificant amounts. It follows that general insurers should consider reviewing their investment skills. If they have significant assets to invest, a cost-benefit analysis will typically justify buying investment expertise, either in-house or externally.

To sum up, the hidden costs of inefficient investing can be substantial. With an eye on the bottom line, general insurers would do well to make sure that their investment resources – in terms of skills, time and organisational effectiveness – are large enough to manage current assets and keep pace with the portfolio as it grows.

Good investment governance will pay for itself. The alternative is far more expensive.

For a copy of our publication, *Efficient investing-key principles for non-life insurers*, please email [globalinvestmentreview@watsonwyatt.com](mailto:globalinvestmentreview@watsonwyatt.com)

**“ Good investment governance will pay for itself. The alternative is far more expensive. ”**





# Alternative investments

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## From trees to greenhouse gases, investors are searching for more diversified sources of return.

The spectacular growth of interest in alternative investments is now leading investors to seek out less crowded corners of the market in their continuing quest for return and portfolio diversification.

Since equity markets cracked in 2000, institutions have shifted significant assets out of equities into real estate, funds of hedge funds and private equity in the search for alternative sources of return.

As institutions grow more comfortable with alternatives, they are expanding the range of assets they are considering in order to improve rewards for the risks taken.

The investment management industry is responding to this demand by making more products available to institutions.

In this article, we explore four of the more unusual investment opportunities that have attracted attention recently. As with all alternative investments, investors should keep their eyes wide open and be aware that implementation and monitoring are not for the faint-hearted. Investing in markets that may be illiquid and volatile can be a wonderful source of uncorrelated return, but it usually involves unfamiliar risks.

## Timberland – growing money on trees

Timberland has been a top-performing asset class for institutional investors over the past 20 years. So far, most of the activity has been in the US, but investors' appetite is now extending to other parts of the world such as New Zealand.

Why buy trees? The key attraction is a 'real' asset that has returns uncorrelated with equities and bonds. There is a chance for active management to produce superior returns, and timber may offer some protection during equity bear markets.

Timberland is defined as a forested area capable of producing more than 20 cubic feet per acre per year of industrial wood crops. Income, mainly from sales to lumber and paper companies, accounts for about one-third of total returns. Capital gains from changing timber and land values, and from tree growth accounts for the rest.

There are several ways to invest. Larger institutions may choose segregated accounts (minimum \$100 million) or limited partnerships known as Timberland Investment Management Organisations (TIMOs).

Smaller investors can opt for timberland Real Estate Investment Trusts (REITs), although REITs' liquidity may destroy a key source of return from timberland, which is the premium for investing in an illiquid asset.

Investment opportunities are very tricky to assess. It is difficult to put hard numbers on the value of timberlands as they are mainly in private hands, and transactions are rare.

The size of the investable market has been estimated at about \$500 billion, with one-half of this in the US. But less than one-third of investable timberland may be available for open transactions. Performance data is also thin, and open to interpretation.

A final word of caution: the weight of money searching for active returns from timberland could reduce alpha opportunities in future.

## **CAT bonds – betting against disaster**

Catastrophe (CAT) bonds are high-yield debt instruments sponsored by insurance companies. They specify that in the case of predefined catastrophic events, such as a hurricane hitting Florida, the issuer's obligation to pay interest (or repay the principal) to investors is deferred or forgiven if losses exceed a 'trigger' point.

The attraction of CAT bonds for insurers is that they can lay off risk onto investors, who will reap large gains – typically LIBOR plus 4 to 7 per cent – if the risk does not occur. CAT bonds can also be a powerful diversifier for investors, as the occurrence of catastrophes is generally not linked to the performance of other asset classes.

The CAT bond market had a sluggish start, but took off after 9/11 when worldwide insurance premiums rose and insurers lost their appetite for covering large-scale risks. Although insurance has picked up, the market is still only worth approximately \$16 billion.

CAT bonds are typically sub-investment grade, but they can be structured in different ways. Some investors, for instance, may prefer lower returns in exchange for principal protection while others would risk more for a higher return.

Several – but not all – large investment banking groups are active in structuring and trading these bonds, which are typically offered to investors through private placements.

As with all alternatives, CAT bonds come with several caveats. The

secondary market is small and pricing is difficult as valuation models do not fully capture insurance risks. Investment risks are unfamiliar and unpredictable (despite reams of research on catastrophe risk). This means that bond managers will be unable to apply their usual skills.

Lastly, performance is difficult to assess because of the rarity of events. But from 2002 to 2004, Swiss Re's BB Cat Bond index has a return of 26 per cent – close to that of the Lehman BB High Yield index (28 per cent) but with lower volatility.

## **Carbon trading – pricing greenhouse gases**

The concept of a market in carbon emissions is relatively new, and intended to reduce global warming. The carbon market took off after the signing of the Kyoto Protocol, which came into force in February 2005, and says that industrialised countries must cut greenhouse gas emissions substantially by 2008 – 2012 (the US did not sign).

Rather than enforce quotas for emissions, the market allows them to be 'traded'.

There are two main ways to trade carbon. The first is via so-called 'cap-and-trade' schemes, which grant permits to companies giving them the right to pollute up to a set limit. They can trade their quotas with other companies – selling a surplus or buying extra pollution rights. The second way is through schemes that grant emissions credits for financing projects in developing countries.

So how can investors get involved? One route is as intermediaries in the cap-and-trade market, where hedge funds are key participants, though pension funds are more likely to invest (through intermediaries) in the longer-term project-based market.

Both approaches assume that demand will push up the price of emissions. But the market is new and complex, and requires a high degree of specialist knowledge.

## **Leveraged loans – financing buyouts**

Leveraged loans are syndicated loans to sub-investment grade (BB+ and below) corporate borrowers. The 'leverage' here refers to corporate debt rather than to a geared investment portfolio.

Leveraged loans are typically floating-rate debt. They tend to have a senior ranking in a company's capital structure, and so are likely to have a lower default rate than bonds. The majority of leveraged loans are used by private equity firms to finance leveraged buyouts, but companies also use leveraged loans to finance their activities.

So how can institutions find their way into one of these loan syndicates? They generally do so via pooled funds run by specialist managers. The manager needs to be able to source these assets, and so will have strong relationships with private equity sponsors and syndicate banks. Skill in credit analysis is essential, preferably with a track record of avoiding defaults.

The leveraged loan market is developing fast, especially in Europe, where it provides a crucial underpinning to the continent's growing leveraged buyout sector. However, it is still relatively small. This means that capacity is limited, and fees are hefty.



# The world's **500** largest asset managers

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The world's largest 500 asset managers controlled \$53.6 trillion at the end of 2005, an increase of 10 per cent over 2004, according to Watson Wyatt research.

UBS became the first manager to pass \$2 trillion in assets under management, and retained top spot for the sixth year running, while BGI overtook Allianz to gain second place.

The P&I/Watson Wyatt World 500 ranking is compiled in conjunction with leading US industry publication *Pensions & Investments*. The 2005 survey marks a milestone in many respects, as our retrospective analysis shows. Since the bursting of the equity bubble in 2000, there have been dramatic changes in the shape of the asset management industry, and many of these trends are reflected in the rankings.

During this period, investors diversified out of traditional equity mandates into a raft of other strategies, including global property, credit strategies, emerging markets and funds of hedge funds. At the same time, they began to focus on absolute rather than relative return mandates.

Asset managers who adapted to the new environment reaped big rewards, from new inflows, and because of the higher margins associated with non-traditional products.

New products such as enhanced indexation and active higher-return have driven growth at many firms and liability-driven investment strategies have also boosted assets, thanks to a move by larger pension funds to match their assets more closely with their liabilities (see page 8).

M&A activity has also made a comeback, as firms become more focused on their core business strengths. This trend is highlighted by some asset managers acquiring funds from banks and insurers that want to exit the business.

