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Can UK plc survive Turner plan? The Times, Business View, by Bernard Casey, 28 December 2005

Adair Turner clearly believes that libertarian paternalism is not an oxymoron. The chairman of the Pensions Commission believes that retirement savings can be increased if people are obliged to save - but the compulsion would be soft.

Employees would be able to opt out, and Turner suggests that those with high-interest debts, such as credit cards, should probably do so.

Those that stay in will be able to choose how their savings are invested, and for those who do not want to make their own choice, a default fund will operate.

Individuals will contribute 4 per cent of pay but can save more. Employers will be obliged to make contributions at 3 per cent.

How might employers respond? Some, such as the EEF, representing manufacturers, are broadly in agreement with the proposed National Pensions Savings Scheme (NPSS). The EEF has itself suggested a similar scheme.

Others, including the CBI, the Small Business Federation and the British Chambers of Commerce, have been sceptical or critical. They point to the cost burden and the implications for competitiveness, employment and even the survival of companies.

Research, in which members of the **Pensions Institute** at **Cass Business School** were involved, has tried to assess how British companies might respond if pension contributions became mandatory. The research included a representative survey of 750 private-sector companies.

Companies of all sizes and sectors were covered. Employers were not asked directly about mandatory pensions, since that would have encouraged a potentially negative reaction. Rather, amid a host of other questions about their performance and expectations, they were asked about how they might respond to hypothetical increases in labour costs.

The 3 per cent employer contribution envisaged for the NPSS is not dissimilar to one of the hypothetical situations raised in the survey: the increase in labour costs was the equivalent of a pension contribution rate of 2 to 2.5 per cent.

The survey indicated that more than 80 per cent of companies were not making such a contribution. However, most of these were very small: more than four-fifths had fewer than ten employees, while most the remaining fifth had between ten and 49 employees. The firms that would be obliged to contribute were not only small, they were also low-paying. In more than a quarter of firms the majority of employees were earning under Pounds 15,000 a year.

Many of the companies already had a pension arrangement in place -this was the Stakeholder Pension that all employers with at least five employees are required to "designate". Most firms comply. However, four out of five do not make any contribution and, as Turner points out, where there is no employer contribution there is seldom an employee contribution.

The most commonly cited response to the sort of increase implied by Turner's proposal was to try to pass the costs on to consumers. More than four in ten suggested this. Three in ten said they would do nothing.

Only one in ten talked of reducing employment and only three in a hundred contemplated closure. It was firms in the non-internationally traded sector that were more likely to try to pass costs on to customers: seven out of ten construction firms and more than six out of ten catering and hotel companies.

The researchers also made an estimate of the number of job losses that might occur if employers carried through the reductions and closure they foresaw. Perhaps about 200,000 jobs were at stake. Nearly four out of ten of these would occur in companies with fewer than ten employees, and nearly eight out of ten in companies with fewer than 50 employees. The researchers concluded that the impact of mandating would not be a substantial threat to UK competitiveness, and that it was companies on the margins of the economy that were most likely to be affected.

Two questions remain. First, faced by an increase in labour costs, some employers might offer their staff inducements to opt out. Turner has discounted the likelihood of such behaviour, saying that the 3 per cent rate was not sufficiently large to encourage abuse.

Second, the employees who are likely to be affected are low paid and often have interrupted careers. Even if they are not induced to opt out, they will be saving little. They are unlikely to be making other savings, and the assets they build up in the NPSS might still be insufficient to save them from future means testing.

Turner was clear that he wished to see reduced means-testing in the future.

However, if low-paid workers were rational, they might well still feel that it was better to use their limited resources to consume today and to bet on the state bailing them out in the future.

Bernard Casey is a senior research fellow at the **Pensions Institute, Cass Business School**

More immigrants 'key to retirement crisis', By Philip Aldrick, Daily Telegraph, 02/12/2005

Britain will need more immigrants than ever before if it is to meet the pension shortfall expected under Lord Turner's recommendations, according to an industry expert.

Using Lord Turner's own forecasts, there will be one pensioner for every two people of working age by 2050. Currently it is one pensioner for every four workers.

David Blake, director of the **pensions institute** at **Cass Business School**, said in the most extreme case the country would need a net 500,000 immigrants extra a year to pay for retirees' pensions. Last year, there was net immigration into the UK of 223,000 people. Some 582,000 arrived and 359,000 left, according to the Office for National Statistics.

Mr Blake said: "The demographics are a real mess. There are too many retired people and too few paying for their retirement. It's a consequence of increasing longevity and declining fertility." The problem has been compounded by the baby boomers, who turn 65 around 2010.

He added: "If you want to re-link the basic state pension to earnings, as Lord Turner is proposing, and you don't increase the contribution rate of the younger workforce, then there will be a contributor shortfall of about 500,000 people a year."

However, Lord Turner is proposing raising contribution levels as a proportion of earnings from the current 6.2pc to 7.5pc by 2050, as well as increasing the pension age to 69. Both measures will reduce the number of immigrants required to meet the shortfall, but Mr Blake said they would still need to increase vastly from current levels.

In the worst case, he has estimated that the country will need 10m additional workers by 2025 to pay for the soaring cost of state pensions. Under his best-case scenario, there will be a shortfall of about 2m workers.

Ross Goobey attacks bond shift, Matthew Craig, Pensions Week, 31 October 2005

Alastair Ross Goobey, son of George Ross Goobey, lamented the move away from in-house investment management and attacked the view that pension funds must invest heavily in bonds, last week.

Speaking at **Cass Business School**, Ross Goobey, the former chief executive of Hermes Pensions Management, said his father would not have been able to get the Imperial Tobacco pension fund to shift into equities in the 1950s if he had not been the in-house investment manager.

"As someone who has managed two in-house funds and also worked in the outsourced fund manager industry, I have no doubt which is the superior model," Ross Goobey commented.

"I recognise that it is very difficult for moderately-sized funds to resource top-class investment managers, but by outsourcing all investment management, trustees lose the ability to think for themselves about strategic investment issues.

"How many [trustees] decided equities were overvalued in the late 1990s and that their exposure [to equities] should be reduced? Hermes bought half of a property investment company in May 2000. No outsourced pension fund could have done this."

Ross Goobey said it could be sensible for pension funds to increase their bond allocation, but added that advocates of a wholesale switch into bonds at any cost were not seeing the wood for the trees.

"My response is that it all depends on the strength of the sponsor and its appetite for risk and the cost, including the opportunity cost, of immunising the scheme in this way."

He added that the argument that the high price of an equity put option was related to the long-term risk of equities was bunkum, as such an option had to be marked to market at all times, to reflect short-term pricing volatility, not the longer-term likely outcome.

Ross Goobey said that all the evidence showed that equities produced superior returns to bonds over the long-term.

"If equity risk is not rewarded, why would anyone invest in equity at all?" he commented. Ross Goobey added that increasing longevity had made pensions more expensive and FRS 17 had reduced sponsors' appetite for risk.

He said these factors, combined with pensions legislation and the removal of tax credits, had been disastrous for final salary pensions.

"People are saying that final salary schemes are now past the point of no return. I think that's right and it's an extraordinary turnaround from 1997."

Pension Archive opens at Cass, Pensions Week, 31 October 2005

The Pensions Archive Trust formally launched last week with the inaugural George Ross Goobey lecture at the **Cass Business School** in London.

The archive aims to record information relating to UK occupational pension schemes, as a resource for those studying pension provision and to ensure historic data is not lost as a result of corporate re-structuring.

The archive will be based at City University. Alan Herbert, who initially proposed the idea of a pensions archive, has appealed for more support for the project, either financially or in terms of material.

The aim of the Pensions Archive is to achieve charitable status, raise the finance to maintain itself, provide suitable premises and a qualified archivist and to preserve documents relating to the management and development of occupational and personal pensions in the UK.

Amber signal over the stock market: Now, listen to Goobey's killer line, 29 October 2005, Guardian, Financial Notebook

In these choppy, see-saw stock markets, long-term perspectives from long-term thinkers are welcome and Alastair Ross Goobey, former top man at Hermes, gave some fascinating thoughts on the pension fund industry the other night.

It was the inaugural lecture in the name of his father, George Ross Goobey, who did more than most to create the "cult of equities" in the 1950s by leading a switch by Imperial Tobacco's pension fund out of bonds, the traditional asset class of schemes of the time.

Ross Goobey Snr's thinking was that shares as a whole offered a higher yield than bonds. For a fund to earn less in equities than bonds there had to be a realistic possibility that dividends would be slashed permanently. This, of course, was highly unlikely; thus a pioneering, and very influential, investment decision was born.

Ross Goobey Jnr echoed the trick in March 2003, when the yield of the FTSE All-Share rose above the yield on 10-year government gilts for the first time since the late-1950s. It was, he said, the best opportunity to buy equities for a generation. He was right: the FTSE 100 has subsequently jumped from 3,400 to 5,200. The main thrust of his lecture was a plea that pension fund managers should ignore the herd instinct. Buying low and selling high remains the game and the ability to manage for the long term is one of the prime advantages of a pension fund, as it has always been.

Over most decades - and certainly over most 20-year periods - equities have always out-performed bonds. The post-bubble rush into bonds as a way of matching long-term liabilities should be seen in that context, he argued. It ain't necessarily wrong for weak schemes, but for most it will be a case of not seeing the wood for the trees. In other words, there is a cost, including the opportunity cost, of not taking a 20-year view of equities.

So why don't all pension fund managers think like this? Ross Goobey identified several culprits, like the out-sourcing of investment management to specialist firms, who are expensively hired and fired on the basis of relatively short-term performance. What Ross Goobey calls the "tyranny of the benchmark" - the desire to take the low-risk route and not be left behind by peers - is a related concern.

This blast of common sense against a bond-obsessed pensions industry is highly welcome. On the face of it, you might think it's an argument for a new cult of equities.

Not so fast. Here's the killer line in Ross Goobey's lecture: "Despite everything I have said, for highly mature pension funds, and following the dramatic recovery in equities since March 2003, I support the view that trustees should be moving more of their assets into bonds . . . The equity risk premium has fallen back again, and there is no obvious reason to be a buyer of the market."

From a fundamental fan of equities, that's quite a statement, and a clear warning that right now there's an amber signal over the stock market.

Fifty years on, shares still win; Investment, Graham Searjeant, Personal Investor, The Times, 29 October 2005

HALF a century ago, George Ross Goobey symbolically started the cult of the equity by moving the whole of the Imperial Tobacco Pension fund into shares. It is hard now to believe that until then it was conventional to invest pension and insurance funds mainly in gilt-edged and other fixed- income stocks -a strategy that had only made sense during the 1930s Depression.

Shares were seen as essentially risky, mostly held by wealthy individuals and speculators.

As Alastair Ross Goobey noted this week in a lecture commemorating his father, the switch was made out of hard commercial calculation. When Ross Goobey Snr analysed the fund, he found that gilt-edged stocks yielded about 3 per cent while the company's pension contributions assumed a return of 4 per cent, which happened to be the average dividend yield on shares.

Dividends on an individual share are riskier than income from gilts. Overall, dividends were not only higher but increased, taking share prices up with them.

But if market interest rates rose, as they proceeded to do for much of the next 25 years, prices of fixed- interest stock would fall. Inflation exaggerates these effects. It erodes the value of interest and makes business riskier but tends to be reflected fully in dividends in the long run.

Over the decades, buying by pension funds was the main factor pushing up share ratings and ensuring that dividend yields on shares became markedly lower than interest rates on bonds. This reverse yield gap widened as payout ratios fell and analysts focused on company earnings rather than dividends.

Investing in UK bonds returned to favour in a big way after 1990, when anti-inflationary policies finally started to become credible. Apart from big corrections to the trend in 1994 and 1999, gilt-edged yields fell almost continuously, from 12 per cent to between 4.3 per cent and 4.5 per cent.

After the dot-com bubble burst, many pension funds understandably switched back to bonds and early birds such as the Boots pension fund did well out of it. That process helped to extend the bear market of falling prices to more than three years. Some life insurers were even forced to switch from shares to bonds near the bottom of the market.

Institutional demand for UK shares has yet to recover fully, even though there is a lot more foreign buying. Instead, fund managers have backed private equity bids and bullied companies into making ever more share buybacks to reduce the supply of shares. Even allowing for new issues, the volume of quoted shares has shrunk.

Fortunately, the Ross Goobey line of thinking was never entirely forgotten. The moment in March 2003 when the bear market ended and share prices started springing back was the point at which average dividend yields became as high as interest yields on gilt-edged.

In a sense, however, there has been a full turn of the circle. In a world of predictable, relatively low inflation, low-yielding bonds are seen as the safe choice. The biggest share traders are hedge funds, not pension funds buying to hold.

A small investor with individual holdings, rather than collective investments, cannot spread equity risk as well as a big pension fund, so bonds are relatively more attractive. But to accumulate on the sort of long-term comparison of reinvested income taken by Ross Goobey, there is no contest.

Even today, when dividend yields are net of tax and bonds gross, 19 of the top 100 shares yield as much or more than gilt-edged. This implies that, in the long run, their dividends are more likely to fall than to rise. Is this really true, say, of Alliance & Leicester, Barclays, Legal & General or Severn Trent?

Index-linked gilts, the dividends and capital value of which rise in line with the retail prices index, yield about 1.35 per cent, which is less than 91 of the top 100 shares. Yet their dividends are far more likely to rise faster than inflation than to lag behind. The best guess is that dividends will rise in line with money output -twice the target rate of inflation -although recent performance has been better.

In bull markets, when shares are getting expensive, analysts break the comparison with bonds by focusing on profits rather than dividends. Fund managers argue that there is no difference in returns made from capital gains, one-off payments or dividends. But there is. Dividends are far less volatile than profits, let alone capital gains. Returns based on dividends and future growth in dividends are inherently safer.

That does not mean high yields are best. A cash return that starts below the 3.3 per cent average yield but rises at 10 per cent a year will usually be better. But cash today helps.

Activism can have a good name; Business Editor's Commentary, Patience Wheatcroft, The Times, 28 October 2005

MARK ANSON will not be seeking the quiet life when he swaps the top job at America's biggest pension fund for the lead role at Hermes Investment Management, which is half the size. Mr Anson, 46, boasted to a London conference this summer that CalPERS's interventionist approach to hundreds of companies it invests in could be shown to improve returns. "It is something we would like to see across the globe," he added.

Hermes is the obvious vehicle to turn that thought into action in Europe. It has a long tradition of calling boards to account rather than trading their shares a common sense practice turned into commercial philosophy under Alastair Ross Goobey. Fifty years ago, George Ross Goobey, manager of the Imperial Tobacco pension fund, pioneered funds investing their assets in a semi-permanent portfolio of large shareholdings in a wide array of companies. At the time Anson was appointed, Ross Goobey Jr was bringing that thinking up to date in a memorial lecture for the new **Cass Business School** pension archive.

A train of logic links the two. Big funds cannot easily trade. The money saving alternative is to be "passive" long-term investors, roughly tracking an index. To be passive in trading, however, it makes sense to be active in corporate governance, to be share owners rather than shareholders, as Mr Anson puts it.

Perversely, activism has earned a bad reputation recently. It will be part of Mr Anson's job to distinguish between the selfish short-term arm-twisting of some hedge funds and efforts to raise long-term returns for all of a company's owners.

George Ross Goobey still backing equities, By Daniel Brooksbank, IPE.com 21/Oct/05

Previously unseen papers from the late George Ross Goobey, the founder of the ‘cult of equity’ in the UK, are to be used to make a new case for the asset class at a lecture by his son.

Alistair Ross Goobey, the former chief executive of Hermes Pensions Management, will draw on the writings at a lecture at the Cass Business School on October 27.

Ross Goobey junior – who’s now chairman of the International Corporate Governance Network - will argue that pension fund investment has come full circle to where it was when his father created the equity “cult” in the early 1950s.

He will argue that with returns from bonds flagging, there is a need to return to equities.

Ross Goobey senior’s papers have been donated to the new Pensions Archive Trust, which will be launched at the lecture. His son will be the first president of the trust, based at City University.

The archive aims to provide a central source of information to students and others making a study of pensions provision in this country.

Pensions face early retirement, by Barry Riley, Financial News, 15 October 2005

Pensioners will eventually die. But the process will take much longer and will be more expensive than companies expected when they set up their pension schemes many years ago. Ominously, it is beginning to look as though the pension schemes will expire first.In the US, it is clear that the beleaguered Pension Benefit Guaranty Corporation, the federal agency set up in the 1970s to run a mutual insurance scheme for US corporate pension plans, is facing a crisis in the motor industry. This will be the third big US industry to suffer a pensions meltdown, following in the footsteps of steel and airlines.

The collapse into Chapter 11 bankruptcy a week ago of the auto parts group Delphi is expensive in itself. But the bigger danger is that Delphi's former parent, General Motors, will be sucked into bankruptcy, too, as the only way out of the burden of its pension and healthcare legacy costs that are destroying its competitiveness.

A financial crisis at GM may be some time off. Yet last week the yield spread widened sharply between the debt of the car giant and its Gmac financing offshoot, on expectations that Gmac may be sold off. After the Delphi bankruptcy, Standard & Poor's downgraded GM a notch below Gmac and deeper into sub-investment grade territory.

If you believe GM, its huge pension plan, with $90bn of obligations, is fully funded by assets. That assumes the motor giant will continue to support the scheme indefinitely and ignores the possibility that Delphi will be able to offload some of its pension burden onto its former parent.

But according to calculations leaked from the PBGC there would be a deficit of $31bn on sudden termination. The agency itself is already $23bn in deficit, not counting the further black holes dumped on it in recent weeks by the bankruptcies of Northwest Airlines, Delta Air Lines and now Delphi.

The global pensions industry had hoped that rising equity markets would bail it out of its problems. But US stocks have fallen slightly this year. European equities have done better, but falling bond yields by increasing the present value of long-term liabilities have done a lot of damage.

In the UK, several substantial corporate schemes are only two-thirds funded. The biggest deficits in absolute terms are those of British Telecom, British Aerospace and Lloyds TSB. The actuarial consultancy Punter Southall complained last week that the UK equity market did not regard pension fund deficits seriously enough as the debts that they certainly are.

The response from companies shocked by the sudden descent of their pension schemes from the carefree surpluses of the 1990s to the yawning deficits of the post-2000 years has embraced three phases.

First came the hasty closure of final-salary schemes to new members, plus simple optimism that the markets would turn the situation round again. Second, companies sought ways of financing the deficits through enhanced contributions over five to 10 years, while adopting liability-matching investment strategies.

But in many cases this repair job is becoming costly. The third stage, now beginning, may bring the closure of schemes to new accruals and the eventual removal of liabilities from balance sheets. The exit routes are far from clear, however, and bankruptcy in the UK does not offer the extraordinary flexibility of America's Chapter 11. Delphi is proposing to cut wages by a third while offering senior executives a stock option package in a successor company.

But one option for British pension scheme sponsors may be to shift future accrual to elsewhere in the European Union - Ireland, probably - where at least British schemes could avoid paying fast-rising premiums to the Pension Protection Fund, the UK's new, but already hard-pressed, version of the Pension Benefit Guaranty Corporation. Or scheme members could be paid cash incentives to switch into defined-contribution plans.

Pension deficits are blocking merger deals and causing credit rating downgrades. In the UK there is the threat that the new Pensions Regulator will order companies to cut dividends or abandon equity buy-back programmes so that capital can be diverted to reduce the debts owed to pension schemes.

According to the report Pyrrhic Victory produced this month by the **Pensions Institute**, a unit of the **Cass Business School**, UK companies feel that they are losing financial control of their pension schemes under pressure from regulatory "clearance" rules and are thus being penalised for having voluntarily set up costly defined-benefit plans in the past.

British Airways, for instance, faces a struggle against low-cost competition from Ryanair and easyJet, not to mention the bankrupt US airlines that have abandoned their pension liabilities but are still flying across the Atlantic.

The traditionally cosy relationships between corporate executives and scheme trustees are unsustainable. Finance directors and other top bosses will feel it is appropriate for them to leave trustee boards. Moreover, actuarial consultants will have to choose one side or the other, sponsors or trustees, thus sharply raising scheme costs.

Corporate pension schemes have been based on promises for the long term. But such promises, notionally funded but not guaranteed, are, it now appears, worth very little in an increasingly competitive and short-termist global business climate.

Pension accounting rules could be relaxed after employer anger, by Phillip Inman, The Guardian, 14 October 2005

Employers were given a glimmer of hope yesterday that strict pension accounting rules may be relaxed after the Accounting Standards Board announced it was launching a review of the financial reporting of pensions.

The board said vociferous criticism of the pension standard FRS17 by employers, trustees and actuaries had forced the review, which would look at a broad sweep of issues. Some have argued the valuation of pension liabilities based on a market value "snapshot", one of the important elements of the FRS17 rulebook, has brought volatility to the valuation of pension fund deficits. They have asked regulators for more flexibility to judge the overall performance of the fund.

The board said the decision to initiate a review was also spurred by the new pensions regulator and Pension Protection Fund, which rescues final salary occupational schemes affected by the collapse of their employer.

"These changes could not have been anticipated when FRS17 was developed and may have an effect on the relevant financial reporting," it said. The standard was published in 2000 but only came fully into effect from January this year.

Many of Britain's top 100 companies are paying pension contributions worth in excess of 20% of employee salaries to close pension deficits highlighted by FRS17. A report last week based on interviews with major employers said many would honour their obligations to their respective funds, but in the medium term would close the schemes and shift to personal-pension style schemes. The report, by the **Pensions Institute** and

Cass Business School, highlighted frustration among employers at a significant increase in regulation over the last two years and the resulting drag on profits and cuts in dividend payouts.

The government wants to base the funding for the PPF on a risk-based levy for defined benefit schemes. Those with the largest deficits would pay the most. The proposal has angered employers such as BT, which has a pounds 5.1bn deficit but argues there is no current risk of insolvency.

Accounting Standards Board chairman Ian Mackintosh said: "Accounting for pensions remains one of the most important and controversial areas of financial reporting. While FRS17 stands comparison with any other pension accounting standard in the world, the scale and significance of the changes that have taken place since the standard was published has led us to conclude that the time is right for a fundamental review."

The board said it would look at areas that some critics of the standard claim have been abused by employers. They argue that the discount rate and the expected return on assets in the fund have been artificially inflated by some employers to reduce deficits.

The unintended consequences of the Pensions Act 2004, by Stewart Ritchie, Director (Pensions Development), Scottish Equitable

The **Pensions Institute** (not to be confused with the Pensions Policy Institute) has published a new report entitled "Pyrrhic Victory? The unintended consequences of the Pensions Act 2004". You can tell right away from its title that this report does not conclude the Pensions Act 2004 is an unqualified success.

Pyrrhus was a Greek warrior king who did not know when to stop. In 281 BC he defeated the Romans, but at huge cost to his own army. He is reported to have said, "one more such victory and I am lost". This new report suggests that "victories" such as the Pensions Act 2004 have been won at a high cost to occupational pensions.

A main conclusion of the report is that "in the place of a final salary-linked pension all but a minority of very large companies will introduce contract-based defined contribution schemes – a trend already well under way. Our findings also suggest that companies with existing trust-based occupational DC schemes are looking to move to a contract basis, reflecting their general weariness with, and their desire to withdraw from, the complexity of trust-based benefits". This certainly accords with my own views and experiences. Not all who hold such views are willing to express them directly, but in many cases actions speak louder than words.

There are eight key findings in the report, as listed in the box below.

Key Findings of Pensions Institute Report

1. The Act disconnects the historic alignment of the interests of trustees and the

sponsoring employer.

2. Company directors are likely to withdraw from trustee boards.
3. The new requirements for Trustee Knowledge and Understanding (TKU) may alienate older, highly capable trustees.
4. The business model of actuarial and investment consultants is under scrutiny and is expected to change.
5. Clearance is likely to favour trustees but create problems for employers.
6. There are serious doubts over the longer-term viability of the Pension Protection Fund (PPF).
7. Employers feel they have lost control of their DB schemes and will close to future accrual.
8. To proceed with confidence, employers need the flexibility to design benefits that are appropriate to their size and financial strength.

In defence of the Government, it is only fair to point out that the Pensions Act 2004 contains some liberalisation (e.g. removal of compulsory indexation of money purchase pensions, and tax free cash on Protected Rights), most of the measures are well intentioned, and some of the measures are obligatory as a result of the European Pensions Directive, IORP. Indeed, some pensions lawyers argue that the Pensions Act 2004 does not go as far as IORP requires, especially in the area of solvency of defined benefit schemes.

Perhaps the most ominous aspect of this report’s findings concerns future accrual for people who were in a defined benefit scheme before it closed to new entrants. One consultant is quoted as saying “in time everyone will be in DC as schemes close to future accrual. Companies will be under pressure to do this, as to run a two-tier workforce makes no sense because DC members will demand higher salaries. It will be easier for employers to switch everyone to DC for future service.”

Two asset managers warn in the report that a move to DC may lead to other problems in the future, particularly regarding adequacy.

In the greater scheme of things, I see this Pensions Institute report recording a set of trends which is inevitable and logical. For defined benefit in the private sector the cost has become so high and so uncertain that employers must address it, even for existing members. This could mean higher retirement ages, higher employee contributions or lower accrual, but none of these removes the discrepancy with more recent employees. The duties of trusteeship have always been onerous if they were being properly carried out, but now the Pensions Act 2004 spells out just how onerous they are, and the Pensions Regulator will be looking out for trustees who don’t measure up. A move to a contract-based pension vehicle at the earliest of practical opportunity has suddenly become a lot more attractive.

