

On Pensions, Politics and Reality

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Why does a very large percentage of the UK population not plan for retirement? Don't they know that people can expect to live longer and longer? Don't they know that the ways in which one can enjoy spending money is ever increasing? Or is it because they just don't care? None of these answers is satisfactory. Of course people know that life expectancy has increased tremendously over the years. Of course they know of the pleasures of long holidays to exotic destinations, eating out properly, etc. and of course they care. It is just that, after scandalous disasters such as Equitable Life and the closure of a large number of pension schemes, people don't know whom to trust anymore and where to put their money if they decide to actually save up for retirement. The retirement industry needs to restore its financial health but maybe even more urgently it needs to restore confidence in its ability to deliver what is promised.

Nobody should be forced to work for more than 40 years. A proper pension should therefore start at 60-65. Also, because pensions are much more about being able to live a decent old age than simply about money, pensions should be indexed to inflation. Scrapping indexation and forcing people to work longer are easy ways to improve the pension system's health but at the same time such measures cut deeply into the essence of what a proper pension should be like. As such, these measures do little more than emphasize to people how uncertain their pensions, of which they used to think they were guaranteed, really are.

From here it is only a small step to defined contribution schemes, which unfortunately are becoming more and more popular by the day. Defined contribution schemes make no promises as to the outcome of the investment process. If upon retirement there's not enough money in the pot, it's the beneficiaries' problem and theirs alone. Obviously, the outcome of a defined contribution scheme cannot really be referred to as a 'pension' any longer as it very much depends on the woes of the global capital markets how much money will be available upon retirement. If you're lucky, you retire rich. If you're not, you retire poor.

To judge from what has happened over the last couple of years, properly managing a defined benefit scheme, i.e. generating the pensions that people need and are counting on, appears an incredible challenge. Why is that? First of all, one needs to realize that pensions and premiums are of a highly political nature. An investment bank that promises a customer a certain future payoff, for example by selling that customer an option contract, will determine the price of that option by studying various hedging schemes and their residual risks. Based on that research the bank will subsequently set the option price such that the expected payoff of the hedge at least equals the payoff promised to the customer. Pensions and pension premiums do not result from a similar process, however. They are the result of a political negotiation process where negotiators often lose sight of the realities of the capital market, which eventually determines what realistically can and cannot be done. As a result, pensions promised may simply be too ambitious given the premiums paid in and the reality of the global capital markets.

Unfortunately that's not all. Faced with a highly complex task, most pension funds appear to be seriously mismanaged. Very substantial amounts of money are wasted every year while at the same time obvious risk management opportunities are systematically ignored.

1. Despite the fact that the essence of their job is to cover the fund liabilities, many pension funds more or less pretend those liabilities do not exist and manage their portfolio as if it were a simple mutual fund. Consequently, most pension funds are highly return-oriented and hire active outside managers to do their actual investing in an attempt to pick up as much 'alpha' as possible. These managers charge substantial fees and so do the consultants that help to select and evaluate these managers. There is overwhelming evidence, however, that active management only adds costs, not value. This means that in aggregate pension funds pay away billions in fees every year while getting inferior performance in return.
2. Most pension funds stubbornly stick to the traditional asset classes of fixed income, equity and real estate. Over the last two decades, however, a whole new range of investment alternatives has emerged. The returns on many of these, which include commodities, hedge funds, managed futures, and private equity for example, are only weakly correlated with traditional asset classes and therefore offer very significant diversification, i.e. risk reduction, potential.

3. The last two decades have seen an explosion in the availability of risk management products that allow investors to modify the risk-return profile of their portfolio with great ease. All the major investment and commercial banks employ large derivatives teams, able to structure tailor-made risk management solutions to virtually any problem. This is especially relevant for pension funds where ending up with less money than required to pay the pensions promised is a lot worse than ending up with a little bit more. Recent research at Cass Business School (see Kat et al. (2003)) has shown that even relatively simple option strategies can tremendously improve the risk return profile of pension fund portfolios.

How can we explain this widespread waste of money and risk management potential? Again, a lot boils down to the political nature of pensions. When it comes to the selection of pension fund trustees, political considerations often carry more weight than a solid background in investment and financial risk management. Although their intentions are undoubtedly good, most of these individuals are simply not up to date with the latest academic research, new developments in the marketplace, and the existence and use of complicated risk management tools. They do what probably anybody in a similar situation would do: they eventually ignore what they don't understand and lean towards the average. Knowing that there is safety in numbers, in pension fund investment management it is generally preferred to fail conventionally than to succeed unconventionally.

By never venturing too far from the average, pension funds avoid being exposed. The last few years provide a wonderful example. Although pension funds collectively have lost hundreds of billions of pounds, this has not led to a formal investigation into current investment management practices; something which undoubtedly would have been the case if a single individual fund had lost a billion or two while no other did. Since they all lost, we are to think those losses were unavoidable, refrain from asking any nasty questions and accept it as a fact.

As a consequence of the lemming-like behaviour of pension funds, many pension fund portfolios turn out to be remarkably similar in terms of composition and rebalancing. This brings us to the idea of a Pension Protection Fund (PPF), which again is primarily a political fabrication that lacks a sense of reality. Holding similar portfolios, many pension funds are likely to get into trouble simultaneously. The amount of money required to make up for these shortfalls will be enormous. With losses

highly correlated among participants, paying relatively small contributions into a PPF will therefore offer little protection. Recent experience in the US and Germany confirms this. Furthermore, since a PPF is likely to invest in similar assets as the pension funds that it is supposed to protect, it is likely that when pension funds get into trouble the PPF will be in trouble as well, leaving nothing more than an empty bucket.

So what about the idea of a PPF itself? Good and bad luck will always play an important role in the ultimate outcome of the investment process. A limited safety net to cushion the unavoidable cases of bad luck therefore makes a lot of sense. As mentioned before, however, many of the losses reported by pension funds could have been prevented by more efficient and more sophisticated risk management. It would be wrong for a PPF to cushion these losses as well since they are simply due to mismanagement, not bad luck. Pension funds themselves should take responsibility for the way they manage their investments, and not be allowed to simply offload that responsibility on a PPF.

So where do we go from here? First, the industry, the government and everybody else who is involved in pensions need to realize that anything other than a defined benefit scheme with pensions linked to inflation is not satisfactory, simply because it doesn't provide what is needed, i.e. a high degree of certainty about one's post-retirement standard of living. As soon as one accepts this key principle it becomes evident that the focus of many current discussions is entirely misplaced. We should talk about how to generate the pensions that people need, not about how to massage pensions to balance the budget again. Second, pensions need to become less political and 'get real'. We need reality checks on the viability of what is being promised, strict supervision of the way in which pension fund investments are managed, and minimum requirements with respect to the level of knowledge and understanding of the people in charge. Only in such a context does a PPF make sense. Pension provision is one of the key features of a modern society. It should be left to professionals best qualified to do the job, properly compensated and without too much political interference. If not, the future of pensions as we know them looks very bleak indeed.

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H. Kat, T. Kocken, and H. van Capelleveen – How Derivatives Can Help Solve the Pension Fund Crisis, AIRC Working Paper, 2003 (forthcoming Journal of Portfolio Management, 2004).