Managers with a firm foothold in emerging markets have also done well. Emerging market equities returned 19 per cent for the five years to 2005 compared with a flat performance for US equities, and 3.7 per cent for European equities.

In contrast, managers with a fixed-income bias have seen more sluggish asset growth recently. The rise of emerging market economies is also reflected in the growing presence of local asset managers. The ranking now includes 10 Brazilian managers, five Korean managers, three Chinese managers, and three Chilean managers.

The top 20 managers had a lower rate of attrition (35 per cent) than the 500 as a whole (42 per cent, or 210 of the original managers in the 2000 survey have dropped out). But in a reversal of a long-term trend, the 20 largest managers are no longer gaining market share as a group. In 2005, they controlled 37 per cent of total assets of the 500, almost the same proportion as five years before (38 per cent). Ten years ago, however, they controlled less than 30 per cent of the total.

Clearly, successful asset managers can follow many different business models (see page 14 for more information on this topic). The past five years have seen the rise and demise of both large and small firms, as well as a radical rethink of investment strategy. One enduring theme is that the key drivers in asset management are not deep pockets and distribution, but adaptability and superior skill.

“ The key drivers are not deep pockets and distribution, but adaptability and superior skill. ”

**Figure 1 | Top 20 asset managers in 2005**

P&I/Watson Wyatt world 500. Ranked by US\$ millions, as at 31 December 2005

Rank	Manager	Country	Total assets US\$ millions
1	UBS AG	Switzerland	2,016,000
2	Barclays Global Investors UK Holdings Ltd	UK	1,513,043
3	Allianz Group	Germany	1,493,488
4	State Street Global	US	1,441,058
5	Fidelity Investments	US	1,421,903
6	AXA Group	France	1,260,202
7	Capital Group	US	1,165,754
8	Crédit Suisse	Switzerland	1,128,365
9	Deutsche Bank AG	Germany	1,026,875
10	Vanguard Group	US	957,589
11	Legg Mason	US	864,399
12	JPMorgan Chase	US	847,369
13	Mellon Financial	US	781,323
14	ING Groep NV	Netherlands	647,867
15	Northern Trust Global	US	617,915
16	Morgan Stanley	US	601,756
17	HSBC Holdings plc	UK	576,200
18	AIG Global Investment	US	571,885
19	Crédit Agricole SA	France	565,414
20	Aviva plc	UK	545,339

Source: P&I/Watson Wyatt

**Figure 2 | Top 20 asset managers in 2000**

P&I/Watson Wyatt world 500. Ranked by US\$ millions, as at 31 December 2005

Rank	Manager	Country	Total assets US\$ millions
1	UBS Asset Management	Switzerland	1,533,002
2	Fidelity Investments	US	1,037,503
3	Credit Suisse Asset Management	Switzerland	867,000
4	AXA Group	France	840,353
5	Barclays Global Investors	UK	801,295
6	Kampo	Japan	769,753
7	State Street Global	US	725,251
8	Allianz	Germany	672,000
9	JPMorgan Fleming	US	638,800
10	Vanguard Group	US	587,699
11	Deutsche Bank	Germany	585,759
12	Capital Group	US	560,958
13	Merrill Lynch	US	556,731
14	Mellon Financial	Netherlands	530,000
15	ING Group	Netherlands	467,858
16	Morgan Stanley	US	457,159
17	Zurich Group	Switzerland	440,371
18	Citigroup	US	431,953
19	AMVESCAP	UK	402,000
20	Nippon Life Insurance	Japan	399,228

Source: P&I/Watson Wyatt



# The world's 300 largest pension funds

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US funds' loss of market share has been among the biggest changes over the past five years.

Total assets of the world's 300 largest pension funds rose a respectable 11.5 per cent in 2005, according to the annual survey conducted by *Pensions & Investments* and Watson Wyatt. This pushes assets of the 300 to \$9.36 trillion, up from \$8.39 trillion at the end of 2004.

Stable markets and increased contributions from plan sponsors helped to boost assets. The biggest gainers were funds exposed to rising equity markets and a stronger US dollar. The growth, however, was far less than the previous year's 27 per cent hike in assets, partly because investment returns were lower, but also because currency movements in 2005 masked the true rise in asset values at many non-US funds.

Even taking these factors into account, the numbers suggest slower growth among the larger funds as they mature. The top 20 pension funds grew their assets by 8.9 per cent in 2005, to \$3.52 trillion (37 per cent of the total). Inflows may also be slowing because of a switch from defined benefit to defined contribution pensions.

A look at how the ranking has changed over the past five years reveals just how much the world has changed for the largest pension funds.

At the end of 2000, assets of the top 300 were \$6.17 trillion. They had held up well during that year, despite plunging world equity markets, but were to shrink to \$5.4 trillion in 2001. Their recovery since then has been dramatic, a 74 per cent increase in assets, but this figure includes some major additions to the rankings, so the year-on-year asset numbers are not strictly comparable.

In 2002, Japan's government Pension Investment Fund joined the ranking at No.1, and has retained top spot ever since. The fund was formed in April 2001 when the government broke up the fund's tightly-controlled predecessor and relaxed investment constraints. The fund is under pressure to perform because of government forecasts that pensioners will account for more than a quarter of Japan's population by 2025.

The other major entry to the ranking was Norway's huge \$236 billion Government Pension Fund, which came in at number 2 in 2005, owing to a change in its designation. (It was formerly the Government Petroleum Fund.)

But perhaps the most striking change over the five years has been US funds' loss of market share. In 2000, US funds commanded 66 per cent of the total assets of the 300. In 2005, that share had shrunk to 45 per cent.

This drop is partly down to the fall in the value of the US dollar (nearly 30 per cent against the Euro over the five years). But the disappearance of leading US corporate funds at the higher end of the ranking and the inclusion of other large funds as noted above tells the same story.

In 2000, 15 of the top 20 funds were US-based, including five corporates – General Motors, General Electric, IBM, Lucent Technologies and Boeing. All but GM had dropped out of the top 20 by 2005.

Calpers, the giant California public fund, topped the ranking for years, followed by Dutch public fund ABP. Calpers has slipped to fifth place, while ABP now ranks above it at number 3.

**Figure 1 | Top 20 pension funds in 2005**

Ranked by US\$ millions, as at 31 December 2005

Rank	Fund	Country	Total assets US\$ millions
1	Government Pension Investment	Japan	870,587
2	Government Pension	Norway	235,849
3	ABP	Netherlands	226,974
4	National Pension	Korea	214,184
5	California Public Employees	US	195,978
6	Pension Fund Association	Japan	183,352
7	Federal Retirement Thrift	US	167,165
8	Local Government Officials	Japan	137,153
9	California State Teachers	US	133,988
10	New York State Common	US	131,861
11	Government Employees	South Africa	124,167
12	Postal Savings Fund	Taiwan	117,265
13	Florida State Board	US	114,935
14	General Motors	US	114,271
15	New York City Retirement	US	105,860
16	Ontario Teachers	Canada	99,490
17	Texas Teachers	US	94,384
18	New York State Teachers	US	87,353
19	Public Schools Employees	Japan	85,224
20	PGGM	Netherlands	84,986

Source: P&amp;I/Watson Wyatt

Both funds employ state-of-the-art investment strategies, but ABP has grown far faster, increasing by 26.8 per cent for the five years to 2005, against a rise of 13.9 per cent for Calpers. (The figures are calculated in local currency terms.)

The growth of Asia's retirement funds is also mirrored in the rankings. In 2000, four Asia ex-Japan funds were listed, whereas now there are nine, including one from each of India and China.

Korea's National Pension Fund ranks just behind ABP, at number 4, while Taiwan's Postal Savings Fund (number 12) has grown 55 per cent (in dollar terms) since 2000. Other Asian pension funds are creeping up the ranking, including Singapore's Central Provident Fund (number 27) and Malaysia's Employees' Provident Fund (number 29).