DB scheme closures to rise - Pensions Act puts a burden on employers that could adversly affect the UK economy, according to the Pensions Institute. By PAULINE SKYPALA. FT REPORT - FT FUND MANAGEMENT, 10 October 2005

Measures taken by the UK government to underpin private sector pensions are likely to backfire and hasten the demise of traditional defined benefit pension schemes, according to the latest report* from the **Pensions Institute**, part of **Cass Business School**.

Many DB schemes, which provide a pension linked to salary, have already closed to new entrants. New rules being brought in under the Pensions Act 2004 are likely to accelerate the closure rate and encourage employers to close schemes to future accrual by existing employees as well, the report concludes.

In requiring trustees to negotiate robustly with sponsors on closing deficits and to set contributions at rates expected to achieve solvency in five to 10 years, the Act places a huge burden on employers that is likely to affect the UK economy.

Debbie Harrison, senior visiting fellow of the Pensions Institute and co-author of the report, says: "If trustees try to achieve the statutory funding objective (SFO) funding level within five years - as many are expected to do - this will prevent companies with significant deficits from paying dividends to their shareholders, raising finance for the business, and engaging in corporate activity."

Employers are up in arms at the unwarranted interference in their businesses, and the way financially strong companies are being forced to subsidise the weak via the Pension Protection Fund levy. It is the last straw, completing the transformation wrought by successive legislative changes of a flexible pension promise into a legal guarantee.

The Pensions Institute says many employers are now seeking to get out of DB provision as soon as possible. It suggests employees will gain greater security of benefits in the short term, but at the expense of losing access to DB schemes in the longer term. "It will be a Pyrrhic victory for pensions policymakers," says the report.

Its findings, based on interviews with a wide range of interested parties, also highlight the increasing pressures on the pension fund trustee bodies that run DB schemes.

"The new Act appears to encourage conflict rather than conciliation," says a pensions lawyer quoted in the report. "The Regulator is encouraging trustees to take an aggressive and confrontational approach in negotiations with the company."

Trustee boards are also likely to be deprived of the input of company directors, who are expected to give up trustee positions to avoid perceived conflicts of interest. Alistair Byrne, fellow of the Pensions Institute and co-author of the report, says the resulting disconnection between scheme and sponsor will leave trustee boards "rudderless" unless new governance structures are introduced to maintain the exchange of information.

Schemes are expected to make more use of independent or professional trustees in response to these changes, although there are concerns about the cost, particularly for smaller schemes.

The requirements for trustee knowledge and understanding (TKU) could further undermine trustee boards by alienating older trustees without higher educational qualifications, but with a good understanding of the company. Their place is likely to be taken by middle managers, which would weaken the diversity of the board, says the report.

Many respondents to the report question the need for all trustees to have the specified level of knowledge.

"On the board there should be a range of skills - there is no sense in them all having the same skills. Good governance calls for diversity," comments a trustee.

Small and medium sized companies are likely to be hit hardest by these changes, and are expected to seek to get out of DB provision sooner rather than later.

But there is a wide expectation that occupational pension provision will ultimately shift to a DC basis for all employees. These DC schemes are more likely to be contract-based than trust-based as employers see benefits in handing the administrative functions over to a life company.

The expected wholesale shift to DC raises many questions for government and private sector providers. An earlier report by the Institute on DC provision found a growing gap in provision in the SME sector as providers and advisers find it increasingly uneconomic to market to these companies.

The last word goes to a pensions lawyer: "There is no point in having the best regulation in the world if there are no schemes left to regulate."

*Pyrrhic Victory? The unintended consequences of the Pension Act 2004

Bosses warn over high cost of pension protection. By ROBERT BUDDEN, 8 October 2005, FT MONEY

Employers have called for an overhaul of the government's safety net for final salary pension schemes in a development that could see this last-ditch protection for final salary pension schemes watered down.

This week the Confederation of British Industry added its voice to bodies such as the National Association of Pension Funds which have warned that the costs of running the Pension Protection Fund risk escalating out of control.

The PPF, which was set up in April this year, provides an income guarantee to members of final salary pension schemes if their employer goes bust. Currently, for people who have yet to retire, the scheme pays out 90 per cent of their retirement income entitlement up to a cap of Pounds 25,000 a year. For people who are already drawing an income from their final salary pension, there is no cap on benefits and they receive 100 per cent of their income.

The CBI estimates that the costs to companies of the scheme in the first year could be Pounds 600m - double the government's initial estimate. Employers and pensions bodies argue that the rising costs of running the PPF - which is funded by a levy on companies operating final salary schemes - could accelerate the closure of final salary schemes, not just for new employees but also for existing members.

"More people are saying what we have been saying for some time," said Christine Farnish, chief executive of the National Association of Pension Funds. "An inevitable consequence (of these rising costs) is that companies will be quietly getting out of final salary schemes."

Research released this week by the **Pensions Institute**, based at the **Cass Business School**, suggests that, within five years most final salary pension schemes will be frozen to existing members with future contributions diverted to money purchase schemes.

"Next year we estimate the levy will be between Pounds 600m and Pounds 1bn," said Adrian Waddingham, chairman of the Association of Consulting Actuaries. "The ACA always told the government that it was not wise to make the scheme as generous as it is."

The pensions industry is also angry that, via a quirk in pensions rules, the government has been able to pass companies into the PPF even if they became insolvent before April this year. Turner & Newall, a vehicle parts company with 40,000 pension members, first went into administration in 2001. But, because a secondary administration was triggered after April this year, it now falls under the PPF, allowing the government to pass on the burden of honouring these pensions to employers.

"The government used this device to put in a secondary claim," said Waddingham. "This is very naughty when the government is not guaranteeing the PPF."

Some pensions experts are speculating that the PPF will have to be watered down. Some believe this could see the Pounds 25,000 annual income cap fall. There is also a possibility that a cap and a lower percentage payout will be applied to pensions in payment.

This week pensions campaigner Frank Field MP suggested that all members of final salary schemes pay Pounds 50 a year towards the levy.

"The other option is that the government steps in to pick up some of the costs," said the NAPF's Farnish.

CBI urges big rethink on pension safety net. By BEN HALL and NICHOLAS TIMMINS, Financial Times, 6 October 2005

Employers' organisations yesterday called for a big rethink on the way contributions are to be levied for the government's pensions lifeboat as an independent study warned that the drive to protect those still in final salary pensions will prove "a pyrrhic victory".

John Cridland, deputy director general of the CBI, said that industry was increasingly alarmed at the liabilities being built up by the Pension Protection Fund and the levies required to pay for them.

The PPF's proposals "simply will not deliver increased security for pension scheme members at an acceptable price for employers," he said. The CBI estimates the levy will cost up to Pounds 600m in its first year - double the government's original estimate.

The PPF was set up to protect employees' pensions when their employer becomes insolvent. It will be funded by a levy on solvent corporate pension schemes. Consultation on the funding proposals ended this week.

The CBI warned that if the more solvent corporate schemes were forced to subsidise the premiums of weaker ones, their sponsoring employers would be encouraged to close defined benefit schemes.

The CBI's comments came as the **Pensions Institute**, based at the **Cass Business School**, warned that the government's pensions legislation would lead to a string of unintended consequences. It will damage business and accelerate the closure of defined benefit schemes, the institute said.

Employers are planning to get out of defined benefit pensions as soon as they can, the institute said. It estimated that within five years most defined benefit schemes - as many as 10,000 - will have stopped new accruals for existing members, on top of being closed to new employees.

Based on extensive interviews with companies, trustees and advisers, the institute said recent legislation has turned "a voluntary pension promise into a legal guarantee", angering employers.

Mr Cridland reinforced the CBI's call for the government to become the "guarantor of last resort" for the PPF. He also called for the government - rather than the strongest companies - to subsidise the levies of the weakest schemes.

The size of the levy companies are required to pay to the fund will be calculated according to their scheme's deficit and their credit rating. But Mr Cridland said a key weakness of the proposals was that they did not take into account guarantees given by parent companies of their subsidiary's pension promises, and a string of other financial measures that can underpin a firm's pension scheme. "Without this, companies who are extremely unlikely ever to make a call on the PPF will pay large levies - diverting money from the pension scheme to finance the PPF," he said.

The Pensions Institute said the government's Pensions Act was likely to see trustees press companies to plug pension deficits within five years, rather than over a decade or more.

Pensions regulation 'killing final salary schemes', by Phillip Inman, The Guardian, 6 October 2005

Tough pensions regulation designed to protect employees in final salary occupational schemes will prove a pyrrhic victory for unions and the government, a report warned yesterday.

Employers angry at tighter regulation and higher running costs after the 2004 Pensions Act are preparing to cap their liabilities and restrict future benefits, said the **Pensions Institute** at **Cass Business School**. Its survey of employers revealed a significant level of disenchantment with government pensions policy and a determination to avoid further responsibilities that were proving a drag on profits.

Big employers could close their final salary schemes to existing employees, effectively freezing all payments into them, or cut benefits by switching to a pension based on a career average salary rather than a final salary.

"Employers will pay up and then leave the battlefield, turning their backs on trust-based occupational pension provision. The biggest casualties will be the footsoldiers of British business, the employees, most of whom face an uncertain future in less generous, defined contribution schemes," the report said.

The report says employers are angry about the level of regulatory interference in the way they run their business and the confrontational approach taken by trustees, both of which it argues are direct consequences of the Act.

Employers who responded to the study planned to get out of final salary provisions at the earliest opportunity "to eliminate a business risk over which they feel they have no control and the nature of which has changed fundamentally under new legislation", the report said.

Pension gap hits £130bn, 6 October 2005, Daily Mail

THE combined shortfall in Britain's final salary company pension schemes now tops £130bn according to a report from the Association of Consulting Actuaries.

That is far higher than previous estimates putting the deficit for FTSE 100 companies at between £40bn and £50bn.

A separate report from the **Cass Business School** warns that firms will try to ditch their final salary schemes over the next few years as the full impact of the Pensions Act hits home.

Debbie Harrison, coauthor of the study, said that the closures would be an unintended consequence of the legislation, designed to protect scheme members.

It has forced companies to treat benefits once offered on a voluntary basis as legal obligations, which firms fear they cannot afford.

UK MPs start parliamentary pensions group, IPE.com 2/Aug/05

Members of Parliament have set up a group aimed at forming a pensions consensus.

The All-Party Parliamentary Group for a Pensions Consensus is chaired by Lynne Jones, the Labour MP for Birmingham Selly Oak. It had its inaugural meeting in Westminster on July 19.

Speakers included pensions minister David Blunkett and **David Blake**, professor of pension economics at the **Cass Business School**.

The new group replaces the All-Party Parliamentary Group on Pensioners' Incomes, which has now ceased to exist. The new name reflected “a greater emphasis on the need for all parties to come together and agree on a way forward for UK pension policy”.

“This group will be a great chance for MPs to hear from a wide range of pensions experts,” said Jones in a statement. “The better informed MPs are, then the more likely they are to come together on this issue.”

“To have the Secretary of State address the first meeting gives the group a great foundation, and having MPs join from all three main parties shows that there is the political will for a consensus,” said Roger Turner, head of Unite, the National Federation of Royal Mail and BT Pensioners.

“What we need to do now is ensure that this is delivered, so that pensioners now and in the future can enjoy a decent standard of living.”

The MPs will next meet in the autumn, around the time that the Pensions Commission issues its final report.

Risk is a four-letter word in Britain, By Debbie Harrison, Financial Times, June 25 2005

Adults in the UK are deeply risk-averse - far more so than their American counterparts - and most prefer to avoid financial risk altogether. These are the findings of the first major quantitative survey of UK consumer attitudes to risk.

But general education is far more important than affluence in determining an individual's risk profile. According to the study, educated investors are more willing to take a risk and are also more likely to have a structured approach to their finances.

The survey, "Benchmarking UK consumer attitudes to risk", is the result of collaboration between Distribution Technology, a provider of financial and investment planning tools to organisations such as American Express and Friends Provident, and the **Pensions Institute**, an independent academic research organisation based at Cass Business School in the City.

The research was based on interviews with 966 people between the ages of 18 and 75, who were representative of the UK population in terms of sex, geographic regions and wealth distribution. It followed a 2004 FSA report, "Consumer understanding of financial risk", which was based on a series of qualitative focus groups.

The research found that investors have very different attitudes to risk, depending on whether they are facing a gain or loss. For example, where an individual is faced with a choice between a fixed (or guaranteed) loss and a gamble (which could result in a larger or smaller loss than the guaranteed option), they display more willingness to accept risk and will tend to go for the gamble, pinning their hopes on a favourable outcome.

However when the same individual is faced with a choice between a certain or uncertain gain they tend to be more risk averse and prefer the certain gain based on the "bird in the hand" principle.

In the context of pre-retirement planning, investors who are underfunded and face an inadequate retirement income may tend to overreact and take too much risk in seeking a more favourable outcome.

Traditional approaches to individual risk tolerance are based on the concept of the "rational investor", which assumes individuals have complete knowledge of all the factors that could influence an investment and that they are willing and able to accept a straightforward trade-off between risk and reward.

David Blake, director of the Pensions Institute, says: "This type of analysis is flawed because it is usually based on a scale calibrated as a result of discussions with a few individuals or focus groups.

"It is not statistically sound and does not measure the individual against the population."

The questions in the survey were based on risk questionnaires developed with the Pensions Institute and built on academic work from around the world which used a "behavioural finance" approach to interpret why people do what they do rather than what they think they ought to do. As such, the survey provides insight into the under-researched area between common perceptions of individual risk tolerance and the amount of risk people are actually prepared to take in practice.

Blake argues that the dramatic reduction in risk tolerance that accompanies ageing needs to be better understood in the context of our equally dramatic increase in longevity.

"With retirements lasting 20 to 30 years, it is essential for people to achieve higher returns during this period to sustain their standards of living. This is particularly important given the trend away from guaranteed salary-linked (defined benefit) pensions and towards investment-based money purchase (defined contribution) arrangements."

Equally important for retired investors, the report found that most people want to enjoy their gains as soon as possible and are averse to deferring the benefits.

This is highly relevant to the annuity market, where people use their defined contribution pension funds to buy a lifetime income.

The majority of purchasers opt for a high initial income that remains level, rather than a lower initial income that rises in line with inflation.

The report of initial findings is at www.distribution- technology.com

Cass Business School offers pension science MSc

IPE.com 9/Jun/05: UK – The Cass Business School in London is offering what it says is the first MSc degree in pension science.

"Cass Business School, which already has earned a reputation for excellence thanks to its Specialist Masters Courses, is introducing a new MSc in Pension Science, the first of its kind," the institution said.

The 12-month degree covers core courses in pension economics, pension finance, comparative pension systems, social policy and ageing, accounting, law and regulation, and relevant quantitative methods.

It is aimed at those "seeking a comprehensive understanding of pension systems and their applicability in varying international contexts".

Graduates will learn about different types of pension systems and how they have developed as well as how they are funded and about the risks they face.

At the end of it they would be "able to advise governments, institutions and companies in any country on pension matters".

"The Department for Work and Pensions is enthusiastic about the development of this qualification, and would welcome applications from individuals holding the prospective Pensions MSc," said Robert Laslett, chief pensions economist at the DWP.

"The combination of economics, finance and actuarial science on the one hand, with an understanding of law and regulation on the other, would be very well suited to the analytical and policy needs of the department."

It takes a lot of cash to cover the essentials, By Alistair Byrne and Debbie Harrison, Financial Times, May 7 2005

News that BAE Systems, Europe's largest defence company, is close to a deal with its unions that would reduce its £2.8bn UK pension liability by £1.7bn has focused attention on the scale of the crisis in company pensions.

It emphasises the need for investors in UK companies to review their equity portfolios in the light of Britain's pension shortfall, which analysts say is damaging profits and hindering merger and acquisition activity. Put bluntly, investors in certain companies are exposed to a major risk that they may not even be aware of.

The problem affects companies that run "defined benefit" pension schemes that promise employees a retirement income linked to their salary. Many of these schemes have significant deficits, which means they have insufficient assets to pay the benefits they have promised, even allowing for future investment growth.

"These liabilities are very real and akin to a debt on the employer," says Stephen Cooper, head of accounting and valuation research at the investment bank UBS. Investors should take a deficit very seriously, Cooper warns, particularly where it is large relative to the company's market capitalisation.

Estimates vary but according to the actuarial consultant Lane Clark & Peacock, FTSE 100 companies have a stated aggregate deficit of about £40bn. However, the underlying shortfall could be much greater because many schemes do not use up-to-date assumptions for life expectancy.

If a company underestimates the period for which it must pay pensions then it will also underestimate the deficit. Bob Scott, a partner at Lane Clark & Peacock, says that if updated mortality tables were used, this could add a further £20bn to the deficit for FTSE 100 companies, taking it to £60bn.

As the law stands, it is the employer's responsibility to make good any shortfall between pension fund assets and liabilities. With the introduction of the 2004 Pensions Act last month, which includes a new standard for scheme funding, companies are under pressure to increase regular contributions and make one-off payments where necessary. The legislation effectively gives trustees of these schemes the power to force employers to pay more if this cannot be agreed voluntarily.

The Act also brought in the new Pensions Regulator, who has wide-ranging powers to ensure that companies do not avoid their pension obligations.

But the important point for investors is that all these developments make it virtually impossible for a solvent employer to renege on its pension commitments. Few if any companies can afford to transfer these liabilities to an insurance company by purchasing annuities as the costs are usually prohibitive.

Lane Clark & Peacock suggests that the pension deficit of the FTSE 100 companies measured against the full annuity "buy-out" cost is £125bn - more than three times the stated level of aggregate deficit. The result is that most employers are stuck with pensions liabilities extending into the next 50-60 years, even if they have closed their final salary pensions to new members. And where employers make additional contributions to plug deficits they will be forced to do so out of profits, so shareholders will suffer.

Lawrence Churchill, chairman of the new Pension Protection Fund, has even questioned whether companies should be paying dividends at all if they have a pension fund deficit.

The extra contributions required to shore up deficits can be very significant. In March last year Marks and Spencer announced it would pay £400m into its pension scheme to reduce the deficit identified in an updated actuarial valuation. The contribution was funded by a bond issue and was equivalent to more than 70 per cent of the group's profits for the year. BAE Systems' 2004 annual report shows the pension deficit widening to £2.7bn from £1.9bn in 2003, reflecting updated assumptions about longevity and indicating that the company will have to pay higher contributions in future.

The way pension funds are invested is also very relevant, as this will affect the risk to which the company and its shareholders are exposed. Some experts suggest that investment grade bonds are the closest match to a pension scheme's liabilities, as these provide a stream of income to cover pension payments.

"Where the scheme invests a high proportion of assets in equities, this represents a risk for the company because there is a mismatch between assets and liabilities," UBS's Cooper explains. "In this situation, effectively the company is running a leveraged investment fund within the business. Investors need to evaluate both the operating company and the leveraged investment fund [the pension scheme] to get a clear picture."

Financial advisers to mergers and acquisitions say buyers need to reflect pension scheme liabilities and deficits in the pricing of deals. Scott suggests that where the deficit is a significant percentage of the sponsoring employer's market capitalisation - 25 per cent or more - this "could deter corporate predators".

Martyn Pilley, partner with the accountant RSM Robson Rhodes, goes even further: "A pension fund deficit can wreck a deal."

Several high-profile cases have already driven this point home - most notably the failed takeover of WH Smith by Permira, the private equity group, and Philip Green's aborted bid for M&S, both in 2004. More recently, a bid for chilled food producer Uniq failed for a similar reason.

For investors the availability of information on pension scheme deficits is improving as new accounting rules are phased in. FRS 17 and its international replacement IAS 19 both show the final salary pension deficit on the balance sheet but the latter also requires a company to disclose any "material assumptions" used in determining its scheme valuation.

This latter standard may help reveal any outdated mortality assumptions companies have used in their calculations and therefore give a truer picture of a company's pension debt. Only if private and institutional investors can access this critical information, will they be able to judge whether a company's share price valuation fairly reflects a future hit to profits as money is redirected to shore up the pension fund deficit.

Debbie Harrison and Alistair Byrne are senior visiting fellow and fellow respectively of the ***Pensions Institute*** *at Cass Business School.*

Lesson in saving rather than scrimping, By Debbie Harrison, Financial Times, April 9 2005

"This isn't just about encouraging people to save through pensions. It's about changing attitudes, so that people get into the lifetime savings habit - and stay there. To achieve that we need to give a clear message that it pays to save, that it is safe to save and that there is a real incentive to save."

And there you have it in a nutshell. David Willetts, MP for Havant and shadow work and pensions minister, is both a pragmatist and intellectual (his nickname is "Two-brain").

He says he has thought long and hard about the British attitude towards personal financial planning and he is deeply concerned that the savings ratio - the amount we save relative to our disposable income - has halved in recent years. This is despite a marked increase in longevity and the erosion of the basic state pension.

"Do we have a savings crisis? Yes, we do. We have a large number of people facing retirement on incomes significantly lower than they need and expected. That's a crisis. Pensioner poverty is a crisis. People are simply not doing what the government hoped. They are not saving - they are not planning for their financial future."

As we sit over lunch at the **Pensions Institute** at **Cass Business School**, where Willetts is a visiting professor, we are in the heart of the British financial services market, surrounded by academics and practitioners who design and promote the products on which our financial future depends. To the untrained eye, the City appears as eager and willing to sell as it ever has. So what has gone wrong? Why aren't we buying?

"Government should give a clear message that it pays to save. Right now many people are deeply confused about whether they should even save at all. If they do they may lose access to the means-tested pension credit. We need to link the basic state pension to earnings inflation, so that it provides a meaningful income - this will start to reverse the trend towards means testing."

There is a lot of cross-party support for Willetts' call for state pension reform. Means testing doesn't just confuse pensioners - 1.6m of whom do not claim the pension credit to which they are entitled - it confuses the private savings market and employers as well. The Pensions Commission interim report, published in October, made this clear.

"The Pensions Commission found that independent financial advisers were wary of selling to people who might lose their eligibility to the pension credit if they built up private savings. Employers have the same fears with their pension schemes," he explains.

Willetts is something of a philosopher at heart as well as a politician and an economist - a healthy hangover from his student days at Oxford where he graduated with a first in politics, philosophy and economics before heading for the Treasury. "We can't solve the pensions crisis overnight. Conservatives don't have a magic bullet but we would reform the state pension system to ensure it pays to save. And - importantly - we would make it safe to save."

One of the most urgent issues Willetts wants to address is the perception that company pension schemes are not safe. "We should give more to help people who did the right thing by joining their company pension scheme but who lost their savings when the firm went bust with its pension fund in deficit." He approves of the Financial Assistance Scheme, set up by the government to compensate people who are ineligible for the Pension Protection Fund, which started earlier this week.

"The assistance scheme is a good idea but it doesn't go far enough." This scheme will cover 80 per cent of the benefits promised but initially it will only apply to those with less than three years to retirement. "The other victims don't know where they stand. Conservatives would use the un-claimed assets of banks and financial institutions to replenish the pension funds of those who have seen their savings wiped out through no fault of their own."

Willetts recognises that it's not enough to make company schemes safer. One of the problems revealed by the disappointing take-up of stakeholder schemes is that many employers have lost their appetite for providing staff pensions.

"We can only encourage people to join good schemes if these schemes exist. If we want good schemes for employees, we should give bosses an interest in providing them. Conservatives would remove the cap on how much money senior executives can hold in their pension fund on the condition that every employee of the firm can join the same scheme on similar terms."

Willetts' model has much in common with the "401K" company schemes in the US, where a combination of anti-discrimination rules for executives and automatic enrolment for the workforce helps to align the interests of employers with their staff. "I don't mind if there are fat cats as long as there are fat kittens too," he says.

So the Conservatives would make it pay to save and make it safe to save. What about the incentives to save? "Incentives need to be explicit - they need to be vivid. I have proposed a lifetime savings account where contributions would be matched by the government, using the supermarket principle of 'buy one get one free'. We need something that is flexible and attractive for younger people, many of whom have student debt and are struggling to save a deposit for their first home.

"If we give them a real incentive to start saving early, with easy access to their money, this will get them saving for life, not just for retirement. That's what we need - to create a precautionary, prudent approach to lifetime savings that works throughout the lifecycle."

UK Pension Commission looking at annuity market, By Fennell Betson, IPE.com 11/Apr/05

The Pensions Commission will be looking at what tax and regulatory changes are needed to reshape the working of the annuity market, the commission chairman Adair Turner said in London.

Turner queried whether the selling of annuity products where the risk of death was so low provided much benefit in terms of cost optimisation. “It is probably a good idea that we write less annuities at the very early ages,” he said.

It would be most useful if the marketplace for annuities focused at the long end. “This may tend to happen through free market forces,” he added. “But we would be wary of doing anything which would be subsidising the long-term annuity market as we want fair pricing of the very long-term uncertainties in annuities and so create an incentive for later retirement.”

In addition, efforts should be made to develop product options enabling people to arrange “annuitisation between 55 and 75. There might be people willing to accept that risk”.

“One of the things the Pension Commission will be looking at is whether there would be any tax or regulatory changes that would be required to facilitate that sort of product take-off.”