In 2000, only four Latin American funds were listed (Banco do Brasil's Previ and three Chilean funds). This number had risen to 11 funds in 2005, including four based in Mexico.

**Figure 2 | Top 20 pension funds in 2000**

Ranked by US\$ millions, as at 31 December 2005

Rank	Fund	Country	Total assets US\$ millions
1	California Public Employees	US	171,542
2	Stichting Pensioenfond ABP	Netherlands	140,987
3	New York State Common	US	124,973
4	California State Teachers	US	111,552
5	Florida State Board	US	106,328
6	Assoc. of Local Public Service Personnel	Japan	106,033
7	General Motors	US	105,800
8	Federal Retirement Thrift	US	100,191
9	New York State Teachers	US	90,093
10	General Electric	US	88,490
11	Texas Teachers	US	87,150
12	New Jersey Division	US	82,052
13	National Public Service Personnel	Japan	79,710
14	Postal Savings Fund	Taiwan	75,600
15	Public School Personnel	Japan	70,129
16	New York City Retirement	US	68,701
17	IBM	US	68,274
18	Lucent Technologies	US	67,505
19	Wisconsin Investment Board	US	66,225
20	Boeing	US	65,162

Source: P&amp;I/Watson Wyatt



# Country roundup

## Australia

The Australian superannuation industry has been through a period of rapid growth, consolidation and change in 2006. Total superannuation assets grew 24 per cent over the 12 months to March 2006, to reach a total of A\$906 billion. They are expected to surpass A\$1 trillion by year end. New contribution flows remain strong at around A\$5 billion a month.

Changes to legislation from 1 July 2006 require superannuation fund trustees to be licensed by the Australian Prudential Regulation Authority (APRA). The licensing conditions have proved to be so onerous for many trustees, particularly those of smaller corporate funds, that many have opted to wind up and transfer to commercial master trusts or not-for-profit 'industry' superannuation funds.

In its May 2006 budget, the Commonwealth Government announced radical changes to the taxation of superannuation benefits. These changes, effective from July 2007, will remove all taxation on superannuation benefits paid to members above age 60, and will introduce a fixed dollar cap on the annual amounts that employers and employees can pay into superannuation funds.

The changes have been welcomed by the superannuation industry and are expected to accelerate the rate of growth in superannuation assets.

The Australian equity market continued to roar ahead on the back of a booming mining sector, returning 24 per cent in the year through June 2006 (and an annual 24 per cent during the three years since mid-2003). Once again, this strong performance underpinned double digit returns for most funds.

The trend towards greater investment choice continues, with approximately 5 per cent more funds offering choice to their members between June 2004 and June 2005. Official figures for June 2006 are yet to be released, but this trend looks set to continue.

Like their overseas counterparts, most Australian funds have relied almost exclusively on equities (and to a lesser extent property) as the engines of growth in their investment portfolios. (The large industry funds are an exception to this trend, having embraced alternative assets since the mid-1990s).

But now Australian funds are increasingly turning to alternative asset classes such as private equity, infrastructure, timber and hedge funds to provide additional sources of real growth and to reduce overall portfolio risk. In addition, over the past year or so, a few high-profile superannuation funds have started to use commodity futures as a new asset class.

Fund managers have been quick to respond to the growing appetite for alternative assets, and many wholesale pooled investment vehicles have been brought to market.

## Belgium

The performance of Belgium's pension funds is recovering thanks to two years of healthy returns. In 2005, Belgian funds achieved returns of 15 per cent (weighted average returns net of fees), following returns of 8.9 per cent in 2004. These results are restoring the balance over the long term, so that over a period of 10 years, the average return of Belgian pension fund assets now amounts to 7.9 per cent. Last year's excellent result can be attributed chiefly to investments in equities (up 27.9 per cent) and real estate (up 22.9 per cent).

There have been small shifts over the year in pension funds' average asset allocation. The weight of equities in portfolios increased very slightly, from 43.7 per cent in 2004 to 44.2 per cent in 2005, while bond weightings also rose, to 41.6 per cent (a 1.7 per cent increase over 2004). Property continues to be a popular asset class, with allocations growing to 7.5 per cent of the portfolio (up from 7.2 per cent in 2004). All these increases occurred at the expense of cash, where pension funds reduced their allocations by 2.9 per cent.

Unlike their peers in most other countries, Belgian pension funds make nearly 80 per cent of their investments through UCITS collective investment schemes. These offer smaller pension funds the opportunity to diversify, but have the additional advantage of allowing funds to avoid withholding tax on investment income.

As for currency allocation, the euro zone accounts for about 90 per cent of bond investments. Equities have traditionally been more diversified, with 54 per cent invested in the euro zone and the remainder invested in the US, in non-euro European



countries and in Japan. Emerging markets account for 4 per cent of assets. It is the larger pension funds that tend to diversify more into US and non-euro European countries and to emerging markets.

Based on Belgium's minimum funding requirements, the overall funding level for pension funds continued to rise in 2005 and now stands at about 140 per cent (up from 130 per cent or so in 2004). Note, however, that minimum funding requirements in Belgium are not excessively demanding, as they are based on a 6 per cent discount rate and do not allow for salary or cost of living increases.

“ Unlike their peers in most other countries, Belgian pension funds make nearly 80 per cent of their investments through UCITS collective investment schemes. ”



## Canada

The strength of the Canadian equity market, driven by commodities, and the rising Canadian dollar have made it unappealing for most pension plans to move assets outside of Canada. As a result, the repeal of the foreign property rule in early 2005 did not have a material impact on asset allocations. This rule had previously capped pension fund investing outside Canada to just 30 per cent of assets.

Like their peers elsewhere in the world, Canadian pension plans have been undergoing extensive policy reviews. Funding issues and the shift to mark-to-market valuation of assets and liabilities continue to be the main drivers for institutional investors reviewing their strategic asset mix. Many are showing an increased interest in asset/liability reviews in a 'risk budgeting' framework. The same issues have spawned a proliferation of new products marketed as a solution for some of these problems.

The most publicised 'new' strategy for Canadian plans is LDI, which is the topic of numerous conferences and articles. While there is a lot of talk about LDI, the take-up by pension plans is still very low as they come to

terms with understanding how it works and what the risks may be. A major impediment is the focus on benchmarking against peer universes, and the commensurate tracking error embedded in LDI strategies.

Canadian pension plans are willing to accept some tracking error against their peers in order to include a limited allocation to alternatives in the absolute return space. Their main focus so far has been on real estate, private equity and funds of hedge funds employed as 'alpha' overlays (adding return and diversity to the asset mix).

Continued low bond yields are creating both problems and opportunities in fixed-income portfolios. In an effort to boost returns and keep the asset class attractive, bond managers have been adding new product to their line-up, including high yield and global bonds, collateralised debt obligations and portable alpha. They are offering these strategies within traditional bond portfolios on an opportunistic basis. We expect to see increasing divergence in bond returns as a result.

## China

At the end of 2005, about 24,000 Chinese companies had set aside approximately 68 billion yuan (\$8.6 billion) for supplementary pension purposes, which could potentially be converted into defined contribution based corporate pensions under the Enterprise Annuity (EA) system. EA legislation was passed in 2004 with a view to supplementing China's social security funds.

But although the potential for the EA market is huge, the pace of growth has been disappointing. So far, only

nine corporates have signed pension management contracts with fund managers and invested funds into the market.

The rest of the assets are still sitting in custodian banks earning a cash rate of around 2 per cent. The complexity of negotiating with various EA service providers and a lack of investment knowledge are the main factors to blame. According to the regulations, the company has either to appoint a professional trustee, or form an EA management committee, and then sign separate contracts with the custodian banks, administrators, and fund managers. Current investment restrictions allow equity allocations of up to 30 per cent, but most corporates still prefer a 'capital guaranteed' investment approach, with low equity exposure.

According to the Chinese Ministry of Labor and Social Security, social security funds have been growing at an annual rate of 20 per cent in China. Total assets had reached 1.8 trillion yuan (about \$230.4 billion) at the end of 2005, accounting for 10 per cent of the country's GDP for the year. Old age pensions account for about 60 per cent of the social security funds.



However, these funds face noticeable problems both in investing and in operating. In the past, instead of purchasing state treasury bonds with returns of less than 2 per cent, large sums from the social security funds were placed with major banks. But as savings deposits from ordinary people continued to rise, banks have been reluctant to accept deposits at negotiable rates. Concerns have also arisen over the management of social security funds in China while they are searching for better returns. Since 1998, investigations have been carried out regarding the suspected embezzlement of more than 16 billion yuan from the massive social security fund.

In addition to this social security pool, there is a 200 billion yuan (\$25.4 billion) strategic reserve called the National Social Security Fund (NSSF). The NSSF has recently paved the way for pension assets to be invested overseas. It plans to allocate US\$600 – 800 million to five mandates (Hong Kong equities, US equities, global ex-Hong Kong, ex-US equities, and a cash plus mandate), and has conducted an open tender. The NSSF's approach to investment and operations management is expected to have a big influence on how other pension assets are managed in China.

## France

The latest statistics on savings plans in France confirm the great popularity of these vehicles. With €69 billion in assets under management, the savings plan market is now equal in importance to the more traditional pension fund market. In 2005 alone, savings plan assets grew by 22 per cent.

The still tiny but rising star of this market is the new PERCO (Plan



d'Epargne Retraite Complémentaire) plan, which was introduced in 2003. PERCO is a long-term savings plan with assets locked in until retirement. By the end of 2005, 23,000 employers had sponsored PERCO plans, amounting to €330 million in assets, and with 100,000 active participants.

In addition to the PERCO's tax advantages, the chief explanation for its success is the simple approach that most providers have adopted in marketing their products. Instead of multiplying investment options, PERCO providers have chosen to standardise options with a limited number of funds. This is especially true for small companies, but even for larger employers, the trend is towards simple solutions.

The life cycle option, which automatically adjusts the investment mix depending on the age of the investor, is particularly popular: 44 per cent of participants to PERCO plans have selected this approach.

Regulations stipulate that a surveillance committee must be established to monitor the PERCO funds. These committees are made up of employee and employer

representatives who are not investment professionals.

As a result, these committees have tended to focus on the administrative aspects of these savings plans, rather than the investments. As a result, bundled underperforming investment products are often implemented by default, with poor ongoing monitoring of their performance.

As the savings plan market matures, it is important that it be put on the same footing as international pension fund markets, with equal access to the best international investment managers.

The result should be more sophisticated investment products and higher performance. The most pressing issue for surveillance committees will be to increase their knowledge of investment matters. Proper training is essential to monitor investment managers and make informed decisions, given the level of responsibility these committees bear.

The French government has recognised the importance of this issue, and will give tax credits to employers who offer the appropriate training to their employees.

## Germany

The investment strategies of large institutional investors in Germany – insurance companies, industrial companies, pension funds and others – are undergoing significant change. One catalyst has been the liberalisation of investments following the 2004 German Investment Act; another is the continuing trend for companies to outsource ‘book reserved’ pension liabilities, moving them off the balance sheet into specialised trusts.

These trends have resulted in increased demand for asset classes that have not typically been popular with German institutions, such as emerging market bonds and equities, high yield bonds, private equity, and especially direct real estate investments in the US and Asia as well as in Europe. These paradigm shifts have produced a rapidly growing supply of mandates for new asset managers, as well as cooperation between Anglo-Saxon and German managers in the market.

This trend is expected to continue. German investors such as insurers, large retailers and manufacturers have identified direct real estate investments via professionally managed property funds as a substitute for their own passively-managed and primarily German-based properties. These investors are considering selling their property portfolios, and allocating the money to professionally managed funds that invest directly in property across all risk types. Their aim is to diversify their portfolios and enhance return.

We are also seeing the rise of sale and sale/lease-back transactions in the German market. These types of transactions are executed mostly by distressed companies to recover their

operating business, or to raise new money for other types of investment.

Another significant issue in the German market is a new emphasis on transparency, led by the BVI Association (Bundesverband Investment und Asset Management eV) and affiliated investment managers. These managers are putting pressure on German-based pension consultants (there are about 35 domestic players) for more transparency in their manager selection process.

Many of these domestic consultants are under-resourced but still try to cover a wide spectrum of asset classes. As a result, investment managers are starting to look into their selection approaches and methodologies.



“ Another significant issue in the German market is a new emphasis on transparency, led by the BVI Association. ”



## Hong Kong

Assets in Mandatory Provident Fund (MPF) schemes grew by about 26 per cent in 2005, to exceed HK\$150 billion by the end of the year. Two-thirds of Hong Kong's employed population of 3.4 million (as surveyed by the Census and Statistics Department) were covered under MPF schemes, which are defined contribution based.

According to the MPF Schemes Authority, total MPF contributions reached a level of more than HK\$26 billion in 2005. Members' growing interest in voluntary MPF contributions, which accounted for HK\$2.6 billion, or 10 per cent of total MPF contributions received last year, is expected to boost further growth in MPF assets.

In March 2005, the MPF Schemes Authority moved to enhance the transparency of information for investors as defined in the Code on Disclosure, and adopted the industry's 'Performance Presentation Standards'. These standards specify the methods and minimum content that trustees and service providers of MPF schemes should use in calculating and presenting the past performance of MPF funds. With effect from 1 July 2005, fund factsheets of a registered MPF scheme should comply with the requirements stipulated under the standards.

Hong Kong continues to benefit from its role as a financial and servicing centre for enterprises in mainland China, which uses Hong Kong as a window for raising funds. As a result, capital raised in H-share equity IPOs had a record year in 2005, led by the China Construction Bank. Greater demand for the listing of China-related companies in



Hong Kong is expected to continue in 2006.

Significant progress has been made in the development of Asian bonds. Of the three 'exchange traded funds' that were authorised and listed in Hong Kong during 2005, two are sub-funds of the Asian Bond Fund (sponsored by regional central banks).

Real estate continues to be a popular asset class, and investors showed a

healthy appetite for the relaunch of the link REIT (which raised about HK\$22 billion of funds) together with two new REIT listings (Prosperity and GZI) in the final quarter of 2005. In 2006, some non-retirement funds have either included or considered including global real estate securities in their investment strategies to increase diversity.

**“ Hong Kong continues to benefit from its role as a financial and servicing centre for enterprises in mainland China. ”**



## Ireland

In January 2006, the Pensions Board, at the request of the Irish government, completed the initial stage of the National Pensions Review. One of the key findings was that more than 900,000 people, almost half the country's workforce, do not have private pensions. At least 450,000 of these are women. It is widely accepted that pension coverage and adequacy targets will not be met without some change to Ireland's current pension system. While the Review advocated a continuation of the existing voluntary system for supplementary pensions, it did not rule out the introduction of some form of mandatory private pension provision in the future. The Pensions Board has been tasked with investigating the feasibility and costs of implementing various methods of doing this. In the meantime, the Review has recommended enhancements and incentives to make existing schemes more attractive and transparent to potential savers.

The Review did not recommend the implementation of a number of regulatory changes that had been proposed for defined benefit (DB) schemes. However, another priority task for the Pensions Board is a comprehensive review of the Minimum Funding Standard. The fear remains that the current regime, if left

unaltered, will result in a substantial reduction in DB coverage in the private sector within a short period of time. In recent months, a number of large, high profile pension schemes have announced reductions to the benefits offered, or have closed to new members. The Social Welfare Law Reform and Pensions Bill 2006 did provide some respite for sponsors by introducing provisions allowing them, in certain circumstances, to substitute equivalent fixed pension increases for index-linked increases in the event of a pension scheme wind-up

This has a significant beneficial impact on the funding requirements for schemes that provide index-linked pension increases because there is a considerable pricing difference between index-linked annuities and those with fixed rate increases.