He continued: “It is really an issue of how do we end up with the market equivalent of drawdown products, which are now primarily concentrated at the higher income end”

There is, Turner stated, a stage beyond where there probably should be annuitisation, which should logically shift back over time. “We should be focusing our appetite and our capacity for longevity risk absorption at the most useful end.”

Turner was giving a lecture at the **Cass Business School** in London on the topic of "Pensions, Risk and Capital Markets".

Turner rejects criticism of Pensions Commission report, By PAULINE SKYPALA, Financial Times, FTfm, 11 April 2005

Adair Turner, chairman of the Pensions Commission, has rejected criticisms of the thinking behind the Commission's first report by producing empirical evidence to support the assumption that equity risk decreases over time.

But despite this defence, he said defined benefit pension funds should not, and he believes increasingly will not, invest in equities. Speaking at **Cass Business School** last week, Mr Turner discussed the conventional wisdom that the risk of holding equities reduces over the long term, and that equities are sure to provide better returns than bonds. He said this belief had been disputed, particularly among the actuarial profession, some of who say the assumption is technically flawed and that pension funds should be invested in bonds. It has also been challenged by John Ralfe, an independent pension consultant and former finance director at Boots who was the architect of the switch to bonds by the Boots pension scheme in 2001. Mr Ralfe said the Pension Commission's acceptance of the conventional wisdom undermined its analysis of the advantages of a funded pensions system over a pay-as-you-go system.

Mr Turner said an analysis of 20-year investment periods showed 16 per cent of them provided returns of less than the benchmark of a 2 per cent annual risk-free real return. This compares with 32 per cent for five-year periods and 42 per cent for one-year periods. In addition the size of the shortfall was no greater over longer periods than shorter ones.

"The empirical evidence suggests long-term equity investment is less risky than short-term, but still riskier than index-linked bonds," he concluded.

The implications for pension funds depended on whether they were defined benefit or defined contribution schemes.

For DB schemes, the disadvantages of investing in equities outweighed the advantages. The strongest argument against holding equities was that shareholders have no interest in that approach.

If they wanted to take a leveraged position in equities they could do it themselves," said Mr Turner.

UK takes £2.4 trillion risk on a long life, Christine Seib, The Times, 8 April 2005

BRITAIN has taken Pounds 2.4 trillion of longevity risk despite lacking certainty on how life expectancy will change, Adair Turner, the chairman of the Pensions Commission, gave warning last night.

Mr Turner, who has been charged by the Government with finding a solution to the pensions crisis, said that this gamble was likely to result in a fall in annuity rates.

Speaking at the **Cass Business School**, in London, Mr Turner said that experts were likely to have correctly predicted improvements in mortality rates for the next 15 years. "(But) from 20 years out we could well have error rates that are quite as big as those that emerged in the last 20 years."

Mr Turner said that the UK did not have a "robust" way of calculating how life expectancy may change. Despite this, he said that the Government and companies had taken on about Pounds 2.4 trillion of longevity risks.

Insurers have sold Pounds 80 billion of annuities for which they have had to make assumptions about when people will die, while companies have taken the same risk by promising Pounds 800 billion of final salary pensions.

The Government has promised a further Pounds 450 billion in unfunded public employer pensions and there are Pounds 1.3 trillion in state pension promises.

Mr Turner said that as fewer and fewer people have access to final salary pension schemes, more of the longevity risk would pass to annuity providers.

The risk is then likely to be passed to the Government as insurers buy longevity bonds to support their annuity sales.

The Pensions Commission is due to deliver its final report after the general election.

Longevity risk weighs on trustees, Review by Adrian Boulding, Pensions Strategy Director, Legal & General, Headline Money, April 2005

To me, Longevity Risk is the "must read" article in this month's Pensions Management. It asks if capital markets could provide solutions, and that's a route not many people have given thought to yet.

Turning inside, the article by **Alistair Byrne** and **Debbie Harrison** gives a detailed account of the recent longevity risk conference held by Cass Business School. As the authors point out, this was not any old conference, but the first international longevity risk conference! Byrne and Harrison take us through the thought processes of that day, starting with some scene setting. The UK economy has £1000 billion of liabilities exposed to longevity risk and life expectancy for pensioners has increased by over 20 per cent since 1980.

It would be easy to get depressed by the scale of the problem. Indeed, Byrne and Harrison do point out that it's bad and getting worse, citing the deficit of the Footsie 100 company pension schemes which would be £20bn greater than is actually reported if they used up-to-date mortality tables. But their article is generally upbeat. It describes some of the real solutions that capital markets are now offering, like the Swiss Re and European Investment Bank (EIB) bonds, whilst explaining the scenarios different bonds cover. Apparently, the Swiss Re bond protects against catastrophic mortality changes such as nuclear attack, whilst the EIB bond looks more like a group annuity.

The authors show genuine enthusiasm for using capital markets to handle longevity risk, whilst recognising that this approach is very much in its infancy. They astutely point out that designing them is only a first step, and that an active market in the bonds will be necessary before they become widely used. The two authors have succeeded in producing a seamless piece, without any evidence of the "cut and shut" sometimes seen from dual authorship. Perhaps it helps that they are both visiting fellows at the **Pensions Institute**.

Scheme switch by employers hits workers' pension savings, By Norma Cohen, Financial Times, March 18 2005

Some of the best-known companies that promote employee pensions as evidence of worker-friendly policies are paying into the savings plans of a small fraction of their workforce.

According to the BBC's *The Money Programme* tonight, the recent shift by employers to defined contribution pensions - where benefits depend on investment returns and the amount saved - from defined benefit pensions, which are typically a proportion of final salary, has left tens of thousands of workers with no pension savings.

While the result is sharply reduced expenditure by companies and a consequent boost to corporate profitability, the trend raises questions about government efforts to shift greater responsibility for retirement savings to individuals.

Stephen Yeo, partner at actuarial consultants Watson Wyatt, which conducted research into why workers did not take up pensions programmes, said there were three stumbling blocks.

"First, many workers are on salaries that are too low for them to want to save," Mr Yeo said. "You might find a high take-up of pension savings at an investment bank but a lower one at a retailer where average salaries are lower."

Second, companies promoted pensions with varying degrees of enthusiasm. Third, companies that automatically enrolled their workers in schemes had high participation rates because inertia often stopped people from making financial decisions.

The findings come just months after a study by the **Pensions Institute** at **Cass Business School** concluded that employees were often discouraged from joining the workplace pension scheme by finance directors keen to keep costs down.

BBC Reveals New Pensions Black Holes, Money Programme, BBC2, 18 March 2005

The BBC's flagship business series *The Money Programme* has uncovered massive new pension black holes at the heart of some of Britain's best-known companies. In the final film of the special series "Pensions Panic", to be broadcast on Friday, 18th March at 7pm on BBC2, reporter Michael Robinson reveals that thousands of employees in companies such as WH Smith and Boots now have no pensions at all.

While in recent years attention has been focused on the problems faced by traditional final salary pension schemes, *The Money Programme* has been investigating the more risky cash-based "defined contribution" pensions which new employees in the majority of major British companies are now offered.

Defined contribution pensions were introduced over the past ten years by most major British companies after they closed down their final salary schemes. But while final salary schemes are now carefully scrutinised by city regulators and company auditors, little attention has been paid to the defined contribution schemes which replaced them.

The Money Programme team set out to discover how many of the employees eligible for these pensions had signed up to them. The results, reported by the programme, were startling.

At WH Smith, Britain's best known newsagent, 82% of the employees who could sign up for the new pensions hadn't done so. Which means around 14,000 of WH Smith's staff have no pension with the company

At Boots, Britain's best know chemist, 92% of eligible employees haven't signed up, leaving 30,000 staff with no pension at the company.

And at Mitchells and Butlers, owners of national pub chains like All Bar One and Harvesters, a staggering 97% of eligible staff haven't signed up for the company's new defined contribution scheme, leaving around 11,000 staff with no pension at the company.

These were among the very few companies prepared to disclose their take-up figures. Most of the major British companies the BBC team approached refused to give their figures.

Commenting on the many major employers' who refused to reveal their defined contribution take-up figures, **Debbie Harrison** of the City University's Cass Business School **Pensions Institute** told the programme: "I think for a lot of companies it's possibly an embarrassment that, as a caring employer, they have only 20% let's say of the whole of their workforce in their pension schemes. It begs the question, 'What are you doing for the other 80%?' And the answer is nothing."

With defined contribution pensions, most companies only contribute anything to their employee's pension pots when the employee does as well. So low take-up of pensions by eligible staff is good news for company profits and for shareholders.

Former Downing Street pensions adviser Dr Ros Altmann told the programme that employers had little reason to encourage take-up of defined contribution pensions among employees with their spending priorities, "If individuals don't value pensions and don't really want to put their own money in and the employer says, "Well, if the individual doesn't want to do it, I don't need to encourage them to, and then I can get away with not putting my contribution in either", you'll have a situation which is developing in many companies where the finance director says, "I don't see much value in putting money into a pension and I can get away without it, so why bother?"

Call to examine longevity bonds idea, By Ben Hall, Financial Times, February 24 2005

Ministers will ask the pensions commission to examine the idea of longevity bonds to help pension schemes cope with increased life expectancy.

By embracing an idea raised by the Conservatives last year, the government is hoping to foster a more consensual approach to pensions policy at Westminster.

The commission, chaired by Adair Turner, will also be asked to look at whether to abolish the compulsory purchase of annuities for the over-75s, as demanded by the Conservatives and Liberal Democrats.

Alan Johnson, work and pensions secretary, today will outline six principles by which the government will judge the recommendations of the Turner commission, expected in October, and future pension reforms.

The principles are: to build a consensus among political parties, employers, employees and the pensions industry; that the state has a role in preventing pensioner poverty; that everyone has the opportunity to build an adequate retirement income; that any reforms are fiscally sustainable; that the pension system is easier to understand; and that it is fair to women and carers.

Mr Johnson has said he will not prejudge the outcome of the commission, although Labour will "set out its stall" in its election manifesto.

He hopes the statement of principles will allow him to rise above the cut and thrust of party politics in order to try to establish a broad consensus for a long-term solution to pensions reform.

"Pension policy spans parliaments, governments and generations," he will say in a speech to the Institute for Public Policy Research, a think-tank.

But the Tories and Lib Dems accused the government of producing "motherhood and apple pie" answers and of avoiding contentious choices before the election.

"I find it hard to believe that after seven years in office only now are ministers prepared to make a statement of principles underpinning pension reform," said Steve Webb, the Lib Dem pensions spokesman. Mr Johnson had to clarify where he stood on a citizen's pension based on residence rather than national insurance contributions; what future he saw for the means-tested pension credit; and whether voters "should be allowed to make informed choices on the different parties' pension proposals".

David Willetts, shadow work and pensions secretary, said: "Principles ought to be a guide for action, but Alan Johnson is using them as a substitute for action."

Pensions Week: News Just In... : Longevity needs a financial product to hedge against risk, by Gregor Watt, Pensions Week, 21 February 2005

Financial instruments must be put in place to hedge against longevity risk, academics warned last week.

David Blake, professor of pension economics at **Cass Business School**, said although longevity has been improving over the last 150 years, the issue must be addressed now.

"Longevity has been improving steadily over the last 150 years. We need to address the issue of when it tails off, how it tails off and what we do if it doesn't," Blake said.

Blake, who is also director of the Pensions Institute, suggested offsetting growing longevity risk with investment in companies that form a natural hedge against rising life expectancy as they benefit financially as people live longer.

However, Michael Johnson, consultant at Tillinghast Towers Perrin, said there are a number of drawbacks in that option.

Aside from term assurance, pharmaceuticals and residential care homes, there are few companies that can readily be identified as beneficiaries, he said.

Mark Azzopardi, head of insurance and pensions at BNP Paribas, said longevity bonds could provide a solution.

"We had solutions for interest rate risk and we had a solution for the problem of inflation rates, but we had no solution for the longevity risk," he said.

The solution they came up with is a bond issued by the European Investment Bank that uses official life expectancy figures to calculate the annual payment, reducing over time as the base population falls.

Azzopardi said the product does come at a premium over current bonds available on the market and is not a perfect match to liabilities but he said that not many assets are, and some schemes have a restricted choice of investment.

"A lot of pension funds either can't or won't use swaps," he said.

These bonds he said are "the sort of asset that pension scheme trustees want to buy and would be able to buy".

Age concern;City Diary, by Martin Waller, The Times, 19 February 2005

WHY is it that people born in the 1920s and 1930s are living longer than expected, to the despair of the insurance companies? Three widely divergent theories were on display at the City's **Cass Business School** yesterday.

According to Farooq Hanif, a Lehman insurance analyst, it's all to do with smoking habits. "It seems increasingly that what you do in your twenties has a significant effect on how long you live."

For the actuaries, Gavin Jones of Swiss Re has suggested that life expectancy is all about what happens between conception and the age of five. Chris Hatry, of Legal & General, had a more personal view. "Being a vegetarian -my particular explanation is that this generation have all eaten cabbage in the war."

UK’s PPF could be a “new arena of conflict”, By Daniel Brooksbank, IPE.com 18/Feb/05

UK – Consulting firm Towers Perrin has warned that the UK’s new Pension Protection Fund could usher in a “new arena of conflict” between employers and scheme members.

The launch of the PPF would mean that the objectives of employers and pensioners would diverge, said consultant Michael Johnson.

He told a conference on longevity risk and capital markets at the **Cass Business School**: “A new arena of conflict is going to emerge.”

“If a market for longevity does not develop the PPF will be overwhelmed,” he added.

He said that while longevity risk was important it was a “second order” problem. “There are plenty of parties keen to shed longevity risk but very few natural takers.”

And he said that longevity risk as an asset class “lacks homogeneity”.

He likened the current longevity crisis to the Latin American debt crisis of the late 1980s that was addressed by the then US Treasury Secretary Nicholas Brady – the father of the Brady Bond.

Johnson says that trustees, like the countries involved in the Latin American crisis, will have to cut deals with creditors.

He was critical of how the reality of defined benefit schemes was “obscured by timid legislation, legal ambiguity and poor actuarial communication”. He asked: “Are equity markets fully pricing in the risk?”

Since longevity primarily affects shareholders, Johnson suggested the solution lay in the equity, not fixed income, market.

There was scope for innovation as the concept became more familiar.

BNP Paribas sees interest in new longevity bond, By Daniel Brooksbank, IPE.com 18/Feb/05

BNP Paribas says it is seeing trustee interest in the so-called longevity bond it plans with the European Investment Bank.

Mark Azzopardi, head of insurance and pensions at BNP Paribas’ global risk solutions, told IPE at the sidelines of a conference that UK pension scheme trustees are interested in the bond it plans to issue in conjunction with the EIB later this year.

“There’s been a lot of interest,” he said, adding it was important to plug into the trustee meeting cycle. Azzopardi was speaking at the longevity risk and capital markets conference at the **Cass Business School**.

Legal & General’s Chris Hantry, who designs liability matching products for pension clients, told delegates that a traded market for longevity could make annuities cheaper and pension schemes less risky. This would have “considerable benefits to society in general”.

The EIB said in November last year that it would issue a 25-year £540m (€775m) bond as part of a product designed by BNP Paribas aimed at protecting UK pension schemes against longevity risk.

A Lehman Brothers analyst told the conference that pension liabilities at top UK companies could be “much much larger” than expected due to the mortality assumptions being used by the schemes.

Senior equity analyst Farook Hanif cited estimates that up to £20bn could be added to pension deficits at companies due to changes in mortality assumptions. But he said: “I think it could be much much larger”.

He explained: “We don’t know what assumptions they are using.” He suggested there could be up to a 24% increase in liabilities.

Pointing to the fact that several corporate defined benefit schemes have deficits that are larger than the sponsor’s market capitalisation, Hanif said: “You can image the gearing effect.”

“UK Plc is very much exposed to longevity risk.”

Gavin Jones, strategy research actuary at Swiss Re, said that DB schemes are discouraged by tax rules from holding excess reserves – which virtually forces them to be underfunded.

Unprecedented demand for London longevity event, By Daniel Brooksbank, IPE.com 16/Feb/05

This week’s conference on longevity risk and capital market solutions at Cass Business School in London has been so popular that the organisers have had to set up an external video link.

The event is due to take place on Friday and Professor David Blake of Cass’s Pensions Institute says its popularity has “exceeded both expectation and venue capacity”.

He said it has been necessary for the team to take the “unprecedented” step of organising an overspill in the form of a video link to the main auditorium, located nearby.

He said: “Thus, to ensure the health and safety of our audience, we shall issue admission tickets to the main auditorium for the first 150 people who register at Cass on the morning of Friday 18 February.

“We regret the need to take this step but consider it important to forestall disappointment on the morning of the conference.”

The day-long event includes speakers from the Debt Management Office, the Government Actuaries Department, consulting firms, asset managers and academic institutions.

IPE aims to report on the event – if it can get in.

Living with uncertainty: predicting longevity trends, By Alistair Byrne and Debbie Harrison, Financial Times FTfm, February 14 2005

Dealing with longevity risk is a problem that confronts pension funds and insurance companies the world over. The search is on for ways to quantify and hedge a risk that refuses to conform to traditional financial engineering parameters.

Interest is high, with a conference on the subject this week at **Cass Business School** in London almost four times over-subscribed by representatives from governments, regulators, investment banks, insurance companies, pension funds and academics.

These diverse parties share what John Shuttleworth, a partner at PwC, the accountancy firm, describes as the desire to know and understand the unknowable and the incomprehensible.

Michael Johnson, a consultant with Tillinghast, says: "The key question we face is to what extent will future mortality experience differ from the expected, as represented by current mortality tables?"

At present, academics argue that the rapid increase in longevity, highlighted in the Pensions Commission 2004 Interim Report, may tail off at age 100, or, with possible medical advances, may increase to 150.

A third school of thought suggests lifestyle trends such as rising rates of obesity may mean that cohorts born in the post-war period will not live, on average, markedly longer than previous generations.

The jury is likely to be out for some time but the question has immediate implications for state, employer-sponsored and private individual pension provision - the three pillars of retirement income on which the western world has depended since the second world war.

The issue is also highly relevant for those who assess the creditworthiness and profitability of publicly quoted companies. Farooq Hanif, equity analyst for the life assurance sector at the investment bank Lehman, is concerned about the implications of mis-pricing longevity risk for the profitability of insurance companies.

"Institutional investors need to know whether insurers have made prudent reserves in the light of new projections of longevity. We have already seen some companies take significant charges against profits to keep pace with mortality improvements."

The problems that beset insurance companies are dwarfed by those that currently threaten defined benefit (DB) pension schemes. In broad figures, reserves for annuity liabilities of UK insurers are about £70bn, whereas the liabilities of DB schemes are about £750bn. Public sector schemes have unfunded liabilities of more than £350bn, which has huge implications for government policy.

"At least the insurance companies have updated their mortality tables on a regular basis, even if these may have underestimated the potential problem," Mr Hanif observes. "DB schemes have tended to focus on the asset side and the role of equities in meeting liabilities. Until now it's possible that they haven't really taken increasing longevity into account. Limited disclosure over how DB schemes project future mortality makes this hard to judge."

While the FRS17 accounting standard requires companies to disclose the discount rate used to value their pension liabilities and their assumptions about the return on pension fund investments, there is no requirement to disclose the very significant mortality assumptions.

This point is likely to come under the microscope as institutional investors begin to examine much more closely the full DB risk to which a company is exposed.

Bob Scott, a partner at actuarial consultant Lane Clark and Peacock, says that if updated mortality tables were used to assess DB liabilities, the FTSE 100 companies could add a further £20bn to the current estimated aggregate deficit of £60bn.

Francis Fernandes, head of Actuarial Services at the investment bank ABN-Amro, fears that DB deficits and the risk implications of rapid increases in longevity are having a real impact on the way a company can raise finance and conduct M&A activity.

"There are still many issues for pension schemes to consider in order to construct appropriate solutions to deal with longevity risk." Mr Fernandes says.

"If a pension scheme for a company in the south-east with high-income employees is looking to buy longevity bonds, it needs to recognise that there is 'basis risk' between the life expectancy of its members and the population used for calculating the longevity bond payments."

If this is the case, it may be better for the scheme to use traditional financial instruments to match the cashflows implied by their best estimate of the life expectancy of their own members, rather than use capital market hedges based on very different population profiles.

What is clear from the current debate is that a single solution to longevity risk is highly unlikely and that risk sharing will be as important as risk hedging. This is the type of solution Mr Fernandes has in mind.

"Some employers are looking to find ways to transfer the risk associated with [pensions for] those no longer working for the company to banks and insurers, allowing each institution to take on the elements of risk they best understand."

Mr Hanif agrees with this risk sharing approach but points out that issuers and buyers will not know if the pricing is right for many years. "UK life insurers writing annuity business and employers sponsoring DB schemes have to learn to live with that uncertainty and, perhaps, should expect to hold more capital to support their exposure to longevity risk."

*Debbie Harrison and Alistair Byrne are senior visiting fellow and fellow respectively of the **Pensions Institute** at Cass Business School, **www.pensions-institute.org***

Financial Adviser: Investors lose out in stakeholder 'lottery', Financial Adviser, 10 February 2005

STAKEHOLDER pension holders are investing in a lottery, according to the director of the Pensions Institute.

Professor **David Blake**, director of **the Pensions Institute**, spoke after the **Cass Business School** published new research into stakeholder pensions that he co-authored.

Prof Blake's criticism focussed on the default investment choices that are made when investors do not specify where money from their stakeholder pensions should be invested.

Prof Blake said: "Those with a lack of investment knowledge should feel confident their money is invested in the best possible way. Instead they enter into a lottery.

"They assume that the default option has been selected to meet their requirements, but it appears that in many schemes the choice has been quite arbitrary.

"This lack of consensus on the best investment strategy suggests many of these schemes are poorly designed."

The **Cass Business School** research, based on 35 stakeholder pension schemes from leading asset managers, showed that default fund choices included equity contents of between 60 per cent and 100 per cent, and that only about half of schemes included lifestyling, where the asset mix is changed as the policyholder gets older, in order to reflect their attitude to risk.

It is thought the default fund choice is taken in about 80 per cent of stakeholder pensions.

Prof Blake said the government-backed stakeholder pensions were failing the lower paid individuals who they were designed to protect, and he called for rules to control the default features of the products.

Following draft regulations for modified stakeholder pensions from the Department for Work and Pensions, which indicated a move away from with profits inside stakeholder products, Standard Life and Norwich Union are likely to have to change the default choices on their stakeholder pensions, which place money into the life offices' with profits funds.

Tom McPhail, pensions research manager for Bristol-based IFA Hargreaves Lansdown, said: "The default has to be the lowest common denominator.

"It is probably fair to say that the more decisions people are made to make, the less likely they are to take a pension in the first place, and any pension is better than none at all.
"I like the lifestyling concept and it is likely that this will be introduced in the modified stakeholder plans."

Horror movies? Not really - Other countries' pension policies, by Paul Wallace, The Economist, 12 February 2005

Actually, the international experience isn't as scary as the Democrats imply

FOR Americans, individual retirement accounts may seem a leap in the dark. But other countries have already made that leap. Opponents of George Bush's reforms, from the AARP old people's lobby to the New York Times and just about any Democrat with an atlas, like to suggest that “privatising pensions”, as they put it, has always been disastrous. Is that really true?

Start with Chile, the trailblazer. In 1981, it redesigned its pension system around mandatory saving into individual accounts. Many other countries in Latin America followed in Chile's wake.

A recent study by World Bank economists concluded that these reforms were “a major step forward”. The new pension systems are a big improvement on pay-as-you-go schemes that were generally mismanaged and financially unsustainable. Not everything is perfect. One worry is that too few workers are covered by the new pension arrangements. Another is that the charges for running the accounts have been too high. Even so, real returns on the pension funds have generally been impressive and government budgets have been improved. And in Chile, economic growth was given a boost.

However, Chile's experience is not necessarily relevant to the United States, points out Monika Queisser, a pension specialist at the OECD. First, Chile made individual accounts the centrepiece of the new pension system, whereas they will form only part of America's public pension provision under Mr Bush's proposals. And, second, the old Latin American pay-as-you-go schemes were in a much worse state than Social Security.

It is probably better for Americans to look at other rich countries rather than developing economies. In Sweden, for example, workers put 2.5% of their eligible earnings into private retirement accounts; this is on top of 16% paid into the main pay-as-you-go scheme. Charges for the new accounts are being held down, but the Swedes got off to a rocky start because they started to invest in 2000, when stockmarkets turned down. Things have been happier in Australia, where 9% of workers' eligible earnings are paid into individual accounts: the reforms, which began in the late 1980s, have also raised saving.

However, in both Sweden and Australia, as in Chile, the new accounts are mandatory, while in America they will be voluntary. To find out how voluntary accounts have worked, Americans need to look at Britain, where Margaret Thatcher introduced them in 1988.

That should be enough to put them off the idea for good, according to Mr Bush's critics. In their version of history, Britain's experience was a disaster, in which people who opted for individual accounts were made worse-off by pension mis-selling. Fortunately, the critics are wrong.

To be sure, pensions were mis-sold in the late 1980s and early 1990s: the bill for putting things right was £12 billion ($22 billion). But the mis-selling was out of employers' defined-benefit plans, not out of the state system. Many people were lured away from generous employers' plans into funded individual pensions when they would have been better off staying with their employers' schemes. “Mis-selling was not about people being sold private pensions when state pensions would have been better for them,” says Philip Booth, the editorial director of the Institute of Economic Affairs, a think-tank.

Britain's mis-selling scandal occurred within a distinctive pension system that had long allowed employers to provide part of the overall state benefit in return for rebates on part of their payroll taxes. In the late 1980s, this right to “contract out” was extended to individuals, who were also given the right to leave their employers' plans. In America, as Olivia Mitchell, a member of Mr Bush's pensions commission in 2001, points out, there is no “contracting out” for private workers in Social Security and the new individual accounts will form part of Social Security.

What about high charges? Here the critics have more of a point: charges have been a drag on the performance of individual accounts in Britain, as in many other countries. But Mr Bush is well aware of this. His aim is to keep fees as low as 0.3% of fund values by centralising the administration of the new accounts.

Britain does offer one lesson—about cutting benefits through changes to indexation. In 1980, the Conservative government started “uprating” the first-tier basic pension benefit with prices rather than wages (which rise faster). Pensioners may not have noticed at the time, but eventually they got cross. The Conservatives now back restoring the link to earnings. There is a surprisingly wide consensus that state pensions have to be made more generous. “Fiddling with indexes may work in the short term,” says **David Blake**, director of the **Pensions Institute** at City University's **Cass Business School**, “but in the long run it fails the test of political sustainability.”

The future may be DC, but investors need a better deal, By Pauline Skypala Financial Times, February 6 2005

Watson Wyatt has seen the future of pensions, and it is DC. The consultancy, which advises about 2,000 UK defined contribution schemes, is urging the pensions industry to work harder at designing suitable fund choices.

There is little doubt that the DC model is becoming the dominant one in the UK. There are twice as many DC schemes open to new entrants within FTSE 100 companies as defined benefit. But while the trend has been well observed, asset managers have taken little notice of it as a business opportunity.

Attention remains focused instead on the big prize of winning defined benefit scheme mandates, as DB schemes dwarf the DC variety in terms of assets under management.

“One of the problems with DC is that it is characterised by a dominance of insurance company thinking that is really old-fashioned,” says Ros Altmann, an independent pensions consultant and a governor of the London School of Economics.

“You will still find schemes only offering a balanced or a lifecycle fund option, or even with-profits.” Providers admit DC fund design has not been a priority. “DC has been a bit of a poor relation in terms of the thinking caps of people like us,” says Euan Munro, head of Strategic Solutions at Standard Life Investments, which last week launched a suite of specialist funds for defined benefit schemes. He says it is a big issue for the economy going forward, though, and believes it should be tackled in the same liability driven way as defined benefit schemes.

The current approach lacks sophistication. Occupational DC plans typically offer a choice of six to 10 funds, while retail plans such as group personal pensions or stakeholder schemes offer 11 to 20. This choice appears to be window-dressing in many cases, as most DC scheme members (more than 80 per cent) opt to invest in the default fund.

New research by the **Pensions Institute**, at **Cass Business School**, on the default funds offered by stakeholder pension schemes finds wide variation. Equity content varies from 60 to 100 per cent and only half of schemes automatically include a lifecycle feature to switch the asset mix from equities to bonds and cash in the years leading up to retirement. The switch typically starts five years before retirement, but variations range from three to eight years.

“These differences can have a significant effect on the range of retirement outcomes that scheme members can expect,” says **Alistair Byrne**, a lecturer in finance at the University of Strathclyde and one of the authors of the report.

New regulations will force all stakeholder pension members into lifecycle funds from April this year. Andy Hunt, senior investment consultant at Watson Wyatt, says lifecycle is a good concept, but needs to be broadened out. It treats all members uniformly, but different personal circumstances can make a significant difference to each member's needs.

Mr Byrne says lifecycle funds have several drawbacks. They have to be set up for a particular retirement date, which may cause problems if a scheme member retires earlier than planned, and they are unresponsive to market cycles, with the switches out of equities going ahead regardless of market conditions.

The suggested solution from Watson Wyatt is the introduction of funds with engineered pay-off patterns, with particular emphasis on the constant proportion portfolio insurance (CPPI) approach, where asset allocation is adjusted in response to changes in market conditions with the aim of protecting captal. But in offering downside protection, says Watson, the disadvantage is that in chasing markets the funds may end up selling low and buying high.

Ms Altmann is also in favour of funds offering some form of downside protection as one of a range of default options, citing guaranteed equity funds as an obvious example. But both she and Mr Hunt believe that, in the longer term, fund managers and pension investors must move away from a reliance on equities for investment growth and adopt a more sophisticated approach using a wider range of assets.

Mr Byrne is not a fan of complex products, preferring transparent products that scheme members can understand. “A well constructed low-cost, balanced fund with some kind of lifecycle overlay is probably a reasonable solution,” he says.

He stresses the need to avoid the route taken in the US, where a focus on avoiding short-term losses has led to the widespread use of money market funds as the default in DC schemes.

Standard Life Investments wants to change the perspective entirely. “Lifecycle funds are focused on capital preservation rather than the preservation and growth of post-retirement income,” says Mr Munro.

What is required, he says, is a single generational mutual fund covering people retiring around the same time who will share problems. The Pensions Institute says the current haphazard approach creates a lottery for DC scheme members, who bear a lot of the downside risk previously assumed by employers in final salary schemes. “We need to make sure they are given proper advice to help them manage these risks,” says Mr Byrne.

The stakeholder lottery , by Daniel Brooksbank, IPE.com 3/Feb/05

Cass's Pensions Institute has released research that UK's stakeholder pensions are a "lottery".

"Individuals with a lack of investment knowledge should feel confident that their money is being invested in the best possible way," said Professor David Blake, director of the institute.

"Instead they enter into a lottery. They assume that the default option has been selected to meet their requirements, but it appears that in many schemes the choice has been quite arbitrary.

"This lack of consensus about the best investment strategy suggests that many of these schemes are poorly designed."

UK nears clearance for 50-year bonds, by Jason Corcoran, Financial News, 23 January 2005

The UK's Debt Management Office is likely to issue government bonds with 50-year maturities after it extended its deadline last week to accommodate responses from the pensions industry.The DMO is asking about demand for conventional, index-linked and annuity-type gilts. The indications are that pension funds are interested in ultra long-dated issues of UK government debt.

A DMO spokesman said a decision to proceed would be taken without delay, with bonds being made available by March next year. He said: "This has been a particularly short consultation because we want the decisions quickly, to fit into next year's issuance."

The DMO talked to fund management groups last year to assess the optimum size and type of gilt-edged stock that is needed in future. It was suggested demand for long-dated high-quality bonds will increase because of demographic changes and the demand for products that better match pension funds' assets to long-term liabilities.

The UK pensions industry is the largest investor in British gilts and holds 64% of the total, with a higher percentage of index-linked and long maturity bonds, according to the Office for National Statistics.

The National Association of Pension Funds, which represents pension funds with assets of more than £700bn (€1 trillion), had asked for the later deadline.

A spokesman said: "These are encouraging ideas but it has been a short consultation period and we need more time to look at some of the more complex ideas."

Kathleen Currie, a director of structured products at Axa Investment Managers, said there was demand for ultra-long government issuance because corporate debt is not an option as the credit exposure to those bonds more closely resembles equities in the long term.

She said: "To say that issuance of 50-year gilts would be met with a warm welcome would be an understatement. The benefits that would accrue to the pension and insurance funds and, accordingly, the plan beneficiaries, would be significant in terms of risk reduction."

A 50-year issue would need to be large, although the Treasury has yet to decide on size. Mervyn King, governor of the Bank of England, last year threw his weight behind the longevity bonds.

David Blake, director of the **Pensions Institute** at **Cass Business School** in London, believes the government should issue the bonds so pension trustees are less likely to call on the Pension Protection Fund, an industry-wide safety net due to launch in April.

He said: "Since the PPF explicitly bears longevity risk against bankruptcy, the government should be willing to issue longevity bonds so that plan trustees will be less likely to call on the PPF.

"If the government ultimately covers PPF and plan failures, then this provides an additional reason for the government to issue longevity bonds."

Demand for ultra-long euro bonds in the Netherlands has risen steeply as solvency regulations have been introduced in the €475bn ($617bn) Dutch pension fund market.

The Dutch regulator wants to make pension funds more solvent and is proposing a new risk assessment for asset class selection within portfolios.

Pensions Institute to host longevity risk event , By Daniel Brooksbank, IPE.com 11/Jan/05

The Pensions Institute is to co-host a conference on longevity risk and capital market solutions in London in February.

The International Conference on Longevity Risk and Capital Market Solutions will take place on February 18 at the Cass Business School.

It will be hosted by the Pensions Institute, the American Risk and Insurance Association and the Centre for Risk and Insurance, Nottingham University Business School.

“As populations in countries around the world age, governments, corporations and individuals face increasing risk,” the institute says. “Pay-as-you-go state pensions and corporate pension plans are beginning to put severe financial pressures on governments and companies.

“Mortality improvements especially at older ages make it ever more likely that individuals with inadequate pension arrangements will end their lives in poverty.”

And it said: “The whole private sector pension system in developed economies like the United States and United Kingdom are potentially at risk without hedging instruments such as longevity bonds.”

Even increase in pension scheme contribution rates will not eliminate investment risk factor, Letters to the Editor, Financial Times, December 16 2004

From Mr Alistair Byrne and Prof David Blake.

Sir, One of the conclusions of the pensions taskforce (reports, December 14) is that employers should match employee pension contributions on a 2:1 basis and target an overall contribution rate of 10-15 per cent of salary.

While pension contributions at this level, started from a relatively early age, can produce adequate retirement incomes, it is worth stressing the risky nature of the investment funds in which these contributions are usually invested and the resulting variability in the retirement incomes members can experience.

In many defined contribution schemes the "default" investment option, which most members adopt, is a balanced managed fund, invested approximately 80 per cent in equities and 20 per cent in bonds, with an automatic "lifestyle" feature that switches the fund to bonds starting five years from the planned retirement date.

Some recent work we have undertaken shows that, using plausible assumptions for the risk and return characteristics of the underlying investments, a 10 per cent contribution rate invested in this type of fund over 40 years of pension scheme membership can be expected to produce a pension of about 40 per cent of the member's final salary, and a 15 per cent contribution rate to produce a pension of about 60 per cent of final salary. However, the range of possible outcomes is wide and even with the 15 per cent contribution rate the member has a one in 10 chance of receiving a pension of less than one-third of final salary, if investment returns prove unfavourable.

So, even if we do manage to raise pension scheme contribution rates to the 10-15 per cent range, the issue remains of how to help scheme members understand and deal with the investment risks they face. Lifestyle asset allocation features are helpful in this regard, but do not remove the problem.

Alistair Byrne, Fellow **David Blake**, Director **Pensions Institute** Cass Business School, London EC1 8TZ

Pensions wake up call to employers, by Debbie Harrison, Financial Times: Your Money, December 10 2004

Yet another committee is to tackle the reluctance of companies to offer pension plans, says Debbie Harrison

Private pension savings, long unloved, have been spurned by yet another potential suitor employers. After years of silence on this delicate matter, two recent reports have shed light on the lack of commitment by companies that are supposed to offer retirement savings to their employees.

Yet more research will appear on Monday. It will come from the Employer Task Force on Pensions a group set up by the Department of Work and Pensions and chaired by Sir Peter Davis, former chairman of Prudential and J. Sainsbury.

Several august bodies have been set up to investigate what economists and actuaries believe is one of the country's most challenging financial problems providing adequate retirement income for the next generation of long-lived pensioners.

The main obstacle is that many employers are reluctant to sponsor schemes when there is no quantifiable long-term value to the company or its shareholders.

The taskforce is expected to recommend that employers be required to do more. Ministers are likely to listen because employer-sponsored schemes are the most cost-effective vehicles for delivering pensions provision in the private sector.

Sir Peter's only public comment about the taskforce was made at a fringe meeting at the Labour party conference in September. “Employer pension provision seems to be going backwards, not forwards,” he said. “The days of final salary [defined benefit] schemes are fast diminishing and replacement DC [defined contribution] schemes are almost always less generous and place much greater risk on the employee.”

Sir Peter said the situation was “even worse” in smaller companies, where the taskforce had found a worryingly low level of interest among employers and widespread apathy among employees.

Over the past 15 years, most companies have closed their final salary schemes under which the employer bears the investment and longevity risk. They have switched employees into money purchase (DC) schemes, where the individual member bears most or all of these burdens.

The evidence from the taskforce reinforces the conclusions of Delivering DC, a report on company pension schemes published in September by academics at the Pensions Institute.

It found finance directors unconvinced that the cost of running a pension scheme is offset by an increase in the company's ability to attract and retain good staff.

Professor David Blake, director of the **Pensions Institute**, says Sir Peter's report will be required reading for the government and the pensions industry. “The taskforce will quantify and explain the low level of employer support for pensions, put it in the context of current government policy and consider the potential for future reform,” he declares.

“However, the fact that many employers no longer accept the traditional rationale for running a scheme will make the government's ambition to reverse the balance of state to private provision from its current 60:40 to 40:60 very difficult, if not impossible.” Prof Blake stresses that this isn't a question of simply blaming employers: “It is important to appreciate that employers are not the bad guys here. Finance directors do not oppose pension costs per se, but they certainly question any costs that do not deliver a measurable benefit to the company.”

Even where employers are keen to promote their schemes, they face many uncertainties in terms of potential mis-selling and future litigation. Sir Peter will also highlight the complexity of state pensions. He will be relieved that the Financial Services Authority (FSA) is taking steps to make it easier for employers to promote their pension schemes. But he will say that many employers will still be afraid to do this because they fear that lower earners would be better off relying on state benefits.

If such employees joined their company's scheme and later learned that they could have done better through state benefits, they might sue for mis-selling.

The taskforce has considered whether auto-enrolment, in which employees automatically join the company scheme but have the right to opt out, might improve take-up. Alan Johnson, the work and pensions secretary, favours auto-enrolment but the taskforce will point out that this may not suit all employers.

It will also echo Pensions Institute research, which warns that the apparent success of auto-enrolment in the US is unlikely to be repeated here unless backed by US-style rules that bar employers from funding big pensions for themselves when few of their employees join the scheme. Without such legislation in the UK, employers will continue to secure generous pensions for executives and directors but make it unattractive for staff who would opt out if, for example, the employer insisted on a prohibitively high minimum employee contribution.

The taskforce's report will provide recommendations for employers, the government and unions that will be essential if employer-sponsored pension provision is to be boosted.

It will say that there is no single answer to the problem of inadequate provision for retirement a point made by Adair Turner's Pensions Commission in its interim report in October.

The commission said that the answer lies in a combination of changes to the state system, encouraging people to work longer, and increasing private savings.

Sir Peter is certain to tell employers that many of them will be expected to do more than they are doing today.

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www.pensionscommission.org.uk

www.pensions-institute.org

www.employertaskforce.org.uk

The policy that dare not speak its name has a big part to play in solving a £54bn crisis, by Philip Thornton, Independent on Sunday, 21 November 2004

Ask people to identify the greatest threat to their well-being and most would probably mention global terrorism, climate change or nuclear proliferation. Few outside the world of finance would list the pensions crisis - at least they would not have done before they heard the warning of a £54bn shortfall in the UK.

Ask what we must do about this crisis and the most common answers would be work longer, save more and pay higher taxes. Not many people would suggest higher immigration as the solution, not least because this is one of the most explosive issues around.

Thanks to the myopia and, let's be honest, racism in the debate over migration, economics often has to take a back seat. But with globalisation growing, the view is taking hold outside the oak-panelled corridors of academia that the free movement of labour is as important as the movement of capital. A study by researchers at the Home Office concluded that migrants make a net contribution to the Exchequer of around £2.5bn a year.

This analysis includes neither the beneficial impact of job creation by entrepreneurs, nor the costs of a coping with social or criminal problems. It represents only the extra money they pay in taxes less the money they take in benefits and public services.

Obviously, the contributors are different people from the recipients. That point is quite significant.

In unreported comments a few days ago, Mervyn King, the Governor of the Bank of England, said that immigrants have - indirectly - helped keep inflation and interest rates low. He noted that the benign state of the labour market - low and stable growth in pay despite record levels of employment - was in part due to an influx of skilled workers. Employers had become adept at using migrants with certain abilities to fill specific gaps where they were suffering from skills shortages, he said. "I am sure that demand by employers for extra labour has been met not by raising wages but by targeted use of migrant labour."

The Government, for whom inward migration has been the policy that dare not speak its name, is also starting to come out on the issue. The Home Office, together with the Department of Trade and Industry, is going to use the Highly Skilled Migration Programme - a fast track to a work permit for postgraduates - to target shortage areas such as science and engineering.

But can these people really be asked to help solve the £54bn pensions crisis? A new study by two professors at City University's **Cass Business School** in London shows it is theoretically possible, although the numbers involved would cause palpitations at Labour Party HQ.

David Blake at the school's **Pensions Institute** and **Les Mayhew** at its **Risk Institute** start from the widely accepted background view that rising longevity and declining fertility will put the pensions system under extreme pressure within a generation.

While there was one pensioner in the UK for every four workers in 1990, Government figures show that by 2030 there will be two pensioners for every five workers. Meanwhile, the Government's actuaries project that the pensioner population will rise to 15.2 million by 2031, from 9.6 million this year, against an overall population increase of 5.6 million to 64.8 million. Pensioners will move from 16 to 23 per cent of the population.

Professors Blake and Mayhew have looked at how a combination of later retirement dates and greater immigration could be used to deliver a number of outcomes for pensioner income. Under their worst-case scenario, where neither productivity, activity nor pension payments rose, there would be a shortage of 10 million contributing workers by as early as 2016.

The Government's plan to align the retirement age for men and women at 65 by 2020 would delay the problem until 2024. Even a retirement age of 70 would leave a shortage of three million paying workers by 2030.

By tweaking the assumptions on wages, pension and activity levels, they can accelerate or delay the point at which the shortfall of 10 million kicks in, although that appears to be inevitable.

"These scenarios suggest increases in the state pension age after 2020 look more likely than not," they say. "The alternative, in the absence of any other policy changes, would be substantial and unrealistic increases in immigration."

Their intention is clearly to start a debate rather than offer prescriptions. "Pensions and immigration issues will increasingly dominate the political agenda on national resource allocation over the next half century," they conclude.

The permanent influx of 10 million people, equivalent to the population within the M25, raises wider issues. It would put pressure on housing, transport and education resources. It would also force politicians to face up to the wider question, raised in Prospect magazine this year, of whether Britain would become too diverse to support the mutual obligations that support the welfare state.

The economics would also come under fire, especially from the more sophisticated critics of current policy such as Migration Watch, which suggests policies to encourage procreation and boost productivity

A separate Home Office paper in 2001 said the impact of immigration in mitigating population ageing was acknowledged to be small because migrants also age.

"For a substantial effect, net inflows of migrants would not only need to occur on an annual basis but would have to rise continuously," it explained.

Whatever the rights and wrongs in this debate, it is clear we are going to have to entertain some radical ideas on the issues of both pensions and immigration

UK desperately seeks young to keep pension system going, by Urmi A Goswami, The Economic Times (The Times of India Group), 12 November 2004

NEWDELHI: Immigration has become a matter of survival for the United Kingdom. Its state pension system will soon become unviable given the demographic trends.

Projections show that by 2030, there will be two pensioners for every five workers, while the projected rate of birth, 1.74, is well below the replacement rate.

Attracting young immigrant workers seems to be the way out for the UK. As many as 10 million immigrants would be required by 2025, so that pensioners in the UK can continue to receive œ80 per week from the basic state pension.

Population in the UK is set to increase from 59.2 million in 2004 to 64.8 million in 203. The population increase will be accompanied by an attendant rise in the population above 65 years of age.

At present there are 9.6 million persons above the age of 65, while the projected figure for 2031 is 15.2 million. There will be a near doubling of the pension-recieving population, which constitutes 5.6% of the population currently to 9.8% of the population in 2031.

For the UK, according to a study by **Cass Business School** on the state pension system, there are five possible options. Pensioners can accept a cut in real pensions, contribute more to the fund during their work life, work harder (that is greater productivity), postpone retirement and finally accept more immigrants. According to the authors of the study, **David Blake** and **Les Mayhew**, "any realistic increases in labour productivity, in work effort or in pension contributions by the indigenous population will not be sufficient to compensate for the combined problems of population ageing and declining fertility in the long run."

Immigration has been dominating the UK political debate in the recent past. If the UK is to avoid the taking the immigration route to shore up the state pension system, then it will have to raise retirement age 70 from 65 between 2020 and 2030.

It will also require more of the over-50s to continue as part of the work force. However, not even this can stave off the need to go the immigration way, it will only postpone the inevitable until 2024.

THE BIG PICTURE: An age-old retirement problem that refuses to be laid to rest: As life expectancy continues to rise, could longevity bonds be the answer to protecting pension funds, asks Pauline Skypala, Financial Times (FTfm), 15 November 2004

Professor David Blake was "infuriated" by the news that French bank BNP Paribas is to launch a longevity bond issued in sterling by the European Investment Bank.

The product, designed to protect pension schemes against the risk that their members might live longer than expected, is one Mr Blake, director of the **Pensions Institute** at London-based **Cass Business School**, has been urging the UK government to develop for years.

David Willetts, the UK shadow work and pensions secretary, has also called for the government to take on longevity risk by issuing bonds, despite the obvious objection that it would socialise a risk that should be borne by the private sector.

The private sector seems to have shown its ability to think clever, although the size of the issue, about Pounds 540m, is an indication of the capacity limits. BNP Paribas is hedging the longevity risk it will take on through a contract with PartnerRe, a Bermuda-based reinsurer.

Christopher Marks, head of sovereign agencies and supranationals at BNP Paribas, says the apparent absence of insurance capacity was a critical challenge in developing the bond.

"But it may be that additional private sector solutions will emerge in the wake of a successful first transaction, at an appropriate price," he says.

Mr Marks does see a need for a large-scale solution with government involvement, but probably not through longevity bonds, given the longevity risk the government already bears. It can play a constructive role, he says, by encouraging consideration of private sector products by pension funds.

The problem longevity risk poses to defined benefit occupational pension funds has become clearer over recent years, as the high returns of the long bull market run, which masked the problem, have disappeared.

The Pensions Commission, headed by Adair Turner, former head of the CBI employers' organisation, underlined the problem in its recent report, noting that average male life expectancy at 65 had grown from 12 years in 1950 to about 19 years today, and was projected to rise to 21 years by 2030.

The rise in life expectancy for higher-paid men aged 65, who are the most likely to have occupational pensions, rose even more, by as much as 30 per cent between 1972-76 and 1997-98, according to the UK Office for National Statistics.

Pension funds cannot offset longevity risk using any existing asset and there is huge potential demand for an effective solution to the problem. BNP Paribas's initiative has been welcomed as a step in the right direction, but commentators point out bonds of this type are not a complete solution.

It is a 25-year bond whose interest payments will be based on the actual longevity experience of 65-year-old men. It could be used as a hedge against the longevity risk posed by that particular age group, but will not protect against the risks of younger scheme members living longer than expected, which for many schemes will be the bigger risk.

Actuarial consultant Hewitt Bacon & Woodrow says the type of bond needed to hedge the latter risk would be one with no cash flow for 20 years, then a big one.

Mr Blake says capacity problems for longevity bonds might be resolved by finding parties other than reinsurers willing to assume the risk. He suggests pharmaceuticals companies or long-term care homes as the type of private sector organisations that could potentially issue longevity bonds, as they have the sort of cash flow that is naturally hedged against the risk of people living longer.

"This is the start of something big," he says, adding that the Pensions Institute is working on designing derivatives that could trade off the existence of longevity bonds.

Other institutions are looking at alternative ways of approaching the problem, taking the view that aggregating the risk in one place, with a reinsurer, is not a good solution, and what is needed is a way of spreading the risk more widely.

Employers have widely responded to the problem, for new members at least, by closing their defined benefit schemes and switching to defined contribution. This shifts the pre-retirement longevity risk to the individual, with the post-retirement risk being borne largely by life insurers via annuities.

The Pensions Commission comments that shifting the pre-retirement risk has some advantages. It gives people the freedom to choose between saving more, retiring later or living on a lower retirement income, and gives incentives for voluntary later retirement.

But there is merit, the Commission says, in individuals being protected against unexpected changes in life expectancy in retirement, with the risk being absorbed through annuities. However, rising demand for annuities "raises issues about the capacity of the insurance industry to meet that demand at attractive prices", the Commission notes, given the limited supply of appropriate assets to back them.

This comes back full circle to the question of government involvement. "In the long run, if this (longevity bonds) is going to be a substantial market, the natural issuer is going to be the government," says Danny Truell, managing director and co-head of global investment strategies at Goldman Sachs Asset Management. "The government is already the supplier of pensions of last resort, so it would be issuing against a risk it already has."
BNP Paribas says it hopes to be issuing many more longevity bonds itself, and believes there are opportunities to launch similar issues in the future to match pension liabilities on the European continent or in the US.

10m migrants needed to fund state pension, Financial Adviser, 4 November 2004

THE UK would need 10m more migrant workers before 2025 to maintain the state pension scheme.

Mathematicians at the **Cass Business School** in the City of London said the migrant workers' national insurance contributions were needed to ensure pensioners would continue to receive A £80 a week from the basic state pension.

Professor Les Mayhew, primary researcher and director of the Risk Institute at Cass, said if the retirement age stayed the same, national insurance contributions would not increase and productivity levels would remain static.