Alternative asset classes are topical in Ireland. The National Treasury Management Agency, which oversees the €15.3 billion National Pension Reserve Fund, has made significant progress in implementing its planned 18 per cent allocation to alternatives. By the end of 2005, €170 million had been invested in commodities, while €404 million had been committed to property and €181 million to private equity. However, despite the current interest in these asset classes, Irish trustees have generally been slow to invest in diversity assets other than property.

“ **More than 900,000 people, almost half the country's workforce, do not have private pensions.** ”

## Italy

New pension legislation comes into force in Italy from July 2007, and industry players are awaiting its impact. After years of discussion, the government has finally given the green light to the automatic transfer of mandatory severance contributions (TFR) to occupational pension funds. Previously, employees had to make an active choice to divert these contributions to industry-wide schemes.

More controversially, the government announced plans to divert TFR contributions from opting-out workers and use them to fund public infrastructure, instead of following the example of many other European countries and creating a long-term pension reserve fund. Companies with fewer than 50 employees will be exempted from this requirement.

The new legislation is likely to lead to much faster growth in pension assets under management (currently in the range of €44 billion). TFR contributions represent a potential annual inflow of about €15 billion, of which less than 10 per cent is currently contributed to second-pillar funds.

Italy's institutional investment landscape is very fragmented. There are five groups: insurance companies, foundations, company pension schemes, social security funds for 'liberal' professions (such as lawyers, architects and accountants) and finally 'new' industry-wide defined contribution pension funds. These are the smallest of the groups, but stand to benefit from the new legislation.

No official estimates exist of how much these institutions manage, although we estimate a total of about €130 billion, excluding some €200 billion in insurance company reserves. This is remarkably low compared with the size of the



“ In Italy, unlike anywhere else, foundations are more important than pension funds. ”

economy and aggregate savings in Italy (it is less than 10 per cent of Italy's GDP and less than 5 per cent of total financial assets held by Italian families).

In Italy, unlike anywhere else, foundations are more important than pension funds, both in terms of size and of perceived strategic importance, given their large stakes in some of Italy's major banks.

Most Italian foundations are a by-product of the privatisation of savings banks in the early 1990s, and were initially endowed with shares in local savings institutions. Following consolidation in the banking industry, these endowments gradually

became shares in major banking groups, enabling foundations to play an active role in major deals such as the recent proposed merger between Sanpaolo and Intesa.

However, Italy's foundations have quietly disposed of a lot of their bank shares and have started to embrace best practice asset management principles.



## Japan

In fiscal year 2006, Japanese corporate defined benefit (DB) pension assets grew 13.6 per cent to reach ¥87.8 trillion, their first increase in two years. This was chiefly because of the strong performance of Japanese equities. Japan's TOPIX index soared 47.8 per cent for the 12 months to March 2006.

Since April 2002, Japanese pension funds have been allowed to return some of the assets they had been managing on behalf of the government to its public pension system in order to reduce their burden. This move by corporate pension funds (so-called 'daiko henjo') is one reason why pension assets had declined. But the 'daiko henjo' trend appears to have come to an end, which also helped to boost asset growth last year.

Japanese defined contribution (DC) schemes were introduced in October 2001. Since then, the DC market has grown steadily, with the number of DC participants surpassing two million in 2006. Initially, some large companies adopted DC schemes as they suffered losses in their DB pension assets during long bouts of negative returns between fiscal 2000

and fiscal 2002. In recent years, an increasing number of small and mid-sized companies have been adopting DC schemes. Total DC assets, however, are estimated to be only ¥2 trillion to ¥3 trillion, far smaller than DB assets. This is mainly because of low tax-exempt contribution limits.

In a landmark move, the Bank of Japan, the Japanese central bank, ended its zero interest policy, which had kept short-term interest rates near zero for more than five years, and raised the target for the benchmark overnight call rate to 0.25 per cent in July 2006. The movement of short and long-term interest rates clearly has a significant impact on pension funds' asset allocation and assumed interest rates. Many Japanese pension funds, fearing the interest rate hike, diversified their fixed-income portfolios, with hedge funds being the main beneficiaries. However, in light of the recent low-return environment for hedge funds, and the higher costs of currency hedging, pension funds have started to look for more diversified sources of return.

## Korea

In December 2005, South Korea introduced its first corporate pension law: the Employee Retirement Benefit Security Act (ERBSA). Prior to ERBSA, employers in Korea were required to provide a severance pay scheme (SPS) with benefits of at least one-month average pay per year of service. Under ERBSA, employers are able, in lieu of SPS, to adopt a defined benefit (DB) or defined contribution (DC) retirement plan as long as they receive majority consent from their employees. Employers with fewer than 10 employees have the further option of contributing to

Individual Retirement Accounts (IRAs) on behalf of their employees.

By the end of 31 August 2006, total corporate pension assets were KRW216.2 billion (US \$228 million), split evenly between DB and DC schemes, with a smaller percentage going to IRAs. Overall, uptake of the new pension schemes has been disappointingly slow, but it is also recognised that the market is in its early development stages.

In total, more than 11,000 companies have made the decision to adopt pensions, mostly small employers who are choosing to contribute to IRAs. Larger companies seem to favour allowing their employees to choose between either a DB or DC retirement plan. Many employers are taking the view that there is a five-year grace period before existing tax benefits for SPS funding are scheduled to expire in 2010, and are adopting a 'wait-and-see' approach.

ERBSA seeks to supplement the existing national DB pension scheme set up in 1988 as a basic social



security safety net. The Korea National Pension Scheme (KNPS) continues to grow at a rapid pace, and is now the fourth largest pension fund according to the P&I/Watson Wyatt survey (see page 23). Assets were split 90:10 between bonds and equities/alternatives, with around 8 per cent of total assets invested overseas. It is expected that the allocation to global assets will continue to grow steadily. The fund is projected to peak at KRW1,700 trillion around 2035, after which benefit payments and unfavourable demographics are expected to push the fund rapidly toward deficit within the next 10 years. A motion to increase KNPS contribution levels to address the looming deficit is currently under review by the National Assembly.

Overall, retirement issues are becoming more prominent in the public's awareness, fuelled by recent concerns over South Korea's aging population and the dramatic drop in birth rates. With close to 60 per cent of the population projected to be over 60 by 2050, we expect pensions to remain high on the public agenda for South Korea going forward.



## Malaysia

The Malaysian pension industry is dominated by the national pension scheme, the Employees' Provident Fund (EPF). This scheme continues to grow, underpinned by mandatory contributions of 12 per cent of salary from employers and 11 per cent from employees. Assets of the EPF now stand at more than \$70 billion, with annual contributions (net of withdrawals) averaging \$2.5 billion over the past three years. The other major pension funds in Malaysia are the Pension Trust Fund for civil servants, and the Armed Forces Fund, which have assets of \$11 billion and \$3 billion, respectively.

The EPF has gradually increased its allocation to corporate bonds and loans over the past five years (the weighting was 36 per cent at the end of 2005) while maintaining its allocations to government bonds (38 per cent) and equities (19 per cent) and reducing cash holdings (6 per cent). Investments in alternative assets, such as property and private equities, were insignificant. The EPF returned a 5 per cent dividend to its members in 2005.

Despite the government's liberalisation of foreign investments, pension funds have yet to move into foreign assets on a large scale, amidst a cautious global market environment in 2006.

Meanwhile, the public services department is in the final stages of updating the mechanism to implement a new contribution-based pension scheme for new government employees, including gathering views and input from various parties. The new scheme is expected to be implemented next year, and appears to be similar to the optional EPF scheme introduced in 1991.