"The UK population would grow considerably and furthermore, after 2025, there would be a national insurance contribution shortfall again," said Prof Mayhew.

The scenario is just one of a number worked out using advanced mathematical models developed by researchers at **Cass Business School**.

In 1990 there was one pensioner in the UK for every four workers, but by 2030 the school predicted there would be nearly two pensioners for every five workers.

Another scenario found that a well-managed economy with real growth of 2.1 per cent a year would allow the state pension to increase 1.5 per cent in real terms until 2020.

After this the contribution shortfall continued to rise again and state pension age would have to increase beyond 65.

Professor David Blake, director of the **Pensions Institute** at Cass, and a co-researcher said the only option was to combine a longer working life with increased migration and increased contributions.

Worth voting for, by William Lewis, The Sunday Times, 7 November 2004

PENSIONS are on my mind for a number of reasons this week. Observing the dominance of social issues in the American presidential election -abortion, gay rights and so on -got me thinking about what it is here that we feel similarly strongly about. What type of community issues are there that would lead millions of my fellow countrymen to stand in line for hours to vote?

Thankfully the apparent middle-American obsessions with abortion rights and so-called family values just do not wash here as burning political issues. I would like to think that most people in Britain agree with me that if two gay people want to marry, of course they should be able to. It is called living in a democracy.

So our search for decisive (and divisive) social issues takes us elsewhere.

Banning fox hunting? Making smacking one's own children punishable by a spell in prison? Stipulating what size chocolate bars and crisps we are allowed to buy from supermarkets?

All are clearly inappropriate areas for the government to involve itself in but I doubt that the nauseating interference of Labour is enough to propel millions of angry voters into the booths.

If there is an answer to the current political apathy in Britain, it may well lie in pensions. A report published by the **Cass Business School** last week made the point that "any realistic increases in labour productivity, in work effort or in pension contributions by the indigenous population will not be sufficient to compensate for the combined problems of population ageing and declining fertility".

Drawing on mathematical models of the likely course of the pension issue in Britain, the most extreme scenario thrown up was that 10m migrants will be needed.

That will come about if we in the UK decline to work longer, accept a cut in real pensions, pay higher taxes and keep living longer.

Cutting my pension? Making me work longer and harder? Taxing me more? Opening the doors to millions of new migrants into the UK? These are the sorts of things that I could see becoming the dominant political issues of the years ahead.

Don't just take my word for it. The **Cass Business School**'s professors concluded their report as follows: it is highly likely that "pensions and immigration issues will increasingly dominate the political agenda on national resource allocation over the next half century".

Employers can't solve pension apathy, Citywire, 2 November 2004

Employers know that they are not putting enough money into company pension schemes, but they have no plans to do anything about it.

Research from Employee Benefits Magazine reveals that 56% of employers admit that the money they put into their company pension scheme will not provide adequate pensions for staff. And 50% of these companies are not planning to increase contributions.

But inadequate pensions are not entirely the fault of employers. The research found that 51% of employers offering a defined contribution (DC) plan see many of their eligible staff failing to sign up for it even when employers make a contribution to it.

For many employees, apathy rules when it comes to pension saving. Most employers struggle to enthuse staff about saving for the future - 77% of UK employers offering DC schemes say they are trying to encourage more of their workers to join their schemes.

Despite government efforts to transfer the pension burden on to employers through initiatives such as stakeholder pensions, millions of employees still do not belong to a workplace scheme.

Although all employers with five employees or more are obliged to offer a stakeholder pension, the majority of these schemes are empty with no contributions from either employer, or employee.

Debi ODonovan, editor of Employee Benefits magazine, said: 'Many employers are doing a sterling job trying to improve pension education among their staff, while the best employers still offer top-notch pension schemes. But not all employers feel it is their role to solve the pensions crisis - and why should it be?

Most employers (77%) say they do feel responsible for employees long-term financial well being, although 14% say they dont. Lets hope the message is finally getting through to employees that if they are not fortunate enough to be working for an employer offering an excellent pension with good contribution rates, then they need to take matters into their own hands. They need to join their workplace pension and make decent, not minimum, contributions, said ODonovan.

Actuaries calculate that an employee needs to make pension contributions of 15% of gross earnings, throughout their working life, to retire on a decent pension of around two-thirds final salary.

Only half the working population belong to an occupational pension scheme. Some fortunate employees with generous employers have 10% or more of their salary paid into a pension scheme and typically the employee will top this up with 5% of earnings. But there are still large numbers of employees who have little or no pension provision other than the basic State pension.

Even those employers who have made an effort to provide decent pensions for employees up until now, are being forced to close final salary linked pension schemes and switch to money-purchase, defined contribution schemes, because of the high costs and open-ended commitment of final salary schemes.

Meanwhile researchers at **Cass Business School** in the City estimate that up to 10 million migrant workers might need to enter the UK between now and 2025 in order to ensure that pensioners can continue to receive £80 a week from the basic state pension.

This could be the only way that pensioners can expect to receive their current level of pension if we continue to retire at the same age, we fail to increase national insurance contributions, productivity levels remain static and we continue to live longer.

Under this scenario it would not be possible to raise the real value of the state pension for the foreseeable future. The UK population would grow considerably and furthermore, after 2025 there would be a national insurance contribution shortfall again.

The research spells out what we all know - that there are not enough workers to support pensioners because we are living longer and birth rates have fallen. In 1990 there was one pensioner in the UK for every four workers. By 2030 there is projected to be nearly two pensioners for every five workers.

The UK is facing some tough decisions in terms of state pension provision, warns **Professor Les Mayhew**, director of the Risk Institute at Cass. We can increase our work force via migration, we can work longer or we can increase contribution payments - even if we do this it only keeps the current state pension system stable until 2030.

Co-researcher, **Professor David Blake**, director of the Pensions Institute at Cass, added: ‘The only other option is to combine these factors work longer, increase migration and increase contribution levels. Expecting everybody to work longer may be unrealistic as activity rates among the over-50s have hardly changed in 25 years, and to make any difference there would have to be a significant change in working habits’.

Pensions workforce, Daily Mirror, 3 November 2004

BRITAIN"S falling birth rate and the greater life expectancy of retired people means millions of foreign workers could be invited here over the next 30 years.

Researchers at the **Cass Business School** reckon this will be needed to maintain the level of contributions required to keep the State pension at the equivalent of its present £80 a week.

In 1990 there was one pensioner for every four workers but by 2030 there will be two pensioners for every five workers.

Cass''s Professor Les Mayhew says: "The UK is facing some tough decisions in terms of State pension provision."

Migrants 'key to pension crisis': Foreign workers needed to boost tax take, Ashley Seager, The Guardian, Nov 01, 2004

Up to 10 million immigrants might be needed in Britain by 2025 to ensure pensioners can continue to receive pounds 80 a week from the basic state pension, research out today suggests.

Researchers at **Cass Business School** in London have developed mathematical models of the likely course of the pensions crisis, which point to the need to work longer, save more and allow in more immigrants who will pay sufficient tax to keep the system afloat.

The most gloomy scenario - that productivity and real wages will not increase between now and 2025, and so generate more money for paying pensions - says 10 million migrants would be needed if we did not work longer, pay higher national insurance contributions and kept living longer.

The basis of the problem, it says, is that we are living longer while birth rates have fallen. In 1990, there were four workers to every one pensioner. By 2030 there are expected to be nearly two pensioners for every five workers.

"The UK is facing some tough decisions in terms of state pensions provision. We can increase our work force via migration, we can work longer or we can increase contribution payments - even if we do this it only keeps the current state pension system stable until 2030," said Cass's **Professor Les Mayhew**.

If the government wanted to resist the immigration pressures, the research shows that in another scenario, where the retirement age was raised to 70 from 65 between 2020 and 2030 and more of the over-50s stayed in work, immigration pressures would not appear until 2024.

The five scenarios in the re search, which factored in options such as raising pensions only in line with inflation, cutting them back or changing the retirement age, all showed the pension system becoming more difficult to manage after 2020.

"The only other option is to combine these factors - work longer, increase migration and increase contribution levels," said **Professor David Blake**, another of the report's authors.

These are similar conclusions to those of Adair Turner, who compiled a major report into pensions for the Pension Commission, which was released last month.

Mr Turner's report estimated that 12 million people - one in five Britons - were not saving enough for their retirement. Of those, 60% are not paying into any kind of pension fund. Some experts have estimated a pension savings shortfall of pounds 60bn.

To maintain state pensions, the choice is work longer, pay more tax or relax immigration, economists say.

UK needs '10m migrants for pension crisis', By Daniel Brooksbank, IPE.com, 1/Nov/04

The UK needs up to 10 million migrant workers by 2025 to maintain the basic state pension, according to new academic research.

"Up to 10 million migrant workers might need to enter the UK between now and 2025 in order to ensure that pensioners can continue to receive 80 pounds (115 euros) a week from the basic state pension," said the Cass Business School.

"This could be the only way that pensioners can expect to receive their current level of pension if we continue to retire at the same age, we fail to increase national insurance contributions, productivity levels remain static and we continue to live longer."

"The UK is facing some tough decisions in terms of state pension provision," said Professor Les Mayhew, primary researcher and director of the Risk Institute at Cass. "We can increase our work force via migration, we can work longer or we can increase contribution payments - even if we do this it only keeps the current state pension system stable until 2030."

Professor David Blake, director of **Cass' Pensions Institute**, added: "The only other option is to combine these factors - work longer, increase migration and increase contribution levels.

"Expecting everybody to work longer may be unrealistic as activity rates among the over 50s have hardly changed in 25 years, and to make any difference there would have to be a significant change in working habits."

'Immigration or bust: Securing the future viability of the basic state pension' by David Blake and Les Mayhew is available on request from Cass.

Separately, the UK government is to hold a consultation meeting on the proposed Financial Assistance Scheme for pensions on November 24. The Department of Work and Pensions said: "We are particularly interested in listening to the views of those most affected, consequently, we would like to invite scheme members to attend a meeting with DWP officials."

Consumers ignore the cost of investing, by Alexander Jolliffe, Financial Times: Money, October 30 2004

Consumers who are piling in to funds frequently ignore the costs of investing, say financialplanners.

Private individuals have £350bn invested in shares and bonds, much of it in funds, but all too often bought because unit and investment trusts have performed well in the recent past.

Returns from investing in stock or bond markets frequently revert to a mean, so investors who pile in because equity or fixed-income funds have done well recently could be missing out on the best of a run of good performance.

Ian Shipway, a certified financial planner at THINC Financial Planning, says: "It's typical retail behaviour. They buy something that has already gone up, but they're buying it at the top of the market or close to the top." Instead, investors are advised to research funds carefully. John Shuttleworth, an actuarial partner at PwC, the professional services firm, says: "We put huge effort into researching these people."

Investors who snap up funds because of dazzling recent returns are making the fundamental mistake of assuming that the future will resemble the past, say commentators. Also, they should ask whether fund managers made money because they are good or lucky.

Professor David Blake, director of the **Pensions Institute** at **Cass Business School,** London, who co-wrote research about past performance published by the Financial Services Authority last year, says returns can also be flattered by a "momentum effect" in which good performance passes from one year to the next.

For example, a fund manager might buy in June shares whose prices rise until December. Those prices may continue to go up into the following year, which might be the start of a new period for measuring the fund's performance. Prof Blake says: "The first year's performance gets fund managers noticed, and the second year's returns are used to market them. Then investors pile their money in."

To be genuinely skilled, Prof Blake warns, a fund manager would need to show outperformance which could not have been caused purely by luck and momentum effects.

However, most investors do not have the time or inclination to search out managers who have beaten indices consistently, and have not outperformed because of luck.

Prof Blake says: "The average investor will not be constantly watching the performance of the manager. For typical investors, a passive, well-diversified fund with low charges is the best they can get."

Financial planners agree that the price you pay to buy and hold funds is vitally important.

Their argument is simple: the more a fund absorbs in charges, the harder it will have to work to outperform other funds. Some funds - with no initial charges and annual fees as low as 0.5 per cent - have a lower hurdle to overcome.

Other funds, though, charge as much as 5 per cent upfront and 2 per cent a year. The manager of such a fund must outperform one charging 0.5 per cent by more than 1.5 percentage points - every year for the lifetime of your investment - just to keep up.

Among venture capital trusts, annual fees can hit close to 4 per cent annually. Bestinvest, a broker, this week urged managers to cut charges by calculating them in relation to market capitalisation, which is typically below net asset value (NAV) - the existing basis for costs. VCTs trade at an average discount to NAV of 16.5 per cent.

There is much research to support the high impact of charges on performance. Mark Carhart of the University of Southern California found in a 20-year study of US mutual funds that charges have a one-for-one negative impact on fund performance.

So, for every 1 per cent in charges, there will be a corresponding 1 per cent deterioration in performance. Carhart found no evidence that superior stock-picking skills could make up the difference over the long term.

In addition, trading costs add significantly to overall charges in the UK, says Adair Turner in this month's Pensions Commission report. He says that, even if there were no explicit costs charged by the fund manager, investors would not receive the market return from share prices and dividend yields.

Turner points to an FSA paper that found that an investor would have needed to invest about £1.50 on average in an actively managed unit trust to get the market return on an investment of £1. The difference is accounted for by fund managers' charges, brokers' commissions, the difference between buy and sell prices and stamp duty.

For tracker funds, which follow indices up or down, the effect of charges was lower. An investment of about £1.25 generated the market return on £1. However, Turner says even tracker funds can be expensive.

Alistair Bennett, a certified financial planner at Independence Financial Planning, says charges are particularly important in a low-inflation, low-return environment, because they are likely to eat up a disproportionate amount of returns.

But Bennett is ready to consider more costly funds in less efficient markets where expected returns are greater and where higher charges will not eat up such a large slice of performance.

For those willing to consider the high-charging funds, questions to ask include: what is the manager's investment philosophy? What is the buy and sell process? Then there is the manager's competitive advantage: "Don't use people who rely on stockbrokers' research notes, because they are using information that has gone to the whole market," warns Shuttleworth.

All this suggests that investors should watch prices like hawks when they invest. Bennett advises clients investing in "mature" stock markets such as the UK to consider low-cost exchange traded funds and cheap investment trusts.

"Charges are absolutely vital," he says. "Why on earth would someone pay 2 per cent a year when they could get in more cheaply with exchange traded funds and investment trusts?" Fund performance, Pages M26-M27

HOW DO I FIND THE FUND THAT'S RIGHT FOR ME?

Stick to cheap funds, to judge by academics and regulators who have found that expensive funds eat unjustifiably into investment returns. Fund managers expect equities to generate lower returns than they did during the bull market, so charges are likely to take a disproportionate slice of performance in future.

But do the costs really add up? Yes. An investor who put £7,000 into a typical low-cost FTSE All-Share index tracker for 10 years would pay £711 in charges over 10 years, according to the comparative tables on the Financial Services Authority's website. But someone who invested the same sum in a fund charging more than 1.5 per cent a year would pay £4,076 over 10 years. The person who chose the cheap fund could use the spare cash to pay for a term's fees at a non-boarding prep school, according to the Independent Schools Council.

But surely I have to pay for talented fund managers? Well, many investors pay for actively managed funds which fail to beat their benchmarks. The WM Company, which measures investment performance, surveyed the returns generated by 44 UK equity unit trusts over 20 years. It compared them with the FTSE All-Share and found that only eight funds beat the stock market index.

But I might pick one of the eight funds that beat the market. You might - but will the manager stay with the fund you chose? Sixty-five per cent of fund managers changed their jobs in a three-year period monitored by Credit Suisse Asset Management.

What about past performance? I keep reading about funds that have great long-term records. According to academics who have studied this, some funds did well because of luck, some because of the bull market and others because of a "momentum effect" - the managers bought shares whose prices went up until the end of the year. Those prices may continue to rise into the following year, which might be the start of a new period for measuring the fund's performance. At any rate, what happened historically does not give you reason to think the fund will continue to make money.

So shall I stick to funds where the fund manager's charges are low? Yes, that's what financial planners recommend. But don't ignore the other fees, which go to auditors, custodians and trustees. To find out about them, look up the total expense ratios - complete annual charges - of funds. You pay such fees year in, year out, until the end of the investment. These costs add up: the total expense ratio on Gartmore's £1.4bn European Selected Opportunities fund, for example, is 1.79 per cent, above the annual management charge of 1.5 per cent.

Where can I find these total expense ratios? For unit trusts and open-ended investment companies, you can find them at *www.investmentfunds.org.uk*. For investment trusts, they are at *www.aitc.co.uk*

As a broad guide to price, the average TER for actively managed UK equity funds is 1.6 per cent, while for index trackers it is 1.0 per cent. However, some passive funds are much more expensive than the cheapest, which come in below 0.5 per cent.

If I want to research funds' performance, despite all this, where can I start? Try *www.trustnet.com*, where you can find out whether funds have beaten indices and the average fund in their sectors consistently. To look up managers' performance throughout their careers, not just at their current funds, try *www.citywire.co.uk* or *www.bestinvest.co.uk*

Bestinvest's website's research function allows investors to sort funds by their charges. It also allows users access to a Manager Record Index which examines the performance of fund managers throughout their careers and not just in their current jobs.

And what else should I do to keep costs down? One option for investors who know what they want is to use discount brokers and internet fund supermarkets such as FundsNetwork to cut costs.

Is it as simple as that? No. It is still important to get advice from financial planners about asset allocation - the amount you invest in property, shares, bonds and cash. Even a low-cost equity fund can turn £100,000 into £80,000 if shares drop.

So how can I protect myself from that? Ian Shipway at THINC Financial Planning advises clients to "rebalance" their portfolios every year to make sure they keep appropriate percentages invested in each asset class. For example, if share prices rise, that could increase the percentage of your portfolio invested in the stock market to levels above the amount of risk you are willing to take. If that happens, it may be worth taking some money out of equity funds and reinvesting it in other asset classes.

Isn't it simpler to choose funds that have done well in the past? If you do that, you risk making less than other investors. Shipway says: "If you buy expensive funds, you risk underperforming."

UK’s Turner joins Pensions Institute, by Daniel Brooksbank, IPE.com 15/Oct/04

Adair Turner, the chairman of the Pension Commission which presented its first report this week, has joined the Pension Institute at the Cass Business School.

The director of the institute, Professor David Blake, told delegates to a conference that Turner would be a visiting professor.

Other visiting professors include former UK social security minister Frank Field, and opposition pensions spokesmen Steve Webb and David Willetts.

In February this year the institute moved across London, from Birkbeck College to Cass, in the heart of London’s financial district, with Blake becoming Professor of Pension

Economics. The institute - set up in 1996 - is the only UK academic research centre focused on pensions research.

Last month the institute issued research which found that company finance directors in the UK had “taken control of the defined contribution (DC) pension purse strings and many impose strict limits on the number of employees that join, in order to reduce the company's pension costs”.

Turner is also a visiting professor at the London School of Economics and a former head of the Confederation of British Industry.

In addition to chairing the Pension Commission, he is vice chairman of Merrill Lynch Europe, a director of United Business Media plc, chair of the UK Low Pay Commission and chair of the UK Pensions Commission.

Which route will Turner take?, By Pauline Skypala, Financial Times fm, October 10 2004

All eyes in the UK pension world are focused this week on Adair Turner and the Pensions Commission, who will report tomorrow on their government-commissioned study of problems facing the pensions system, and whether more compulsion is the route to a better pensions saving model.

Compulsion has done wonders for the fund management industry in Australia, making it the fourth largest in the world. But managers hoping for a similar bonanza in the UK should not hold their breath. The UK already has a compulsory pension system in the shape of the contributory state pension, and Mr Turner has indicated that no consideration of compulsion for private pensions can be made independently of a wider look at the economics of pension provision, both state and private.

He has argued that there is little difference between pay-as-you-go state schemes and funded pensions from an economic point of view, other than how the resources flow.

Both rely on the same mechanism of workers supporting pensioners, but that balancing act is coming under growing pressure worldwide from increasing longevity and a falling birth rate, and cannot be maintained without raising either the retirement age, the savings rate or taxes, perhaps all three.

If further compulsion is the right route to take then, given future rates of return, it may be more cost-effective to provide a better state pension than force low-income workers, in particular, to pay the high costs associated with individual private pensions.

The report tomorrow is an interim one that will present analysis and options rather than recommendations, which will follow next year. But it is likely to set the seal on the emerging consensus that reform of the state pension system is the essential first step to solving the problems of pension provision.

That still leaves a vital role for the private funded pension system, and many fund managers have clearly identified the retirement savings market as the prime growth area. Their focus is on offering a diversified range of investment options rather than on scheme design, but the issue of scheme design is central to fund managers, who have some responsibility for ensuring their products are suitable for purpose.

The recent report from the **Pensions Institute** highlighted the problems of defined contribution pension provision among small and medium-sized enterprises. This is below the radar of the big consultants and many fund managers, who still largely concentrate on the plum of the billions held in defined benefit schemes. But people in these SME schemes represent 50 per cent of the workforce and deserve far more consideration than they are getting.

Mr Turner is not in favour of a widespread switch to DC, which shifts both investment and longevity risk from the employer to the individual. His report tomorrow will include suggestions on more flexible options where the risks are shared.

Consultants generally like these ideas too, but the move to DC may already have gone too far for them to fall on fertile ground.

DC looks as if it is here to stay, and contract-based DC, rather than occupational schemes with a trustee board, could well become the norm.

That would be a big loss for pension savers. The trustee system has its drawbacks, but trustees bring an important contribution to the table common sense. That might look like unnecessary caution to fund managers eager to introduce trustees to a range of alternative assets. But managers are prone to leap on bandwagons in pursuit of a bigger market share and do not always stop to question whether the products they are selling are fit for their purpose.

Trustees have not always asked the question either, but at least they are in a position to do so. Members of contract based schemes are given the investment choices deemed appropriate by the scheme provider, and without advice are likely to make no choice or a poor one, as the Pensions Institute report underlined. Default funds are typically of the one-size-fits-all variety, light years from the diversified approach being advocated for occupational DB schemes.

Those schemes have their own problems of course. Listening to some advocates of diversification conjures up visions of DB schemes huddling encircled on the plain, surrounded by hostile forces of inflation, longevity, low returns and demographics. Riding to their rescue are alternative assets, absolute returns and liability driven plans. Will they scatter the enemy and end the day victorious?

Impossible to say, but trustees have to make up their minds whether to embrace this brave new world.

Before they commit to putting 10 per cent or more into hedge funds, they might want to mull over Mr Turner's comments on investment approach. He is in favour of using a wide range of asset classes with different risk/return trade-offs that have the potential to provide attractive returns while limiting risk.

But he adds an important caveat: managers must be able to deliver such products efficiently, with charges that do not wipe out too high a proportion of gross return.

The jury is still out on whether hedge funds, and particularly fund of hedge funds with their double layers of fees, can meet that qualification going forward.

Pauline Skypala is the editor of FTfm

DC schemes not up to scratch says pension body, **by Debbie Harrison, Financial Times fm, October 10 2004**

The UK government's bid to raise private pension provision requires far more than just bums on seats in company-sponsored schemes.

With the trend from defined benefit (DB) to defined contribution (DC) well established, and particularly if Adair Turner's pension commission, which makes its first report tomorrow, comes out in favour of compulsion, a lot more attention needs to be given to getting DC schemes right. Members in these schemes need to be confident that they are investing in the right assets at the right time.

For its first practitioner report, Delivering DC?*, the **Pensions Institute** at **Cass Business School** examined the asset allocations and investment styles used for stakeholder default investment options (the investment fund into which members contributions go when they don't make an active choice to make a choice) and found them lacking in several key areas.

The investment default option is a mandatory feature of the stakeholder scheme and is also widely used by group personal pensions (GPPs). The range of default structures and asset allocations is very varied and includes index trackers, with-profits funds and managed unit-linked funds.

The structure of the default option is crucial, as this will affect the potential outcome for the majority of members.

In practice, although most DC schemes offer a range of in-house and external funds, between 80 and 90 per cent of members accept the default fund and stay with it until retirement. This is not because members actively select the fund as the most appropriate but because they assume it comes with the advisers' and employer's endorsement.

In most cases the fund would have a “lifestyle overlay” (the fund would be structured to take account of the members' stages in life) so that the member automatically switches over a period of years from equities to a final pre-retirement allocation of 75 per cent government long bonds, to hedge the interest rate element of the annuity purchase, and 25 per cent cash, to protect the tax-free lump sum.

Lifestyling will be mandatory for the default option under the “Sandler” stakeholder scheme a modified version of the current model due to be introduced in 2005.

In the small and medium enterprise (SME) market, in which some 50 per cent of employees work, the most common default fund is the managed unit-linked fund run by the life office that provides the scheme.

We examined the managed funds offered by stakeholder providers and concluded that most are run on a near-passive basis: that is, they follow the index and peer group asset allocations very closely.

An annual management charge of 1 per cent (with the option to rise to 1.5 per cent in 2005) appears high for essentially passive investment management. But advisers who generate volume for a particular provider can negotiate this charge down to about 0.8 per cent, particularly where the company employs a comparatively large workforce and/or where the earnings profile is above average. The downside is that lower-earning employees who work for a smaller company are likely to pay a higher than average annual management charge.

The vast majority of DC schemes sold in the SME market are insurance contracts and not trust-based occupational schemes. Richard Stroud, chief executive of the Pensions Trust, which provides a range of schemes for employers in the voluntary sector, believes that trustees in occupational DC schemes play a vital role in selecting and monitoring the funds. “With contract DC the adviser's client is the employer. With occupational DC the trustees have a fiduciary duty to the members to ensure that the funds are appropriate in terms of risk and performance and that they continue to meet these targets. Where managers fall short they are sacked and replaced.”

However, occupational DC schemes are waning in popularity because they are considered to be more complicated than contract DC. Many contract DC schemes automatically start members in the default fund. Members have the option to switch but rarely do so. Some schemes offer a choice of three default funds, which start the switch to cash and bonds at different points. Typically these are described as “opportunity”, where the switch starts three to five years before the retirement date, “balanced” (five to seven years), and “cautious” (10 years).

Robert MacGregor, corporate development director at Alexander Forbes Financial Services, says: “With a pension investment, attitude to risk is largely determined by the period to retirement. Lifestyle structures assume ‘retirement' is synonymous with ‘annuity purchase' and this is not always the case.”

Unfortunately employees rarely understand the fund definitions that dictate their asset allocation at different terms to retirement. Clearly, a young person who chooses a “cautious” fund could miss out on many years of capital growth by switching too soon out of equities, while the “opportunity” investor might still be in equities when he or she is faced with early retirement.

Pension providers in the SME market are working on new approaches to their default funds. Scottish Life, for example, has introduced a more sophisticated default strategy that matches the risk profile and investment objectives of the managed portfolios built from a range of core asset class funds to the member's objectives and investment horizon. This followed research that revealed that most managed funds suffer from poor performance benchmarks, poor risk matching of the fund with the investor's requirements, and poor governance. These issues were also raised by the first Myners review of institutional investment in the UK, published in 2001.

Adrian Boulding, pensions strategy director at Legal & General, points out that in the US it is common to see an asset allocation manager engaged for DC pension schemes. These managers provide a streamlined IT system that enables them to set and monitor asset allocation for each employee, using a combination of the basic funds provided by the scheme. This may well be where the UK market is heading.

* **The Pensions Institute, "Delivering DC? Barriers to participation in the company-sponsored pensions market", by Debbie Harrison, Alistair Byrne and David Blake, price £150, www.pensions-institute.org.**

Shift on pensions policy welcomed, by Isabel Berwick and Josephine Cumbo, FT MONEY, October 2 2004

The government this week gave the first indication that it was taking on board the concerns of critics of its pensions policy.

In a keynote address at the Labour party conference, prime minister Tony Blair signalled a redesign of the pension system that has "the basic state pension at its core". While his comments offered little detail, they were seen as suggesting less reliance on the government's maligned policy of means-tested pension credit.

His comments were given further weight by Alan Johnson, the new work and pensions secretary, who told a fringe meeting at the conference: "We need to have a debate about designing a means testing scheme that is effective for the future." Johnson acknowledged the view of critics that "we would suck more people into a means-tested scheme" if the pension credit, designed as a boost for those with low savings, continued in its current form. It now increases in line with basic earnings while the basic state pension rises only in line with prices.

The government's flagship pension credit, introduced last year, pays about £40 per household each week on top of the state pension to 3.2m people, according to official figures. Critics say the scheme is a disincentive for those thinking of putting away extra savings for retirement because saving over a certain limit would disqualify them from receiving the pension credit.

While the government is reluctant to admit a U-turn, others who attended the conference in Brighton this week saw a definite shift in the planks of its policy.

The Association of British Insurers, which seeks a strengthening of the basic state pension, describes Johnson's comment as "enormously encouraging".

"Taken together with Blair's comments, there is recognition that the reliance on means-testing and the growth of means-testing can't continue," says Joanne Segars, head of pensions and savings at the Association of British Insurers, which estimates that there is an annual £27bn gap in current pensions savings. "Hopefully, this shows that the government is listening to the concerns of the ABI and others calling for reform of state pensions."

Tom McPhail, pensions development director at Hargreaves Lansdown, says there was a real sense of a sea change in policy at the conference. "You could see the political landscape on pensions shifting before your eyes," says McPhail. "I came away with the clear attitude that there would be change."

The prospect that reform may be on the way also delighted pension providers. "There are signs that a fundamental rethink is on the way, and that is very welcome," says Christine Farnish, chief executive of the National Association of Pension Funds.

Observers see Johnson's arrival as prompting a rethink. The former joint general secretary of the Communication Workers' Union took over the work and pensions brief from Andrew Smith, who quit unexpectedly last month amid speculation he had been caught in the crossfire between Tony Blair and Gordon Brown, the chancellor.

Johnson is seen as diluting the influence of the chancellor, the architect of the government's pensions policy and a defender of means-tested benefits. Brown has come under pressure from critics who say his "top-up" strategy is creating savings barriers.

Calls for reform received further backing this week from the findings of a government task force and a report by an independent think-tank, both of which gave a bleak assessment on the state of pension provision by employers.

Sir Peter Davis, the former chairman of Prudential and J. Sainsbury who now chairs the government-backed employers' task force on pensions, said finance directors were looking to offload the liabilities of final salary and other defined benefit schemes, putting the risk of pension provision on to employees.

The task force's findings mirrored those of a study by the **Pensions Institute** highlighting how finance directors in small to medium-sized companies plot to block wholesale (and expensive) take-up of company pension schemes among workforces.

Responding to the Pensions Institute report, pensions expert Ros Altmann says small to medium-size businesses now employing 11m people consider pensions an unnecessary expense.

"This confirms the crisis engulfing pensions and confirms that millions of workers' future incomes are in jeopardy," adds Altmann. "Government policy on pensions has succeeded in undermining future pension provision by introducing major new disincentives for UK employers and employees."

Johnson has acknowledged concerns over occupational pensions and has urged workers to avoid a "head in the sand" approach. He has also announced plans to ensure that at least half of those running occupational schemes are members.

Meanwhile, the government is also coming under pressure from the Liberal Democrats and Conservatives, who want to see restoration of the link between the basic pension and earnings. The link was broken by the Conservatives in 1980.

The NAPF and the Liberal Democrats also want to see the second pension abolished and rolled into a stronger basic pension.

All eyes will now be focused on the report by Adair Turner, head of the Pensions Commission which is examining the private pension system and long-term savings. Turner's recommendations are seen as setting the agenda for the government ahead of the next election.

While the Turner report is likely to re-ignite debate over pensions, calls for the government to reconsider its policy plank will continue.

"Further reform is required," says McPhail. "The Finance Act and the Pensions Bill are going through now - thousands of pages of pensions legislation - but everyone realises we need more."

Companies 'often don't want people to join' by Isabel Berwick, FT MONEY – INVESTING, October 2 2004

Employees at smaller companies are often discouraged from joining the workplace pension scheme by finance directors keen to keep costs down, says a ground-breaking report from the **Pensions Institute**, the independent research group based at the **Cass Business School.**

The report also finds that those who do save in company schemes are likely to face high charges, poor asset management and then a bad deal on annuity contracts.

Debbie Harrison, co-author of the report, pensions journalist and visiting fellow at the Pensions Institute, spoke to many of those involved in selling, setting up and running group personal pensions and stakeholder schemes within companies. They gave evidence on condition of anonymity.

Harrison's sources said company finance directors control pension schemes, and few believe that pensions offer a good return on the company's investment in terms of recruiting and retaining staff. In many cases, companies - even large ones - have tacit limitations on the number of employees they want in the pension scheme.

Many ways are used by companies to deter high take-up of pension scheme membership. Harrison says: "They want to show they have a good scheme, but they don't want people to join. An effective barrier is high minimum contributions. On average earnings, anything over 4 per cent is a real barrier, so they could set up a fabulous scheme with a 6 per cent minimum contribution." Other tricks include holding meetings about schemes long after working hours.

The report notes pointedly: "While pensions for the workforce may not be a priority for finance directors, we understand they usually secure individual advice for themselves and key executives."

Even those who overcome the barriers erected by companies and actually join the scheme may well find themselves disadvantaged.

Harrison and her co-authors, **Alistair Byrne** and **David Blake**, found that there is little choice for employees because there are just three pension providers active in selling schemes to the smaller company market (those with fewer than 100 employees).

IFAs in this market are paid by commission, so they can recommend only the handful of firms that have been willing to enter a loss-leading commission war, which sees payments made to advisers of up to 35 per cent of the total employer/ employee contributions made during the first year of the scheme.

The pension providers have to underwrite each company scheme separately, and this also leads to inequalities. Harrison says: "They look at the earning rate of employees and sector turnover - the 'stickability' of the employees - and the more it tends to be a high turnover, the less attractive it is. They then charge a higher management fee. Lower earners in smaller companies pay more."

Another problem is that some 80-90 per cent of scheme members accept the "default" investment option, usually a managed unit-linked fund or index tracker. "You are not going into top funds," says Harrison. "They are active but virtually index funds. Many people are paying an active management rate for index trackers."

In the case of stakeholder schemes, the annual charge on pension funds is currently capped at 1 per cent, but this can rise to 1.5 per cent from April next year.

There's no individual advice for people who pay into small schemes, and "lifestyling" - the process that sees investments gradually switch from equities to "safer" alternatives as retirement approaches - varies between firms.

Another issue highlighted is the lack of help for employees who reach retirement with a small pension pot. Two-thirds of people don't shop around for an annuity and simply accept the offer from their pension firm. Harrison says this could leave already vulnerable people 25 per cent less well-off than the best market-leading offers.

Many independent advice firms are not interested in doing annuity business for customers with small pension pots, yet the average annuity purchase in the UK is just £40,000.

Tom McPhail is pensions development director at Hargreaves Lansdown - a firm that does business in the smaller annuity market. He says it is hardly surprising that few people bother to exercise the "open market option" for annuity purchase because the instructions for exercising rights are so complex. "They have to wade through three or four pages before they get to the part about the open market option," he says. "There is a fairly widely held perception that it is not worth the effort." **www.pensions-institute.org**. The full report, Delivering DC? - Barriers to Participation, costs £150

* The Financial Times Guide to Self Invested Personal Pensions, sponsored by Chartwell Investment Management, is available free on 01225 446556 Policy shift, Page M30

Will there be a pensions shortfall? You can bet your (long) life on it, by William Kay, The Independent Oct 02, 2004

THE GOOD news: the Government finally recognises that there is a pensions crisis. The bad news: it doesn't have the faintest idea what to do about it.

This week pensions emerged from their traditional sleepy backwater to claim, if not top, then a remarkably high billing at the Labour party conference.

Most notably, Tony Blair took time off from agonising over Iraq to promise that next term a Labour government would "design a pensions system that has the basic state pension at its core". Cor blimey, gov, I thought we had one of those already, must be the old memory playing tricks wiv me.

Keener minds than mine detect a hint that the state pension will do a dance of the seven veils and be stripped of its means testing. At fringe meetings in Brighton, the work and pensions secretary, Alan Johnson (pictured, right), and his minister, Malcolm Wickes, backed away from means testing.

Could it be that the present pounds 79-a-week basic pension will be lifted to the glorious heights of pounds 100, only to be clawed back in tax from the better-off? It looks very much as if the present tax trap will be closed, as Mr Johnson went so far as to say that "we don't want to penalise people with modest savings from keeping those savings".

All these noises suggest that something is going on in the corridors of Whitehall, although it will come to fruition too late for ministers to say more than "trust us, we'll get it right next time". As ever, it's those first two words that are the fly in the ointment.

As it is, knives are being sharpened in advance. Or, as Mr Johnson put it this week, let's have a healthy debate.

It looks as though that is precisely what he is going to get: it was standing room only for latecomers at the fringe meeting that I attended.

Adair Turner, another speaker at the same meeting, made it plain that the interim report of his Pensions Commission will paint an apocalyptic mural of doom, disaster and chaos. He even predicted that his recommendations, which we won't see for a year, will be hedged with caveats.

The basic problem, in Mr Turner's eyes, is that everyone, actuaries, governments and individuals alike, has consistently underestimated the recent dramatic increases in longevity and have been too slow to react. So we're playing catch-up, which will not be good news for those retiring in the next 25 years.

But a new villain was unmasked this week. Sir Peter Davis, the recently departed chairman of Sainsbury's, has popped up as head of the Employers Task Force on pensions, which is due to report soon after Mr Turner.

Sir Peter has found that employers are apathetic to cynical about setting up occupational pension schemes, arguing they are too costly and expose them to unwanted liabilities and possible accusations of mis- selling.

This echoes a survey published this week by **Cass Business School** and the **Pensions Institute** (this pensions lark is turning into a growth industry). It found that company finance directors are "a very significant barrier" to more people being offered an occupational scheme.

That chimes with Government thinking, which wants to see as much funding as possible coming from the private sector - personal or corporate, it doesn't matter.

Tough on the four million self-employed, though.

Smaller companies 'discourage pensions' By Norma Cohen, Financial Times, 29 September 2004

Finance directors at small to medium-sized enterprises doubt company pension schemes benefit their businesses and actively discourage employees from joining them.

The new study, by the **Pensions Institute** at Cass Business School, concludes that many finance directors are not convinced "pension schemes attract, retain and motivate staff".

In many cases they impose strict curbs on employee participation in their defined contribution schemes, it adds.

Christine Farnish, chief executive of the National Association of Pension Funds, said the report, based on interviews with finance directors at SMEs and financial advisers, showed the real reasons why the UK faced a savings crisis. "There is scepticism among finance directors about the value of workplace pensions in recruiting and retaining staff, and similar unease among employees about the value or purpose of joining such schemes," she said.

Financial advisers said the report's findings reflected their experience of smaller company decision-making.

Marcus Whitehead, partner at actuarial and pensions consultancy Barnett Waddingham, said: "Finance directors tell us: 'Yes, we want to do something on pensions but we don't want to pay.' " Limiting member participation was seen as a good way to limit costs while offering the "window dressing" of pension provision, he added.

Mr Whitehead said he had seen companies use a variety of strategies to discourage employee participation, including setting employee contributions at too high a level for young workers, limiting information and holding briefings outside working hours.

Earlier this week Alan Johnson, the pensions secretary, made clear to the Labour party conference that the government would introduce measures to encourage more employees to participate in occupational schemes.

FTfm: Who best to cope with longevity risk?, by Norma Cohen, Financial Times, 12 July 2004

Of all the risks faced by pension schemes, perhaps none is greater than longevity.

Until a few years ago, longevity was a concept that barely registered on the Richter scale of investment cataclysms. Even the actuarial profession failed to spot the rapid improvement in life expectancy for those over 60. Life expectancy improvement for those over 80 - when individuals are past the age at which they are economically productive - is even more dramatic.

With many pension schemes now using estimates of post-65 life expectancy of 20 to 22 years - up from about 16 years a few years ago - pension liabilities have risen by as much as a third, irrespective of any moves in bond or stock markets.

Moreover, a recent paper for the Institute and Faculty of Actuaries suggests that the current rate of improvement in life expectancy is likely to go on for at least another 20 years.

Meanwhile, there is no capital market instrument to hedge longevity risk. While the insurance industry has been clever enough to design hedges against pollution and bad weather, it has yet to devise a longevity hedge.

Moreover, the reinsurance industry - which allows insurers to lay off policy-specific risks as diverse as models' legs, satellites and terrorism - draws a blank on longevity. There is no reinsurance market for the risks of annuities providers.

As a practical matter, the private sector has thrown its hands up and surrendered on longevity risk.

Is is possible that the government, which can spread the risks of longevity over many generations of taxpayers, is the only suitable underwriter for this risk?

In a speech last week, David Willetts MP, shadow minister for work and pensions, outlined some possible capital market instruments - all, he suggests, to be issued by the government - aimed at helping pension schemes meet the twin risks of long-term inflation and longevity.

On the latter, Mr Willetts outlines one option that he describes as the most attractive, which is largely the work of Professor **David Blake** of **Cass Business School**.

Professor Blake is suggesting the issuance of government bonds linked to some index of longevity. They would carry market rates, but be linked to a future life expectancy based on the government actuary's current forecast. But if central forecasts moved up or down by, say, 5 to 10 per cent, then coupon payments would fluctuate accordingly.

Government bonds bearing this structure would then be better hedging instruments for the longevity risks currently borne by insurers and pension schemes. With greater certainty about investment outcomes, reserves held against uncertainties would be smaller and pay-outs larger.

This idea is intriguing. But at its core it assumes that longevity risk is one that is appropriately borne by the government. There are good arguments for this view; for one thing, one might say that this is already the case. The combination of basic and secondary state pensions mean that the government is already underwriting longevity risk for those who either outlive their savings or who could not save enough to provide a minimum standard of living in old age.

However, if that is the central premise, it may be that there are more efficient ways to hedge longevity risk.

One of these might be a form of "put" option, allowing individuals to "put" the cost of their retirement to government if they outlive the expected average age for their own cohort by, say, more than two years. This would allow annuities providers to broadly eliminate one of the biggest risks they face - that of the uncertainty of each claimant's date of death. The same lump sum would provide a much more generous retirement income, and government could claw back tax on the earnings.

Adair Turner, head of the government's Pension Commission, is closely studying the vexing issue of longevity risk, and says it may be possible to design capital market instruments with more efficient hedges.

However, he makes two points. First, if private pension promises are backed exclusively by government debt, government is simply providing pay-as-you-go pensions that are expensive to administer.

Second, he notes that there are two types of longevity risk, one of which is particularly thorny. It is knowing how long a 30-year-old is likely to live on in retirement, a number that will tell you how much that person needs to save during a lifetime of work. In Sweden, he says, this issue is partly addressed by allowing people to choose their retirement age; those with lower savings can work longer.

This is unlikely to be a panacea unless basic state pensions are much more generous. The wealthy live longer, are healthier and are thus able to defer retirement. The poor suffer ill health at an earlier age and need to retire sooner. The state will still have to pick up the tab for the worst off.

The underlying premise must be one that the UK has already accepted, but refused to spell out. That is, longevity risk is one that is most appropriately borne by the state.

Private markets, not to mention private individuals, are ill-placed to measure and price this one.

Norma Cohen an FT senior corporate reporter

FT MONEY - GUIDE MULTIMANAGER FUNDS: Paying to avoid duds By Pauline Skypala, Financial Times; May 08, 2004

The case for the multimanager or fund of funds approach is easy to make: the basic premise is that no fund management group is good at everything, so cherry picking the best managers in each group should improve returns. The growth in the fund industry adds further fuel to the argument: with so many investment funds to choose from, investors have a high chance of picking at least one dud.

Add in frequent fund manager moves, high stock market volatility, and the growth of boutique fund managers whose expertise may not be directly available to retail investors, and who could argue with the view that it makes sense to pay a little extra to have a professional pick the best fund managers and keep them under constant review?

Credit Suisse, which has built up £400m in fund of funds assets in less than three years, quotes figures that appear to clinch the argument. It says that of the 989 funds in the 12 main fund sectors three years ago, only 14 per cent were consistently above average each year, and only 3 per cent in the top 25 per cent. Based on this, says Credit Suisse, the chance that investors will have at least one bad year if they pick their own funds is higher than 85 per cent.

But the real underlying argument investors must accept in the first place to buy the whole idea of the multimanager approach is that fund managers have sufficient skill at stock picking to add value. Furthermore, that these skills can be measured and persist for long enough for other fund managers with manager-picking skills to create a mix of managers with the potential to outperform.

The academic world has often disputed the fund industry's assertion that active fund managers can earn high enough returns through stock picking alone to justify the extra costs of employing them compared to an index tracking approach. Even if there are a few managers capable of such a feat, the professors say, it is impossible to identify them in advance.

Fund managers put much emphasis on past performance figures, and tend to promote the funds with the best performance records. They have also taken to promoting "star" managers on the basis of publicly available assessments of individual manager performance from firms such as Citywire, a specialist publisher.

Their approach appeared to be justified when research by Charles River Associates, commissioned by the Investment Management Association, suggested that there was strong evidence of performance persistence over a variety of time horizons.

But this was challenged by another study last year by professors **David Blake** of Birkbeck College and **Allan Timmermann** of the University of California, commissioned by the Financial Services Authority. They pointed out that Charles River used raw returns, unadjusted for risk, which means that apparent performance persistence reflects funds' risk exposure rather than the skill of the fund managers. This is because high-risk funds are more likely to be top performers, particularly in the long run, while low risk funds are more likely to be among the worst performers. The professors also found "fairly strong" evidence of persistent performance after adjusting for risk, but only in relation to poor performing funds.

The argument for multimanager funds, then, may come down to helping investors avoid poor performers. Given their tendency to follow fund fashions, rely on past performance, and buy at the top and sell at the bottom, this may well be a service worth paying for.

David Furlong, marketing director at Investment Management Selection, which advises on $4bn of multimanager assets, says: "We help eliminate a good deal of the surprises and mistakes an investor might experience."

He says the two funds the firm runs as a shop window for its skills have demonstrated its ability to consistently add value over its competitors over the last four years. He says the firm has a core list of 50 to 60 funds in which it is very active, and a reserve list of another 60 to 70, which is a huge reduction on the thousands of funds worldwide it has screened out.

Consultants Watson Wyatt believes there are particular attractions to the multimanager approach in the world of employers' defined contribution pension schemes, where employees are left to make their own decisions about which funds to invest in. Andy Hunt, senior investment consultant, says that with multimanager funds, employees "get a sophisticated product made simple" that should provide a smooth stream of outperformance.

"It is certainly fashionable to add a multimanager capability to a DC platform. From being a differentiating feature it has become almost a must-have."

But he qualifies his enthusiasm by acknowledging that ultimately, the multimanager approach will have to pass the same test as any other active management approach - does it provide better results than a low-cost index tracking approach?

It is too early to answer that question, and in the meantime, investors face another: how to choose between the growing number of multimanager and funds of funds? They are not all the same.

Hunt says some multimanagers fall down because they are too timid and do not aim for a high enough risk target. "You can end up with quite high fees for tepid performance," he says.

Investors convinced by the multimanager case will still need help finding the right multi-manager fund.

FT MONEY: It does not always pay to follow the stars by Kate Burgess, Financial Times; May 15, 2004

Star fund managers get top billing in the marketing literature sent out to private investors, and make the headlines when they move jobs. Yet there is little evidence that most deservetheir star treatment.

David Mitchison, manager of Framlington Japan, handed in his notice last week and said he was moving to JP Morgan Fleming. Within moments advisers had sent out e-mails telling investors to consider switching out of the fund.

Last month, Insight, the investment management arm of HBOS, lost UK equity star manager Neil Pegrum to Cazenove. Advisers again urged investors to follow him and newspapers speculated on how HBOS would cope.

This devotion to a personality cult runs directly against well-documented research that shows that returns from most actively managed funds - at least those that invest in the big, liquid markets in the UK or US - do not beat their benchmark index.

Legal & General summarises much of the data. It shows that over five years the FTSE All Share index outperformed 55 per cent of actively managed funds investing in UK shares - before fees. After high initial fees, just a quarter of funds managed to beat the index.

Investors would have made more money by backing the index and aiming for market returns than investing with most individual managers, says L&G. The chances of picking a UK fund that will continue to turn in an index-beating return over five years is considerably less than one in five. Of the 72 active funds that outperformed the index in 1998 just 31 active funds were still doing so in 2003.

The longer term statistics are just as bad. Of the 44 actively managed trusts with a 20-year performance history, eight outperfomed the FTSE All-Share index, highlighting just how difficult it is to identify which trusts will be long-term winners, said the WM Company, which assesses performance.

Those funds that do outperform often do so because they are taking higher risks than other funds, say academics, and are unlikely to sustain that outperformance over successive years. If there is any evidence of persistent outperformance it is due to luck and momentum rather than judgement - that is, a fund holds a stock that produces a high return in one year and carries on to the next.

Once you adjust returns for risk that the managers have taken, the only evidence of consistency is on the downside - that is, poor managers systematically underperform benchmarks.

"Losers generally repeat, while winners do not necessarily repeat," was the bleak summation reached by professors **David Blake** of Birkbeck College and **Allan Timmermann** of the University of California in a study for the Financial Services Authority.

Worse, if you do pick a fund that underperforms it could have a very big impact on a portfolio, WM says. The difference between top performing and bottom performing funds was 61 per cent for active funds in 2003. The difference between returns among much lower-cost index trackers, funds which copy stock market indices, is just 3.3 per cent.

Nonetheless, the fund management industry holds to the view that there is such a thing as manager skill and that some managers have star quality.

They point out that buying trackers only works for so-called "efficient" markets in the US and UK. These markets are hard to beat because large numbers of analysts follow stocks and most information is widely known. In contrast, in inefficient markets - for example, markets in small companies or emerging markets - active managers, who may be the only one following a company closely, can add value.

"Active managers do outperform," says Craig Baker, head of manager research and a team of 130 researchers at Watson Wyatt, the pension consultants, although he is vague on how many. His warning to private investors, though, is that picking a fund on past performance - particularly on the basis of a short track record - is dangerous. Too often, returns turn out to be random. "If investors choose a manager on the basis of how they have done recently they might as well buy cheap passively managed funds".
Lawrence Lever, founder of specialist publisher Citywire which ranks fund managers, is a keen advocate of active management, and urges investors to look more at the manager's track record than at the fund's record.

Citywire's contention is that if you rank managers on the basis of all the returns they have earned for all the funds they have managed, it is clear that a small core of fund managers do have talent and do outperform indices. It gives around 5 per cent of UK managers a star rating. But most managers do not stay put long enough to build up a five-year track record in one fund so the studies of long-term fund returns can be misleading.