The Securities Commission has given fund management licenses to two foreign fund management companies – BNP Paribas Asset Management and Nomura Asset Management as part of its liberalisation plan to allow five foreign fund management companies to operate in Malaysia under the Capital Market Masterplan. The aim is to provide a competitive environment to accelerate the growth of Malaysia's capital market. Aberdeen Asset Management was given a fund manager license in 2005, and has started operations.

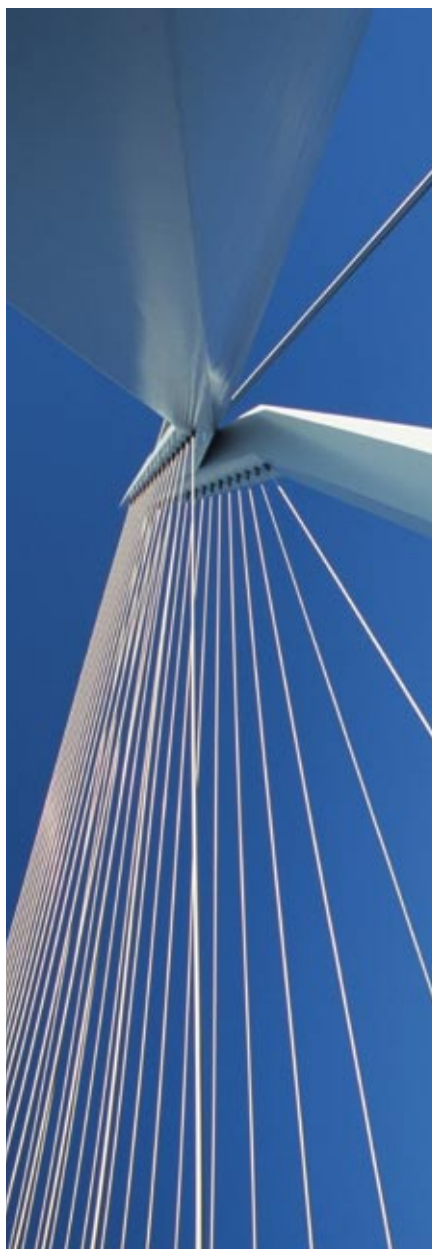
## Netherlands

The Dutch pension sector is still undergoing major changes as a result of constantly changing regulations. The biggest factor is the New Financial Assessment Framework (NFTK), which will be effective from the beginning of January 2007. Originally designed to come into place in 2006, the foundations of the NFTK are now laid down in a new pension act.

The NFTK dictates, among other rules, that pension liabilities have to be valued according to market interest rates. This means that pension funds will become extremely sensitive to movements in interest rates. As a result, almost every pension fund in the Netherlands has evaluated the size of these interest rate risks. However, actions that have been taken vary significantly, both in size and in type of instruments. The result will be that investment returns of pension funds will be more dispersed during the next few years, and developments on the liability side of the fund should also be taken into account.

During the last two years, the Netherlands has seen the growth of a new sort of pension arrangement, called Collective Defined Contribution (CDC). In contrast to the situation in many other countries, pure defined contribution (DC) schemes have never become popular in the Netherlands. However, CDC arrangements have become increasingly common. The key features are a fixed contribution rate for the employer, making it possible to apply DC accounting, and a pension scheme that is based on a 'normal' average-pay scheme, albeit with the possibility to lower accrued pension rights in negative circumstances.

“ **Pure defined contribution (DC) schemes have never become popular in the Netherlands.** ”



On the investment side, liability driven investments have been in the spotlight, but have not been the only centre of attention. The continuing search for return, while at the same time limiting risks (including unrewarded risks) has increased pension funds' allocations to alternative investments. This is in addition to the traditional allocation to real estate investments that has always been a feature of Dutch pension funds. The increased diversification is rewarded through lower solvency requirements, as the pensions regulator increasingly rewards pension funds with sophisticated risk control systems.



introduced in January 2006. This was prompted by projections indicating that the country's oil wealth will not be sufficient to fund future pension liabilities. Companies without pension funds scrambled to set them up by the July deadline, creating fierce competition among insurance companies.

Changing demographics also lie behind the Finnish government's pension reforms. From January 2005, among other changes, workers began accruing pension benefits between the ages of 18 and 68 rather than 23 to 65.

## Nordic region

The past few years have been an eventful time for pensions in the Nordic region.

Swedish public pension funds are being restructured, Denmark's ATP workers' fund now permits members to choose how their money is invested, Norway has just made occupational pension plans mandatory and Finland has made significant reforms to its pensions system. Iceland is the only country where pensions are not yet under pressure.

Many of the reforms across the region feature more participant choice and reliance on private provision, and higher retirement ages.

The significant issue in Sweden is reform of the SKR300 billion occupational ITP scheme. After years of delays, a new ITP plan is scheduled for launch in 2007, allowing employees to put 50 per cent of their assets into chosen products. The new ITP is eventually expected to attract inflows of up to SKR26 billion a year. A portion of the old ITP plan will also switch to DC.

“ **The past few years have been an eventful time for pensions in the Nordic region.** ”

Sweden's new 023 billion state DC pensions system has also attracted attention, with suggestions that the choice of 700 mutual funds could be cut back, and more advice given to participants.

Member choice has been highlighted at Denmark's largest pension fund, the DKR51 billion ATP scheme, which is compulsory for all workers and supplements the basic state scheme. From January 2005, workers have been able to choose whether to leave their money with ATP, invest it in mutual funds, or choose a different pension provider.

Denmark's private pensions sector continues to grow, with premiums increasing 7.5 per cent in 2005, to reach DKR81 billion.

In Norway, mandatory occupational pension legislation (OTP) was

In contrast, Iceland's pension system remains stable, thanks to more favourable demographics, generous pension benefits, mainly from occupational schemes, and a retirement age that is already high (67). The price is also high. Workers must contribute at least 10 per cent of earnings and by 2007, employers will have to raise their contributions from 6 per cent to 8 per cent.

Across the region, institutional investors are poised to put more money into alternative investments – private equity, hedge funds and property – at the expense of traditional bonds and equities. Norway's proposed introduction of the 'prudent person principle' will lift the 35 per cent ceiling on equities, and raise the cap on hedge fund investments to 10 per cent.

## Portugal

Portugal's pension industry has remained fairly static in the past few years, with very few new funds being established. Although new contributions have improved solvency positions during the past year, benefit payments are also increasing as some of the larger funds start to mature. There have been no major fund terminations recently, a welcome change from a few years ago, when this feature hampered growth in the industry. The combined value of all pension funds remains at about 11 per cent of GDP (or around \$23 billion).

During 2006 legislation was introduced to adopt the EU Pension Directive. The main focus of this legislation was to improve transparency and participant communication. Importantly, the legislation introduced the concept of mandatory pension committees, which must consist of at least one-third participant elected (or works council appointed) members. These committees have an advisory role and are responsible for ensuring that details of the scheme are communicated to plan members on a regular basis. The legislation also allows for cross-border funds to be established and for Portuguese citizens to contribute towards any EU-approved pension fund without fiscal penalties.

From January 1 2006, fiscal benefits on 'third pillar' or personal pension contributions were reintroduced, although at levels well below those found in many other EU countries. The year also saw significant debate about the future of the State social security scheme. Significant cuts in benefits are expected within the next 18 months.

“ **Significant cuts in benefits are expected within the next 18 months.** ”

Other changes to social security are anticipated. It is expected that the new and lower level career average style of benefits will be introduced more rapidly, that retirement ages will increase, that caps on benefits will be introduced, that pension increases will be linked to economic growth, and that penalties for early retirement will be harsher. There is also pressure on the main political parties to reach agreement on long-term social security reform, perhaps with a significant element of capitalised personal savings being introduced. In general, it seems that personal savings plans will be favoured above company-sponsored plans.