None of the academic evidence looks at individual performance and it ignores the effect of manager moves, says Lever. Managers move, retire and are increasingly poached - industry statistics suggest that on average managers move every three or four years.

The question for investors is how they can follow these stars. If they switch funds every time a manager moves they incur more charges, and there is no guarantee that the manager will continue to perform as well in a new job.

Citywire says star managers do repeat their winning performance. But a recent paper by academics from Harvard Business School suggests the odds are against it. Boris Groysberg, Ashish Nanda and Nitin Nohria studied more than 1,000 stock analysts working for 78 investment banks in the US from 1988 to 1996.

They found that in many cases when an analyst ranked as a star moved jobs, the star's performance plunged. "There was also a sharp decline in the functioning of the group or team the person worked with," they said. "Moreover, stars don't stay with organisations for long, despite the astronomical salaries firms pay to lure them away from rivals".
One reason, said the study, was that stars are rated on their individual skill but their performance is often more reliant than realised on their co-workers, and the resources, systems and processes available in their old jobs. When these change, so does their performance.

The study applied to analysts, but the authors say that many of the same points apply to the fund management industry. "Our study offers an interesting possibility - that their performance may not be as portable as currently assumed in investment circles", says Nanda, Harvard associate professor.

Where do I find out about fund managers? If you want to put your faith in a fund manager, websites set up by Bestinvest and Citywire both attempt to assess fund managers' records across their careers.

Citywire gives a small number of managers a star rating based on returns they've earned for all the funds they've managed. The returns are assessed over 36 discrete months. These returns are set against the fund's benchmark index and the amount of risk taken by the manager.

The ratings do not, however, take account of what is in the portfolio or the house style or factors such as size. Managers often argue that size constrains performance.
Consultants question whether Citywire's ratings put too much emphasis on past performance collected over too short a period. It takes years to build up a high level of confidence that returns are due to skill rather than random factors, they say.

Citywire also ranks all UK fund managers on the basis of their returns. But these rankings are not adjusted for risk and returns are judged cumulatively over three years - that means that outperformance or underperformance over a short period can skew average returns for several years. Cumulative average returns can also mask volatility. Funds whose returns veer sharply up and down over a period will look the same as more consistent returns from another manager.

I don't want to keep a constant track of what the manager is up to. Surely there is someone who can do it for me? For those investors who are sold on the idea that active management pays but are not interested in keeping tabs on their fund manager, there are multi-manager funds and funds of funds. You have to be pretty sure active fund management works - these funds are themselves managed by individuals who are supposed to be skilled in assessing other managers. The idea is to diversify the risk of a single manager, eliminate any bias to a particular management style or tendency for a fund to perform better in one phase of the economic cycle or another.

However, these funds can be expensive, adding layers of fees. Returns have to be high enough to justify the fees.

What do the big institutions do? Pension funds have increasingly adopted a core-satellite approach. They allocate the majority of a fund to a mix of low-risk, cheap index trackers, index-linked gilts and passively managed funds with the aim of matching long-term liabilities including inflation. Index trackers make up as much as 40 per cent of pension fund assets, according to Watson Wyatt.

Are index-trackers risk free? No. Critics have observed that index trackers are flawed because they buy and hold stocks regardless of valuation or of how much the stocks represent in the index. Trackers can feed bubbles by forcing managers to buy big stocks and sell small stocks, perpetuating the former's outperformance and the latter's underperformance.

Indices and the funds that copy them can go through bad periods, too. Nonetheless, if you believe - as most stock market analysts and historians do - that in the long term equity returns are likely to outperform bonds and cash, then it is important for investors to have some exposure to the asset class. The advantage of an index tracker is that as long as the index still exists, it will track it whatever form it takes and at a relatively low cost - unlike a fund or a manager who can disappear entirely from the industry.

What are satellite funds? Satellite funds are usually a range of smaller, actively managed funds often investing in areas where investors think a skilled manager can add value. These funds tend to be higher-risk specialist funds used to boost returns. Some of them are hedge funds, emerging market funds, alternative investments such as private equity or small companies.

Some advisers advocate that investors use multi-manager funds as satellites although there are potential disadvantages to this approach.

What do you mean? The point of the core-satellite approach is to control risk by putting up to 70 per cent of your portfolio in lower-risk investments such as trackers and index-linked gilts while using higher risk satellite funds to boost returns. The likelihood is that a multi-manager fund that aims to dilute risk will also dilute returns - particularly after charges. Does it make sense to put these in parts of the portfolio needed to take on higher risk to boost returns.

Do fees count that much? If managers can really turn in stellar performance, high fees would be a small price to pay. But they do count a lot, particularly when returns are low. It is always worth looking at the Financial Services Authority's comparative tables on its website (*fsa.gov.uk*).

From the Pensions Bill Second Reading debate in the House of Commons, 2 March 2004

Sir John Butterfill (Bournemouth, West) (Con): It is a great pleasure to follow the hon. Member for Ayr (Sandra Osborne). Few right hon. and hon. Members could fail to be moved by her clear sincerity and her concern for her constituents. However, in examining the Bill, we must consider whether the Government are doing enough and whether it is appropriate to deal with the problems that confront pensioners.

I am one of those who think that the Bill is capable of improvement, and that, if sufficiently amended and seriously scrutinised in Committee, it can provide the basis for a valuable move forward. The Government could have consulted better, and could have produced a much superior Bill. That is shown by the level of criticism from trade unions, the trade bodies associated with pensions, the professional institutions and others.

I should like to summarise what I think the Bill does do‹although it does not always do it clearly‹and what it does not do. It is an enabling Bill with far too much left to regulation. I would be much happier if the regulations were more transparent. Unfortunately, we live in a parliamentary world in which we are all too often asked to rubber-stamp legislation without knowing the details that will come later. We certainly do not know what the detail of the regulations will be. Even more importantly, we do not know the detail of the Finance Bill that will be with us all too soon, although not soon enough to make it clear what will happen on certain important issues that the Bill should address. The Secretary of State touched on the changes that will need to be made pursuant to what happens in the Finance Bill. I think that that is regrettable.

There are a number of issues concerning the regulator, some of which are minor and some major. A minor issue relates to clause 2, which contains provisions to appoint the chairman and other members of the board of the regulator. It does not make it clear whether the chairman is executive or non-executive. Under clause 8, the chairman will chair the non-executive committee, which implies that the chairman will be non-executive, but that should have been made patent in clause 2.

Much more important are the functions of the Bill, which gives wide powers that will make the regulator extremely powerful. Clause 62 deals with disclosure of information by the Inland Revenue. I am worried about whether that function will comply with the Data Protection Act 1998. Subsection (2) removes the secrecy that is usually inherent in Inland Revenue information under section 182 of the Finance Act 1989. It leaves it to the opinion of the regulator as to whether such information should be appropriately revealed.

I find that worrying. Lots of things in the Bill are left to the opinion of the regulator. Most of us want to safeguard the population in respect of the transmission of secret data. The Inland Revenue has walls that prevent one side, such as the valuation division, from obtaining money from the other side, the tax collection department. Presumably, the Bill will destroy those important safeguards. The Minister should reflect on that.

The opinion of the regulator does not apply only to that provision‹I supplied that as an example. In many areas of these extraordinarily wide powers, the opinion of the regulator is the defining issue. The House should consider that.

The compliance required with schemes under the Bill is onerous and costly. For example, clause 118 requires annual actuarial valuations‹the current requirement is triennial. I accept that the Bill goes on to say that the requirement for annual actuarial valuations can be overcome if written actuarial reports are produced every year. However, the cost of obtaining such reports and of the scheme actuary conducting annual valuations is enormous and will be another unnecessary burden on employers that still provide such schemes.

There should be clarity about what is contained in those reports. The Occupational Pensioners Alliance says that there should be transparency and that their contents should be available to scheme members and their trade unions, and I sympathise with that view. I do not sympathise with the need for what amounts to continuous re-evaluation. We are concerned by the current situation because the stock market has recently crashed, and we forget that pensions are a long-term business extending over many years. We should not therefore be motivated to legislate on the basis of a snapshot.

Clause 200 has already been mentioned. It contains the requirement for trustees to have "knowledge and understanding" of all the issues, which include not only legal matters and pensions legislation but valuation and investment. Leading firms of lawyers say that that is not sustainable, because no individual trustee could be so qualified. That would inevitably lead to the appointment of professional trustees at great expense to schemes, which is not necessary.

The regulator will have powers under clause 64 to define that point more clearly, and should use a light touch. Trustees should, of course, be informed, and anybody who takes on the job of a trustee should be required to acquire a level of knowledge. The regulator will need to specify the sort of knowledge required; I would prefer it if the Minister specified the required knowledge in the Bill. Perhaps the certificate of essential pensions knowledge issued by the Pensions Management Institute would be an appropriate benchmark, but there may be others. I hope that the Minister will move in that direction, otherwise trustees will either be deterred from serving or huge additional costs will be imposed on schemes.

The minimum funding requirement has been mentioned many times today, and its specification in previous legislation is fundamentally flawed. There is a huge emphasis on bonds and bond yields. The hon. Member for Ayr (Sandra Osborne) mentioned Ros

Altmann's views on that point. Ros Altmann is right: one can do many things apart from buying annuities, which are propped up by bonds that are in short supply and that have historically provided grotesquely low yields.

Hon. Members may be interested to know that, if investments were made in, for example, commercial property instead of bonds, the situation would be transformed. A few weeks ago, I attended a seminar run by PricewaterhouseCoopers, which showed the yields in commercial property over the past 12 months, the past five years and the past 30 years. Over those periods, commercial property was much more stable and much less prone to fluctuation than bonds. The average yield on all commercial property over the past 12 months is 10.7 per cent.; over the past 5 years it is 10.6 per cent.; and over the past 30 years it is 12.1 per cent. That is double the yield from bonds and annuities. If the Allied Steel and Wire pensioners' funds were invested in property, there would probably be no need to wind up the scheme because they could be paid out of the income from property.

Those figures refer to the overall yield rather than the net income yield. Even after allowing for inflation, the real income yield is still 7 per cent., which gives one some idea of the need to re-examine the components of the minimum funding requirement. That also shows the need for the Government to pursue the establishment of real estate investment trusts‹I am pleased that they say that they will do so‹that contain unitised property, which gets over the problem of illiquidity that has always bedevilled property investment in the past.

What will the Bill not do? It will not get rid of complexity, as the National Association of Pension Funds and the Association of Consulting Actuaries have said. As other hon. Members have pointed out, it fails to deliver on Pickering. It will not sweep away all the old legislation, as we were promised and which was why I welcomed the Bill when it was first mooted. It will not reform section 67 of the Pensions Act 1995, in relation to the simplification of existing schemes. It still leaves us with retained benefits, annual limits, contracting out, guaranteed minimum pensions and all the other old rubbish that could have been swept away by the Bill. That would save a huge amount of effort and worry for the civil servants who have to administer them and for the scheme trustees. It will not reform tax policy or establish the new priority orders that were discussed earlier. I am pleased to hear that it will abolish the compulsory additional voluntary contribution provisions, which were a bad investment for those who took them up, especially given that alternative investments existed that were less risky, did not involve annuity purchase and would have produced better returns.

The Bill does not make it clear whether the PPF will have any indexation, which is another issue raised by the Occupational Pensioners Alliance. Most importantly, it will not provide an incentive for employers. It is ludicrous to expect employers to do things but provide no incentive for them to do so. The Association of British Insurers has suggested a pensions contribution tax credit for employers, which is the least that the Government could do to encourage employers to provide that facility for their workers. If that does not happen, more and more employers will opt out of defined benefit schemes altogether. If that happens‹if schemes are closed to new employees and employers do not continue schemes‹it will reduce the pool of money from which the PPF can draw. It will be left only with the income from schemes that are in trouble, and that will mean the inevitable doom of the fund. It is in the Government's interest to encourage employers to provide such schemes.

The Bill does not clarify the situation of the PPF. Pensions World says that the Bill may be "too steep". Its costs have clearly been underestimated. For example, Watson Wyatt estimates that the present cost of administration of schemes is £90 a member, but **Professor Blake** says that the PPF will add another £80 per member. I think that that is a conservative estimate. The Government must consider the totality of the cost and then allocate it. The right hon. Member for Birkenhead (Mr. Field) and my right hon. Friend the Member for Hitchin and Harpenden (Mr. Lilley) said that the contributions should be made by the members‹I have some sympathy with that view‹but they should not pay the whole amount. That way lies a moral hazard. We need both the members and the employers to make a contribution, so that the employers can see that they will risk increased premiums unless they behave properly.

How will the regulator assess the schemes? That is not clear in the Bill. Who will make the assessment? It would not be appropriate for the scheme actuary to do so. Will some other external actuary make the assessment? Will civil servants make it? It is vital that we know how the assessment of funding is to be made and on what criteria it will be based. If it is based on the present minimum funding requirement, it will be a total disaster. We need a rethink of the whole basis of the assessment of schemes and their future liability. If Allied Steel and Wire had invested in property, it would have done well and it would not need to go down the pan in the way that is suggested.

The whole basis of assessment is key to the way in which we will view the Bill in the future. At the moment, we have insufficient detail to make an accurate assessment and there are many lost opportunities in the Bill. I hope that that will be corrected in its later stages.

UK's Pension Institute moves from Birkbeck, Daniel Brooksbank, IPE.com 3/Feb/04

The **Pension Institute** under **Professor David Blake** is moving across London, from Birkbeck College to the Cass Business School.

"One of the UK's leading pension fund experts, Professor David Blake, has brought his Pensions Institute to Cass Business School," the school said in a statement.

Professor Anne Sibert, Head of School at Birkbeck's School of Economics, Mathematics and Statistics, declined to comment but confirmed that the college, part of the University of London, would no longer be focusing on pensions.

Cass said the institute - set up in 1996 - is the only UK academic research centre focused on pensions research and that it would fit with its own actuarial scientists, economists and governance experts.

Blake will join Cass as Professor of Pension Economics. He said: "Major problems have been encountered in the past because each discipline regarded itself as seeing the entire pension picture."

"By breaking down the barriers we can find solutions that will benefit and influence policy makers and pension plan designers in the real world."

Citing "international demand", Blake said he plans to set up teaching programmes, including a postgraduate course. The institute would also run vocational courses for the National Association of Pension Funds.

"It's great to see that academics from different disciplines are being brought together under one banner and that there is a genuine commitment to share ideas," said pensions minister Malcolm Wicks. "The formation of centres like the Pensions Institute is vital to developing research and teaching in this area."

Deputy director of the institute will be actuarial scientist Steve Haberman, who is also deputy dean at Cass.

PEOPLE: Professor Blake joins City business school By Ruth Sullivan and Nicholas Timmins, Financial Times; Feb 02, 2004

David Blake, a director of the **Pensions Institute**, will take the title of Professor of Pension Economics at London's Cass Business School in what is claimed to be a UK first in uniting a range of disciplines to tackle pensions.

As greater longevity and the prospect of smaller market returns have brought pensions near to the top of both corporate and individual agendas Professor Blake aims to blend together elements including economics and finance to actuarial, insurance, corporate governance, accounting, law and regulation.

The institute will run vocational courses for the National Association of Pension Funds but also plans both academic research and advice to the pensions industry.

UK funded pensions bill goes to parliament, IPE.com 2/Feb/04

Former social security minister Peter Lilley has introduced a bill to parliament calling for the introduction of a universally funded second pension – though the bill has no chance of success.

Lilley, a minister in the last Conservative government, has introduced a so-called 10-minute rule bill that would require people to save so that they would not depend on means-tested benefits. A 10-minute rule bill is a device to enable MPs to express their views and won't lead to legislation.

Lilley said: "My bill would introduce a universal funded second pension to replace the present, largely unfunded state second pension.

"Everyone would have an individual fund into which they would pay enough throughout their working lives to provide a big enough income in retirement - together with the basic state pension, to enable them to avoid being dependent on means-tested benefits.

He told IPE that his idea has virtually no chance of being taken up as policy unless there is a change of government. But he said there had been interest in his ideas from members of the ruling Labour party and others.

The bill is a condensed version of a pamphlet he produced last year for the Social Market Foundation which took onboard comments from, among others, **Professor David Blake of the Pensions Institute**, Mary Francis of the Association of British Insurers as well as Watson Wyatt's David Harris and Mike Wadsworth and Mercer's Tim Keogh.

"Currently we compel prudent people who voluntarily save enough for their own future to pay again through tax to support the less provident who do not save enough and rely on benefits," Lilley said.

"The result of my proposal is that everyone would own their own pension fund which would give people choices and incentives.

"Once people have their own pension fund and know that their minimum contributions will lift them above the means-tested level, they will find it far easier and have every incentive to put in additional savings and save more than that basic minimum.

"My Bill will not only ensure that everyone would have a comfortable and dignified retirement, but would bring about the largest extension of wealth ownership this country has known since the spread of home ownership."

Pensionsvorsorge: Schlechte Fondsmanager bleiben schlecht

(Die Presse) 13.11.2003

Wüsste man mehr über das Risiko von Pensionsfonds, könnte man besser die guten von den schlechte Fondsmanagern unterscheiden.

http://www.diepresse.com/Artikel.aspx?channel=e&ressort=psn&id=387983

WIEN (mip). Risiko - ein bislang sträflich unterbelichtetes Kriterium, wenn es um langfristige Geldanlage zum Zweck der Eigenvorsorge geht. Diese Ansicht vertritt **David Blake**, Leiter des Pensions Institute des renommierten Birkbeck College der Universität London. So kritisierte Blake etwa im Gespräch mit der "Presse" die Verpflichtung bei der österreichischen Zukunftsvorsorge, mindestens 40 Prozent in heimische Aktien anzulegen: Man sollte am besten Risiko durch weltweite Diversifizierung streuen. Den Löwenanteil seines Geldes in ausgerechnet jene Volkswirtschaft zu investieren, deren demografischer Umbruch das staatliche Pensionssystem wackeln lasse, bedeute sein Risiko zu verdoppeln. Einschränkungen bei der Veranlagung seien "keine gute Idee", meint Blake. Er verstehe aber, dass mit solchen Maßnahmen ein Kapitalabfluss aus einer ohnehin gefährdeten Volkswirtschaft verhindert werden soll.

Blake hat kürzlich für das britische Finanzministerium eine Studie erarbeitet, aus der hervorgeht, wie wichtig Risikoangaben für langfristige Veranlagung wären: Vergleicht man die Wertentwicklung von Pensionsfonds nämlich auf der Basis des jeweils eingegangenen Risikos, so zeigt sich, dass schlechte Leistungen die Tendenz haben, sich zu wiederholen. Mit anderen Worten: Durch einen risikobereinigten Performance-Vergleich könnten schlechte Fondsmanager leichter erkannt werden. Leider sei aber etwa in Großbritannien noch immer nicht eine Angabe des Risikos in international üblichen Messzahlen Pflicht.

Blake führt das Phänomen kontinuierlich schlechter Fondsmanager darauf zurück, dass diese Leute psychologische Probleme hätten, sich Verluste einzugestehen und Wertpapiere zu verkaufen, wenn deren Kurs unter dem Einstandspreis gefallen sei.

Blakes Anlegertipp: "Fonds werden von Menschen geführt und von Firmen verkauft." Daher aufpassen, ob ein Pensionsfonds kürzlich mit einem anderen zusammengelegt wurde - denn Fondsgesellschaften verstecken schlechte Fonds gerne durch Fusion mit guten. Und aufpassen, ob eine Gesellschaft schnell gewachsen sei und daher vielleicht beim Personal Abstriche machen musste - gute neue Fondsmanager seien nämlich schwer zu bekommen.

David Blake ist einer der Vortragenden beim Fachsymposium "Capital Market Based Pension Systems", das das Gutmann Center of Competence der Universität Wien in Kooperation mit der "Presse" am 1. Dezember in Wien veranstaltet. Informationen: www.gutmann-center.

Bad Fund Managers Remain Bad, by Michael Prüller, "Die Presse" (Austria), 13. Nov.2003

If one would know more about the risk in pension funds, then one could differentiate between good and fund managers.

Risk – a hitherto significantly under examined aspect, when considering long-term investment for your own retirement. This is the opinion of **David Blake**, director of the Pension Institute of the respected Birkbeck College at the University of London. Speaking to Die Presse, Blake criticised the obligation of having to invest 40% in to domestic equities within the Austrian private pension plan: risk should be spread through global diversification. Investing the lion’s share of your fortune exactly into the economy, whose demographic change is causing the state pension provision to teeter on the edge, means doubling your risk. A limitation regarding the size of the investment universe is “no good idea”, said Blake. On the other hand, he said he understood that the intention of such rules is to limit capital flight from already weakening economies.

Blake recently conducted a study for the British Ministry of Finance, which shows the importance of adequate risk reporting for long-term investment decisions: when comparing risk adjusted performance of pension funds, then the conclusion is that bad performance is persistent. This means that by virtue of a risk-adjusted performance comparison bad fund managers can be more easily identified. Sadly, disclosure of internationally accepted risk measures in many countries is not yet written into law, e.g. in Great Britain.

Blake explains the phenomenon of continuously underperforming fund managers by the tendency of some people to have psychological problems in accepting/realising losses, when the value of securities has fallen below the buying price.

Blake’s advice: “Funds are managed by humans and are sold by for-profit companies.” Therefore, take heed whether a fund has recently been merged with another, as fund management companies like to hide underperforming funds inside outperforming ones. Furthermore, take notice if the company has grown very quickly, as they may be understaffed, because good fund managers are hard to come by.

David Blake is a keynote speaker at the symposium “Capital Market Based Pension Systems”, organized by the Gutmann Center of Competence at the University of Vienna, which is presented on December 1st in cooperation with “Die Presse”.

Infos: www.gutmann-center.at

Asset Class, by Alen Mattich, DOW JONES NEWSWIRES, LONDON, 14 November 2003

There's probably not much scientific rigor to how it's being done, but the pensions industry is making a slow fist of weaning itself off an absolute dependence on the equities market.

But, asks an academic, should it be?

Professor **David Blake**, head of the Pensions Institute at Birkbeck College, decries recently fashionable calls for pension funds to load up on alternative investment classes - particularly hedge funds - or, in a swing to the other extreme, to sell up their equities in favor of bonds.

He's swimming against the tide.

In their latest biennial report on alternative assets, published this week, Goldman Sachs and Russell Investment Group show that, on average, the biggest institutional investors expect to increase the proportion they've got invested in alternatives - which range from private equity, hedge funds and real estate to exotica like timber - during the coming two years.

Among these, the bulk of investment takes the form of private equity in the U.S. and real estate in Europe, but hedge funds are making big strides.

For instance, while it's true that only 21% of European institutional investors have hedge-fund investments, that's up from 15% two years ago. And another 29% say they expect to be invested in 2005.

Private equity has done pretty badly since the bubble burst in 2000. But, overall, institutional interest in alternative asset classes like hedge funds has been reflected in the column miles written on the subject during the past couple of years.

Why?

The stock market crash made big funds think again about the principles on which they were investing. Twenty years of equity bull markets made many forget the risk in risk capital.

Relative returns were no longer very appetizing when that meant losing "just" 15% rather than losing the average 20% of assets in a year.

"Investors are looking for positive absolute rates of returns," says Hal Strong at Russell and one of the study's authors.

"The nature of the downturn made people focus more in terms of investment strategy. Diversification is a big part," says Nigel O'Sullivan, in Goldman Sachs' pensions group.

He added that pension fund trustees had started to look for "uncorrelated alpha" - in other words, fund managers who outperform the markets they operate in across a variety of markets that didn't move in tandem. Somewhere in their portfolio, the trustees would have appreciating assets, even if others were declining.

There's a set of rich and highly mathematical theories about how funds should be invested. They take into account how benefits have to be paid out, the risks and returns the investments carry and how these risks are correlated.

But how that theory is modeled and applied is another matter.

For instance, Nick Horsfall, a senior investment consultant at Watson Wyatt, argues that pension funds should shift 50% of their equity holdings into alternative asset classes in equal tranches - hedge funds, property, currency overlay, private equity and other such exotica. It might be an unscientific approach, but it gives investors diversification.

Another school of thought is diametrically opposed to the thinking at pension fund consultancies like Wyatt, whose investment advice is still broadly based around equity and equity-like products. The thinking among these "radical actuaries" - as Birkbeck's Blake calls them - is a swing entirely away from equities.

Their argument for an exact matching of pension liabilities - in other words a 100% portfolio in bonds - was, famously, enough to sway Boots' pension fund trustees into dumping their entire holding of equities and to go fully into bonds at the top of the boom in 2000. A good call, if lucky.

But Blake says bonds aren't the answer. And alternatives aren't either.

It's fine for growth funds - like endowments or foundations - to have heavy weightings in products like hedge funds and private equity, but not for pension funds, he says.

Similarly, bonds might match liabilities to assets, but they offer little scope for fine-tuning how those liabilities might change - say through changes in mortality rates. Worse still, they're at risk from inflation.

The best way for pension funds to maximize benefits for their beneficiaries, he says, is to grow with the economy in general. And the best proxy for that general growth is through the equity market. The rest is either too limited or at best just offers peripheral returns.

For instance, among hedge funds, by far the most popular strategy is long-short equity. But this class of investing is just an attempt to arbitrage market mispricing. On that basis, it makes sense for the very big pension funds to have a couple of percent in hedge funds - reflecting the amount of mispricing there is in the market - but no more, Blake says.