As for investment strategy, pension funds have been investing more in alternative assets such as property, hedge funds and commodities. The average pension fund allocation is now 50 per cent bonds, 35 per cent equities and 15 per cent alternative investments, of which property dominates at around 10 per cent of portfolios. The average return of 9.2 per cent in 2005 was the best for Portuguese pension funds since 1998.



## Singapore

In recent years, the giant Central Provident Fund (CPF), Singapore's national social security savings scheme, has been reducing the employers' contribution rate as well as the wage cap for contributions as a result of intense labour cost competition within the region.

At the same time, the Singapore government has introduced several measures to encourage retirement savings. This includes reviewing the statutory retirement age to ensure that employees stay employable as they get older, introducing a Supplementary Retirement Scheme to encourage supplementary savings by employees, a cap on cheap funding from the CPF – allowable for housing finance, and more recently, exploring the concept of privately-managed pension plans, with the aim of making CPF savings go further. However, these measures have so far met with limited success.

The government has deferred its plans to introduce low-cost, voluntary Privately-managed Pension Plans (PPPs) as the financial services industry feared that it would be unable to achieve the economies of scale necessary to lower costs and attract clients. Concerns were also expressed that many workers lack the necessary aptitude and sophistication to evaluate the various investment options.

In response to poor investment returns, in February 2006 the CPF Board tightened the admission criteria of funds under the CPF investment scheme. New investment products must now be ranked among the top 25 per cent in their particular asset class worldwide, instead of the top 50 per cent, as outlined in the previous criteria. In addition, a new



fund's expense ratio must fall below the median of existing CPF funds in a particular risk category. Median expense ratios will be reviewed annually.

The government is continuously studying additional ways to improve retirement security. One proposal would require members to purchase a lifetime annuity at the age of 62, rather than accept the current default arrangement of receiving payments from the CPF for a fixed 20-year period.

## Spain

There has been little movement in the Spanish pension market since the Royal Decree of February 2004 approved reforms to the pension system. The main features of the Decree were to reduce investment restrictions and encourage greater professionalism.

However, there have been some developments in tax, regulation and social security. On 17 May 2006, the Spanish government completed the implementation of the EU Pension

“ **The CPF Board tightened the admission criteria of funds under the CPF investment scheme.** ”

Directive into the Royal Decree. The final stage was to incorporate European pension cross-border activities regulation. However, Spanish legislation did not implement Article 19 of the Directive, which would enable pension schemes to appoint investment managers or custodians directly in another member state.

Changes to the tax treatment of contributions and benefits in the Spanish pension market are expected to be approved and finalised by the government in the latter part of 2006. These changes will have a significant impact on both occupational and individual pensions. The main features are changes to contribution limits for both employers and employees, the removal of tax relief on the lump sum at retirement, and a reduction in contribution limits. The government has also recommended introducing a new 'plan' that combines elements from the current Qualified Pension Plans (QPP) and the current Collective Insurance Policies (NQPP). This would be based on an insurance policy.

Like other European countries, Spain faces the problems of an ageing population. The government is having to rethink aspects of the social security pension to ensure adequate benefits in the future. Several legislative measures have been taken, with the aim of reducing the cost of provision. The objectives are to decrease eligibility and, therefore, restrict access to a State pension, reduce the adverse effects of early retirement, and encourage members to extend their working life. However, these modifications are insufficient to solve the financial problems of Spain's social security system.

In 2006, Spain's pensions watchdog moved to reduce perceived conflicts of interest in the system by enforcing actuarial independence.

Finally, Spain is largely a defined contribution (DC) market, but Spanish legislation has yet to authorise a 'life style' approach to DC for plan members. However, in March 2006, the Director of Insurance and Pensions issued a statement suggesting that reforms in investment and the introduction of 'life styling' could be a possibility.



## Switzerland

There has been a major debate in Switzerland about conflicts of interests, insider trading and kickbacks in the asset management and pension fund industries. This debate, based on a few individual cases that have still to be brought before the courts, has pushed pension funds and potential areas of malpractice into the media spotlight. The positive side of this affair is that public awareness of pension fund issues has increased. The negative side is that the media has focused solely on the 'black sheep' of the pensions industry, without mentioning the majority of professionally managed pension funds in Switzerland.

As a result of this negative publicity, Swiss politicians have been quick to demand new regulation. Some support has been seen for strengthening 'insider' rules and legislation. However, other proposals, such as mandatory disclosure of personal assets and trades of trustees involved in asset decisions, have so far not found majority support.



ASIP, the Swiss pension fund association, has always preferred to promote self-regulation and best practice in pension fund governance. Consequently, the existing code of conduct for pension funds has been revised, and pension funds have been encouraged to become signatory members defending new regulation and the pension funds

On the investment side, Swiss pension funds returned an average 13 per cent during 2005, according to performance figures provided by ASIP in conjunction with Watson Wyatt. This result was the highest since 2000, and was mainly due to strong international equity markets, and US dollar strength. However, there have been calls for the Swiss government to cut the guaranteed BVG minimum return of 2.5 per cent to help with building up fluctuation reserves.

Traditional assets (equities and bonds) make up 80 per cent of the typical Swiss pension portfolio, while 20 per cent is invested in other asset classes such as real estate, hedge funds and private equity. Demand is accelerating for global real estate, private equity and emerging market securities.

Asset liability modelling (ALM) studies are now commonplace, but risk budgeting is still used only by a few Swiss pension funds. Smaller pension funds, driven by cost constraints, limited governance, and the growing complexity of many asset classes, favour easy to implement investment solutions. Bigger pension funds, meanwhile, are on the lookout for sophisticated research and new investment approaches.



## Taiwan

In July 2005, Taiwan embarked on sweeping changes to its pension market with the official launch of the New Labor Retirement Pension System. This came a year after the announcement of the Labor Retirement Pension Ordinance, the law detailing the new system. This move opens a new chapter in the protection of retirement welfare for Taiwan's eight million workers.

In the past, under the Basic Labor Law, it was difficult for employers to calculate their pension costs. Workers lost the right to pension benefits if they switched jobs before completing 15 years' service for their employer, and companies did not have to make upfront contributions for their employees. To avoid personnel costs, many unethical employers simply laid off workers.

Under the new pension system, employers have to contribute 6 per cent of each worker's salary every month into individual portable pension accounts to be administered by the government. The new system is expected to attract NT\$150 billion (\$4.55 billion) in annual contributions. Each company must meet a five-year deadline within which it must set aside enough money to cover past pension liabilities. The new system means that for the first time, workers are assured of receiving their pensions without being affected by a change of job or redundancy. Moreover, because contributions are not age-related, older employees will no longer be an unwanted minority. In effect, the new pension system will act as an effective means of solving the problem of unemployment for older workers.

The start-up of any system is typically accompanied by teething problems. Despite the system's official launch

more than a year ago, the investment of contributions has only just begun, because of the incomplete structure of the labor retirement pension fund which invests the money. This fund will be monitored by the Labor Retirement Pension Supervisory Board, which is still in the process of setting up.

As for the investment strategy of existing funds, outsourcing continues to top the agenda. Three of the four key Government funds in Taiwan (Civil Servants Pension Fund, Labor Insurance Fund, and Postal Savings Fund) continued to outsource assets to both local and foreign providers over the past year. The Civil Servants Pension Fund is currently the leader in terms of assets outsourced for investment. These account for approximately 30 per cent of the fund's total assets.

It is expected that the outsourcing of institutional assets overseas will become even more widespread in the local market.

## Thailand

Thailand has a pressing need to boost retirement savings. Most households have insufficient savings to meet their needs in retirement, and only 28 per cent of the country's 35 million workers are covered under the current pension system.

In March 2005, the Thai government announced plans to convert the existing framework of voluntary provident funds into a mandatory centralised system – the National Pension Fund (NPF). The new system will require both employers and employees to pay contributions, initially set at 3 per cent each of an employee's monthly salary. This is expected to rise to 6 per cent, but no definite date has been set for an

increase. Employees will also be allowed to increase contributions without requiring the employer to match them. Employees will be able to choose investment funds from a list of approved fund managers. The new legislation was originally intended to start in 2007, but has been postponed to 2008.

At the end of 2005, the Provident Funds had assets of 324 billion Baht (\$8.8 billion) while the government Pension Fund (GPF) had 287 billion Baht (\$7.8 billion). Over the last two years, the Provident Funds and GPF grew by 7 per cent and 10 per cent a year, respectively.

The bulk of the pension assets are invested in cash and debt instruments, mainly because of risk aversion and investment restrictions imposed by the regulator. The GPF currently has an asset allocation policy of 80 per cent fixed-income, 15 per cent equities and 5 per cent property. At the end of 2005, 76 per cent of the GPF (excluding cash in banks) was invested in fixed-income instruments, 15 per cent in equities, 3 per cent in properties

and 6 per cent in alternative investments. The bulk of the fund (91 per cent) was invested in domestic assets.

The Provident Funds were 11 per cent invested in listed equities, 38 per cent in listed debt instruments, 10 per cent in unlisted securities, with the remaining 41 per cent in cash and cash equivalents. There has been a gradual shift from equities and cash to fixed-income over the past two years, because of the volatile equity market and the low interest rate environment.

The Retirement Mutual Funds (RMF) mainly comprise of fixed income mandates, accounting for some 43 per cent of assets, while equity accounts for 18 per cent and the rest is in balanced mandates.

Currently, foreign investments are allowed only via the Foreign Investment Funds managed by selected mutual fund management companies. Institutional funds may invest abroad, subject to approval and conditions set by the Central Bank.





liabilities than could be achieved through buying bonds. Although pension funds have always tended to invest with their liabilities in mind, this activity has been labelled liability driven investment (LDI) by many, and is being championed by investment banks and asset managers.

Governance continues to be at the forefront of trustees' minds, and they have made a discernible effort to come to terms with the level of their own knowledge and understanding, and to implement the recommendations made by the government-backed Myners' review in 2001. When the National Association of Pension Funds (NAPF)

## “ ... the least generous state pension system in the developed world ... ”

### UK

UK pensions have probably received more scrutiny in the past year than ever before, and not without reason. The Pensions Commission, an independent body headed by Adair Turner, said it was wrong to assume that the UK was a rosy picture of voluntary, privately-funded pensions that generously complemented 'the least generous state pension system in the developed world'. The Commission suggested that the status quo would lead to a deepening crisis of pensioner poverty and that significant changes to the state system were needed. These changes would have to be combined with a revitalised voluntary system, including increased private pension savings. Although not surprising, these findings served to highlight the vital role of occupational pensions.

So how have defined benefit pension plans in the UK responded? The

majority are focused on 'de-risking' in line with their maturity, and are moving out of mainstream equities and into bonds, continuing a trend that started almost a decade ago. In addition, diversification of return-seeking assets is now becoming mainstream, with significant allocations going to hedge funds, property, private equity, infrastructure and some to commodities. While fund of fund vehicles have traditionally been popular ways for institutional investors to access private equity and hedge funds, pension funds are now also considering direct investment in these areas.

Another trend established during the year has been the increasing use of derivative instruments, mainly inflation-linked and interest-rate swaps, to achieve closer matching of

and UK Treasury assess progress in this area next year, they are likely to find that many of the recommendations have been adopted, especially by larger funds.

The pendulum continues to swing towards defined contribution (DC). More time is being spent trying to apply investment lessons learnt from defined benefit, in the hopes that the DC system will strengthen sufficiently to underpin the currently unstable savings structure. Moving away from the current 'provider-led' situation towards smarter, more appropriate solutions will go a long way towards achieving this goal.

There is no doubt that much is expected of the UK's DC pension system if it is to replace DB as the future complement to 'the least generous state pension system in the developed world'.

## US

After several years of living in limbo, US corporate pension plan sponsors finally have new pension funding and accounting rules. These initiatives represent the largest overhaul of pension rules in more than 20 years. And while these rules will affect different plan sponsors in diverse ways, the certainty they provide will prompt sponsors to examine their funding, investment and plan design strategies.

The new funding rules do not come into effect until 2008, but we expect that they will ultimately result in higher average funding levels as plan sponsors seek to avoid benefit restrictions that would kick in if they fell below certain thresholds. In 2005, average pension funding levels were 83 per cent. This is about the same as in 2004.

However, returns on assets among the largest plan sponsors continued their three-year decline. In 2003, plan sponsors saw returns of nearly 21 per cent, but by 2005 they had declined to 9 per cent. The first three quarters of calendar 2006 are encouraging, but not spectacular.

The fluctuation in asset returns is partly the result of concentrated equity exposure coupled with market volatility. The average equity allocation for 2005 was just over 64 per cent. Equity allocations have generally

remained in that region for the last 20 years, regardless of economic trends.

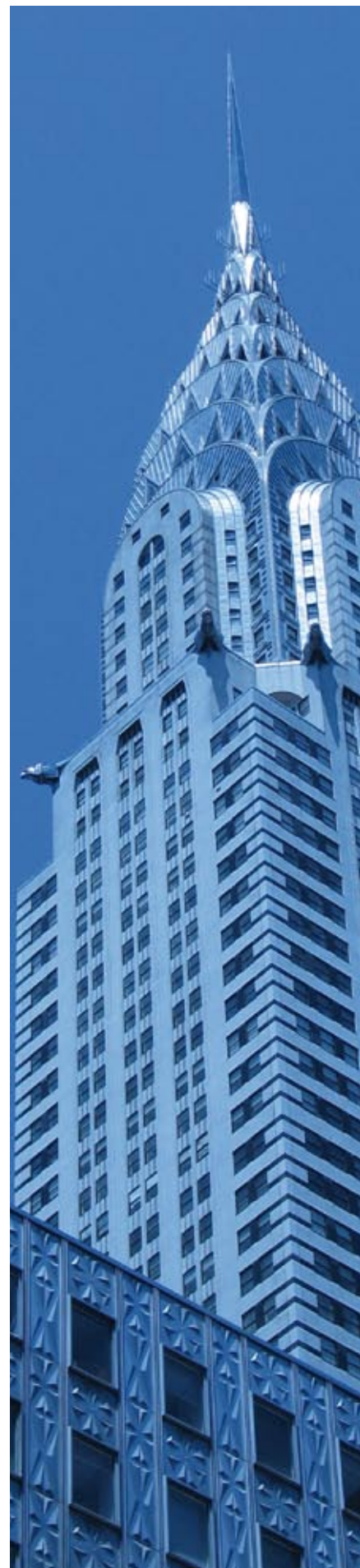
To help plan sponsors better understand the amount of risk that their pension plan poses to their overall financial health and the larger financial markets, Watson Wyatt has developed the Pension Risk Index (PRI). Since its establishment in 2003 we have seen pension risk decline.

About 60 per cent of the FORTUNE 1000 pension sponsors had a PRI value of roughly 1 per cent or less of their market value, suggesting that their pension funds pose minimal risk to their core business. And during the last three years, median pension risk values have decreased from 1.03 per cent to 0.77 per cent.

The heightened attention to corporate pension plans continued over the past year as many large sponsors announced changes to their plans. But with new rules, sponsors can now confidently develop alternative strategies to manage their pension plans. With the upturn in long-term interest rates during 2006, the attractiveness of long duration strategies to control asset/liability mismatches has taken on new appeal, especially given the increased 'penalties' for running funding or accounting deficits.

This, combined with the continued diversification into alternative asset classes, remains the major theme in the US pension investment market.

“ ... the largest overhaul of pension rules in more than 20 years. ”



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