"There's nothing wrong with including zero-correlated assets in your portfolio. That's a good idea. But these (hedge funds) aren't magical assets," he says.

The real problem is that equities are the scapegoat for not very sensible corporate policy during the past decade. Rather than continuing to put money into their corporate funds during the market's rapid rises, companies took pension holidays. The crisis of the past couple of years reflects that "jam today" attitude.

There's no doubt that fashion determines a lot of investment thinking. Pension funds, like provincial outposts and discount retailers, tend not to be at the cutting edge - they're the sort who discovered disco in the early

1980s.

Which means that if there are gains to be made from swings into new styles, somebody else will have made them. Maybe pension funds should stick to something that worked for more than 20 years and merely had a bad three.

(Alen Mattich has been writing Asset Class since its inception in 2002, having been a financial journalist for nearly 15 years, the past seven with Dow Jones Newswires. He can be reached at 44-20-7842-9286 or by e-mail: alen.mattich@dowjones.com)

FT MONEY - COMMENT: 'Fund managers do a lot of window dressing', Alexander Jolliffe, Financial Times, Aug 02, 2003

David Blake has no time for fund managers. A professor of financial economics at Birkbeck College, London, he believes fund management groups mislead investors, urging them to invest without giving them the full picture.

Prof Blake, who co-wrote research into the past performance of funds this year for the Financial Services Authority, the City regulator, believes that "raw" unadjusted data about funds' performance is irrelevant to investors.

For example, a fund could have done well simply because its manager bought risky investments that happened to generate high returns through luck, not the manager's skill. "Fund managers do a lot of window dressing," he says. "All the studies in the US and UK - which have the longest histories of mutual funds - show that raw data have no value."

But worse than that, he says, is the fact that fund management groups advertise just a handful of their funds - the ones that do well. If you believed them, you would think that all their managers were above- average, which of course is impossible.

"Fund managers are like the parents of children at a school," says Prof Blake. "They all say their children are above average. You can't have a roomful of above-average kids, any more than you can have a room of above-average fund managers."

Prof Blake compares fund advertisements with a dubious practice in the US in which people mislead investors into paying for share tips.

This US practice has several stages. First, the organisers write to 10,000 people, telling half of them that a particular share price will rise in the next week, and the other half that it will fall.

If the share price rises, the organisers write to the 5,000 people who were told that it would go up. They tell half that the stock will rise again, and the other half that it will fall. They repeat this process numerous times, and after a month have a small group of investors who have repeatedly been given the right forecast.

At this stage, the organisers write to this small group, offering to sell them share tips for $100. Prof Blake explains: "The people say: 'They got it right four times in a row, so I'll pay.' But it's a pure scam."

Blake says this is analogous with fund management groups, because they set up, say, 20 funds but only promote the ones that succeed. Just as the US operators did not tell their ultimate target investors that many others had been given inaccurate forecasts, so fund management groups rarely tell customers about mediocre or bad funds. "It's not providing consumers with the full range of information," comments Prof Blake.

One step towards informing investors fully would be to publish on the internet adjusted figures about funds' past performance, which would take into account the risks managers ran with their customers' money.

"That would help to identify poor fund managers and deprive them of new money. It would force them to do something useful, like teach in a university, because they can't pick stocks," jokes the professor. But investors who do inform themselves thoroughly will find research* showing that funds that continue to perform well do so only for four years. And finding the genuinely talented fund managers would not be quick: "One of the costs I would incur from active fund management is my time - it would take me hours to search for a good fund manager."

So he says consumers who do not want to switch from one fund to another every few years - paying the associated charges - should buy trackers, which rise or fall in line with equity indices. He believes that investors with limited time cannot beat the market because they are competing with professionals who spend their working lives investing and are likely to get valuable information,and trade on it, before the part-timer. "If there are market opportunities, the professionals will have made their money a long time before you do."

He recognises that trackers have of course followed equities down during the bear market. Indeed, his mother, who keeps her money in a building society account because she wants to avoid losing money, has outperformed him: "My mother's investment strategy has beaten mine by a million miles." But he adds that his funds prospered in the three years to 2000, when share prices were rising.

More generally, Prof Blake says it can be hard to hold asset managers to account because investors must wait years before the quality of their funds becomes clear. "It is easy to be a bad product provider because once you have sold a product, you won't be beholden to the customers for years, maybe until they retire. The value of the product isn't clear as soon as it is with a car."

Even investors who are ready to take an active approach to investing should beware of thinking they can beat the market. Prof Blake suspects that, even if they hire talented advisers who can spot undervalued or overvalued shares, their charges will outweigh any benefits. "Are you as an average investor going to be able to exploit market inefficiencies?" he asks. "No, because your adviser will charge you high fees."

Nor do the financial advisers who distribute funds to private investors escape his criticism. If they understood the fundamentals of investment, they would not push active funds. "If they had a training in modern finance theory, they wouldn't start off by proposing to actively manage money. Your starting point would be a well diversified fund, set up at the lowest cost."

This lack of rigorous training leads financial advisers to focus on products, instead of advising clients about the underlying assets that will generate returns and determine their financial security in old age. "We are obsessed with talking about unit trusts, investment trusts, or life policies, instead of asset allocation."

*Is Money Really 'Smart?' Russ Wermers, University of Maryland. www.rhsmith.umd.edu/finance/ rwermers/persist.pdf

COMMENT & ANALYSIS: The hunt for yield hots up: investors and pension funds plunge deeper into illiquid and riskier assets, Vincent Boland and Ed Crooks, Financial Times, July 22, 2003

On Wall Street, it is bad manners to use the term "junk bond" in the presence of an investment banker. Such securities are known in polite society as "high-yield bonds".

Nowadays, however, that term is becoming something of a misnomer. Today's "high-yield bonds" generate about as much income as bank savings products did in the days when Michael Milken was pioneering the use of scorned non-investment-grade bonds in the 1980s. Some analysts suspect that the word "junk" is in need of a revival.

To be sure, the cutting of bank interest rates to their lowest levels for many decades has done a great deal of good. It has supported consumer spending by encouraging, among other things, a stampede by US mortgage holders to refinance. It has helped companies to work through the massive overhang of debt left by the boom in investment - much of it ultimately worthless - that took place during the late 1990s. And it has kept the financial system running smoothly, enabling banks to make in some cases record profits.

But low interest rates have perverse effects, as well. They create problems for investors looking for income, leading to some questionable investment decisions. If things go wrong, investors may discover that cheap money carries a high cost.

"We're in a world we haven't seen before," says Eugene Flood, chief executive of Smith Breeden Associates, which manages $26bn in assets in Chapel Hill, North Carolina. "The economy has changed a lot, the world has changed a lot and we don't really know what to expect."

Nominal interest rates, both short-term and long-term, have been on a downward trend worldwide ince the end of the "great inflation" of the 1970s. But when Alan Greenspan, chairman of the US Federal Reserve, told Congress last week that the US central bank would keep rates low "for as long as it takes" to build up a head of steam in the economy, he opened up the prospect that US short-term interest rates at 1 per cent - and possibly lower - are here indefinitely.

The impact of low short-term interest rates is reinforced by the decline in long-term rates, prompted by fears of deflation and markets' confidence that the Fed and other central banks will maintain a loose monetary policy. Last month the yield on 10-year US Treasury bonds fell to just above 3 per cent. It has since risen sharply, to more than 4 per cent in recent trading. But it is still well below the level of about 5 per cent at the beginning of last year and more than 6.5 per cent at the beginning of 2000.

For many investors, such an environment, coming after a painful three-year stock market correction, is most unwelcome. "We're all suffering," says Clare Hushbeck, an economist at the American Association of Retired People. But, she adds, the elderly and retired are worst hit, given that they are often encouraged to keep their money invested in bonds and money market instruments. "It's a tremendously urgent and difficult situation for them, and I think a lot of people are caught in it."

Pension funds and other investment funds are caught too. Having assumed that inflation and interest rates would remain high, they have been struggling to meet their commitments to deliver a stream of returns. "An unanticipated deflation like the one we've had is great for investors who have secured those fixed nominal returns but bad news for anyone who has made those promises," says **Professor David Blake, of Birkbeck College, London.**

In Europe and Asia, many life assurance companies have guaranteed minimum nominal returns on savings policies.

In the US, low interest rates have contributed to the swing in pension funds from being sbstantially overfunded during the bull market to being seriously underfunded today. At the end of 1999, pension funds for companies in the Standard & Poor's 500 were running a surplus of about $300bn. In June this year, they were running a deficit of about $300bn, according to Morgan Stanley.

Michael Peskin, global head of the asset-liability strategy group at Morgan Stanley, estimates that about half of the change reflects declines in equity prices. The rest can be attributed to the impact of lower interest rates on fixed-income securities. When pension funds buy bonds for the income, they need more assets to meet any given level of liabilities.

"You would need a huge bump-up in interest rates plus a very large equity return to get us back to the funded status of late 2002," Mr Peskin says.

With little sign of any such recovery, investors are engaged in what has become known as the "hunt for yield". Whether individuals worried about meagre returns in low-risk vehicles or fund managers trying better to match their assets to their obligations, the aim is to lock in higher yields.

US investors have been pouring tens of billions of dollars into mutual funds that buy high-yield bonds, for example, and this year the flows have picked up dramatically. By the end of April, roughly $16bn had already flowed into high-yield mutual bond funds this year - more than during the whole of last year.

That trend is being replicated worldwide, if not quite on the same scale. In Hong Kong, one fund manager says the city's notoriously aggressive investors are using high-yield bond funds as bank-account substitutes.

One consequence of the hunt for yield is that credit spreads for riskier assets have been squeezed. Merrill Lynch's benchmark spread for US BBB-rated corporate borrowers over Treasury bonds is currently 2 per cent, down from 4 per cent last year. The yield on its composite global high-yield measure is just over 9 per cent, down from a peak of more than 14 per cent a year ago. And the interest ratespread for emerging market bonds over US Treasuries, as measured by JP Morgan Chase's EMBI+ index, is down from 10 percentage points last October to a little over 5 percentage points today.

Another sign of the times is the desire of hedge funds to refinance loans originally extended by banks to merchant energy companies, many of which ran into trouble after the collapse of Enron. Lured by the promise of higher fixed returns, the hedge funds helped the banks to clean up the companies' balance sheets and kept an entire sector functioning at a time when many analysts worried about its future.

A third, related feature is the willingness of pension funds and insurers to sacrifice liquidity in return for higher yields. With the benefit of hindsight, many pension funds feel they were overly concerned with holding liquid investments during the stock market boom that ended in early 2000. Now they are so desperate for a high yield that they are putting money into hedge funds, property, mezzanine funds and other alternative assets, knowing they may have to hold these investments for considerable period of time.

Robert Hormats, vice-chairman of Goldman Sachs International, says: "They are saying we don't need 100 per cent liquidity. We can give up liquidity for 10 or 15 per cent of our assets for a longer-term, higher yield."

The key to this strategy is that pension funds do not need the money right away, or even in the next few years. "They are more natural holders," says Mr Peskin of Morgan Stanley. "There is more acceptance of liquidity risk."

To be sure, these features of the hunt for yield - the fall in market interest rates and the flow of liquidity to the marginal borrowers who need it - are exactly the results that the Fed and the other central banks hoped for when they cut lending rates. "In a nutshell, this type of backdrop is exactly what central banks do to encourage investors to assume more risk," says Jack Malvey, chief global fixed income strategist at Lehman Brothers. "The credit mrkets have led us to a global economic recovery."

The Basel-based Bank for International Settlements, the forum for the world's central banks, last month described the squeeze on credit spreads as a "surprising but welcome" result of "unprecedented behaviour among ordinarily conservative investors ... [who have] increasingly developed an appetite for riskier bonds as a way to obtain higher yields".

That appetite is not without danger, however. The search for higher nominal yields may lead investors to expose themselves to greater risks than they realise. Regulators are concerned about the potential fallout, both for individuals and for the financial system.

Britain's Financial Services Authority worries that many investors are suffering from "money illusion": the failure to understand that, because of falling inflation, a nominal return that seems low today could represent a better real return than a much higher nominal rate did a decade or two ago.

"Any investment that today is offering a return of 7 or 8 per cent . . . the amount of risk involved in that will be substantial, whereas several years back it would have been a low-risk product," says Dan Waters, head of the FSA's risk assessment section. "We have a general concern about consumers' understanding of risk."

More broadly, if financial institutions are taking greater risks than they are used to, they may not be properly prepared for what happens if those risks turn bad. A new emerging market crisis or a big corporate default could swiftly puncture what many analysts see as bubbles in the markets for those bonds. Surrendering liquidity for yield could then seem a lot less attractive, if it becomes impossible to escape from assets whose values are plunging.

The last time emerging market bond spreads were squeezed down to such low levels was in the mid-1990s, before the Asian financial crisis: a less than cheering parallel.

The fundamental problem is that investors are still in a state of uncertainty. If interest rates sty low for long enough, investors will adjust to the new environment. We may once again get used to the levels of return last seen in the 1940s and 1950s, and regard the intervening years of high nominal returns as the oddities.

"For 10 or 15 years in the 1940s and 1950s there was a period of very low returns and low interest rates," notes James Paulsen, chief investment strategist at Wells Capital Management, which has $114bn under management in Minneapolis. "If the market was giving us 1 per cent, then inflation was at 1 per cent and the mortgage was 2 per cent. If you talk to Grandpa, these returns [today] are pretty good. And if you stay at these levels for a while, it doesn't seem so frightening any more."

The problems of low interest rates will turn out to be mostly the troubles of transition, caused by individuals and institutions holding beliefs and making promises that would have been sensible in the old world but are inappropriate in the new.

The trouble is that no one can yet be sure whether we are returning to a world that will be something like the 1990s, when the monthly average federal funds rate never went above 7 per cent, or one in which it stays close to the low levels we are seeing today.

If Mr Greenspan and his fellow central bankers are right that deflation can be avoided, and the recovery remains on track, short-term rates will start to rise. The first increase from the Fed, after such a sustained campaign of cuts, will be a seismic event.

After the Fed began raising rates in 1994, signalling that it was no longer fighting the recession of the early 1990s, the reversal was rapid, taking the Federal funds rate up by 1.25 percentage points between February and March. It caused mayhem in stock and bond markets. Next time, investors may have no sooner grown accustomed to the low-rate world than they find it crumbling around them.

As AARP's Ms Hushbeck says: "There will come a time when interest rates will head up with a vengeance again. I don't think we want to wish tht on ourselves, either."

One of the most striking features of the low-interest-rate era has been the extraordinary forebearance of the government bond markets in the face of some startling fiscal blow-outs.

President George W. Bush, under the influence of ideas similar to ones his father dismissed as "voodoo economics", has helped create an expected budget deficit of $455bn - or 4.2 per cent of gross domestic product - for the US this year.

Europe's fiscal discipline has become a standing joke. Germany, once the strongest defender of the rules, is on course to breach borrowing limits for a third successive year.

And Japan's government, which has borrowed an average of 6.7 per cent of GDP each year for the past five, now has a budget deficit approaching 8 per cent.

Yet the interest rates demanded by investors for supporting these profligate governments have been dropping. The latest setback in US Treasury bonds has had little or nothing to do with fears of oversupply; instead, it is being driven by the market's shifting views on Alan Greenspan's beliefs about deflation.

Even after their recent reversal, US Treasuries, German bonds and Japanese government bonds are all yielding less now than they did last year.

For borrowing governments, this forgiving attitude has been a great blessing. Although fiscal positions are deteriorating fast, the cost of debt service is still very low by historical standards.

The US, for example, will next year have net government financial liabilities of about 48.9 per cent of GDP, according to the Organisation for Economic Co-operation and Development. That is roughly the same as the scale of the US national debt in 1989; but the cost of interest on that debt is expected to be 1.9 per cent of GDP, compared with 3.4 per cent 14 years ago.

Similarly, Britain's net debt was roughly 30 per cent of GDP in 1987, as it is today, but the cost of servicing it has fallen from 3.3 per cent to 1.5 per cent of GDP. Japan, which has doubled its national debt since1989, is paying less in interest as a proportion of GDP.

In recent weeks, however, suspicions have grown that investors' patience is limited. The recent fall in bond prices, some economists believe, may be just the beginning.

Government bond rates have been falling until now, in spite of the expansion of supply, for three main reasons: short-term rates are very low; inflation is low and expected to stay low; and developed countries' governments have generally adopted fiscal policies to reassure investors that temporarily rising deficits will not be put on explosive trajectories.

Of those three factors, inflation has been quiescent for a decade and is likely to remain so, although fears of deflation will fade as the global recovery gathers pace. Markets believe short-term interest rates are likely to pick up next year. And governments' commitment to fiscal discipline is considerably less convincing now than it was three years ago.

Worries about rising budget deficits have until now been outweighed by the other factors; that need not remain the case for ever.

Japan's example shows that whenever it seems that bond yields cannot fall any further, they discover some new depths to plumb. But Japan has been through a decade of deflation - an experience that the US and Europe fervently hope to avoid.

The governments all talk a good game about how their deficits are merely temporary reflections of the economic slowdown and how they are committed to borrowing less.

Last week, for example, John Snow, the US Treasury secretary, described the US deficit as "worrisome", adding that he did not want the markets to get the idea the US administration was unconcerned about the deficit.

His worries seem well placed. Soaring government borrowing currently looks like one of the most likely threats that could drive interest rates back up again.

"It is not an immediate threat but there is a precedent in 1994-95, when there was a very strong upswing in long-term interest rates in the US," says Jean-Pilippe Cotis, chief economist of the Organisation for Economic Co-operation and Development. "It was extremely contagious in Europe and it did a lot of damage to the recovery."

The law of averages

Jul 3rd 2003

From The Economist print edition

By definition, not everybody can beat the index. Should fund managers try?

FOR most of the past century, stocks and bonds were only for the rich. Then came mutual funds. These allowed ordinary people to pool their resources with those of other small investors, which gave them access to professional fund managers and allowed them to diversify among different stocks. Mutual funds grew explosively during the 1990s, with total assets in America expanding from $1 trillion in 1990 to $7 trillion in 2000. In Britain, investment in unit trusts, the local equivalent of mutual funds, increased from £46 billion in 1990 to £261 billion in 2000.

More than any other financial product, these vehicles have brought shareholder capitalism to the masses. American investors now have over 8,200 mutual funds to choose from, and British ones about 2,000. Half the households in America have money in one or more. Savers in continental Europe, who traditionally kept their money in banks, started buying mutual funds in earnest about ten years ago.

Choosing a mutual fund is one of the most important financial decisions that an individual can make. Over a period of time, the difference between getting a 3% or a 5% annual return from a mutual fund becomes enormous. Sadly, most of what the fund-management industry calls retail investors are quite bad at finding suitable homes for their money. Consider some of the principles of behavioural finance, which studies the way people make financial decisions. To start with, investors are over-confident, and think that they are better at making choices than they really are. They believe in winning streaks and are impressed by short-term success. They confuse familiarity with real knowledge, and over-react to both good and bad news. Worse, most of them are trapped in a cycle of fear and greed. When the market goes up, they are desperate to rake in more than their neighbours. When it falls, they become convinced that it will never recover.

These traits were much in evidence during the 1990s. Greed led people to switch frequently between mutual funds, always seeking out the latest top performer. But that proved to be a mistake, because the hot funds quickly stopped outperforming the rest. Between 1984 and 2002, the return on Standard & Poor's 500 index was 12.9% a year, according to DALBAR, a mutual-fund research firm. Over the same period the average equity mutual fund returned 9.6% a year, calculates John Bogle, the founder of Vanguard, a low-cost mutual-fund company; but the individual investor in equity mutual funds got an annual return of only 2.7%, because of switching. To give an idea of what those numbers mean, $10,000 invested in the S&P 500 in 1984-2002 would have grown to $89,000, but the average mutual-fund investor's $10,000 would have grown to just $16,200. The mutual-fund business may claim to be free of scandal, but, asks Mr Bogle: “Isn't that at least a minor one?”

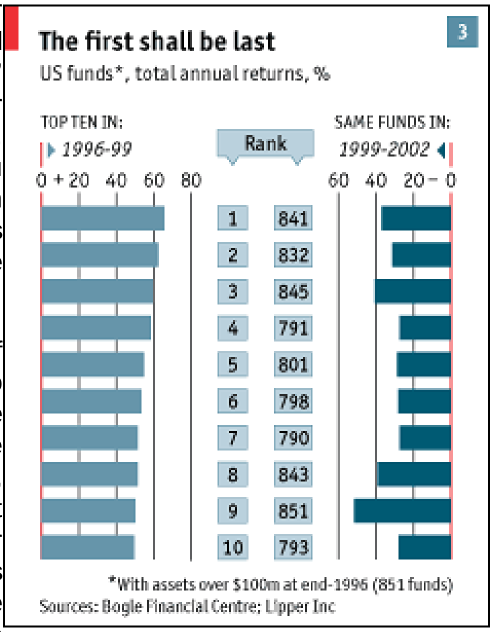
If there is a scandal in the fund-management business, as some people believe, it is of a subtle kind. As the fund-management business grew, it concentrated increasingly on relative performance. Although the law of averages means that only some people can beat the market—the market being simply the sum of everybody's investment decisions—most fund managers sell the idea that they can outperform the rest. The financial media benefit too, because they get money from advertising and free content from portfolio managers talking about their stock-picks. In a book published last year, “The Great Mutual Fund Trap”, Gregory Baer and Gary Gensler imagine a television interview with a fund manager:

In the real world, few fund managers are subjected to this kind of interview. Indeed, some American financial publications told Messrs Baer and Gensler that they would not write about their book, which argues that Americans are needlessly paying billions to the mutual-fund and brokerage industries. “If it's all a matter of chance,” one journalist explained, “why would anyone read my column?”

In return for the promise to outperform, which mostly turns out to be false, active managers earn a generous fee. Most fund managers actively try to beat indices. Passive managers who simply track the market have captured only a small portion of retail investors' assets. Undoubtedly, a few active managers do beat the market, and these are worth paying for. The impossible part is knowing which ones will pull it off.

Most fund managers try to convince investors that they will outperform the market by boasting about how well they have done in the past. This seems reasonable enough: in most areas of endeavour, human beings are judged on their track record. But fund managers themselves know quite well that in their industry past performance is no guide to the future. The head of one of the world's biggest mutual-fund companies argues privately that past performance is not only a false guide but if anything a contrary sign. However, few managers would say as much in public, because it would undermine the way in which the industry sells its products.

Numerous empirical studies have confirmed that strong performance by a fund manager seldom lasts. Napoleon is said to have asked his generals before battle: “Are you lucky?” For fund managers, too, much of their performance comes down to luck, not skill, and the luck rarely lasts (see chart 3). If you look at the top-performing fund managers in most asset classes in a recent period, says Roger Urwin of Watson Wyatt, four out of five will be there by chance rather than pure skill.



A fund manager can use a short period of strong returns to suck in lots of new assets to manage, but that can make it even more difficult for him to outperform his peers. The larger the value of a trade in the stockmarket, the more likely he is to move the market against his fund and his investors. The bigger the fund gets, therefore, the worse its performance is likely to be. There is evidence of some correlation between past and future performance, but it is not of a kind to please investors. In a recent study by Britain's Financial Services Authority, two economists, **David Blake** and **Allan Timmermann**, found that poor fund managers underperform consistently.

You let us down

Retail investors have lost a lot of money in the past three years, and many of them have called a halt. In America, they pulled $48 billion out of equity mutual funds between June 2002 and April 2003. In continental Europe too they are shifting some of their investments elsewhere. Only in Britain are investors continuing to put more money into such funds than they are pulling out. Much of the money that has been withdrawn has gone into bonds or into the bank. Mutual-fund companies such as Janus and Putnam that sold high-risk technology-stock funds have seen the sharpest falls in their assets.

Some fund managers were unscrupulous in the way they sold their funds. Invesco, an investment bank with a fund-management arm based in London, marketed a fund called the Invesco Perpetual European Growth Fund as a diversified European equity fund. The fund pulled in the most money of any fund in Britain in 2000. Many of the stocks in it were listed on the *Neuer Markt*, the German technology stockmarket which was shut down last year. "It turned out to be a technology fund in drag," says a fund-management analyst in London. The fund has fallen by 65% since September 2000.

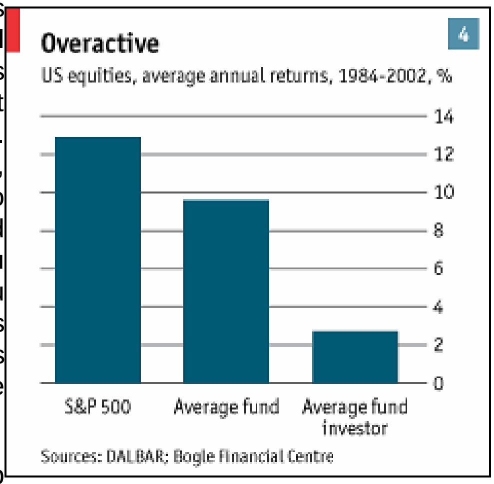
The industry as a whole has done a poor job for investors, says Huw van Steenis, an analyst at Morgan Stanley in London, because it has concentrated too much on selling. In future it needs to give people products that are suitable for their needs, which mostly involves avoiding excessive risks. Some fund managers are privately contrite. "We didn't properly explain risk to the client," says Hendrik du Toit, chief executive of Investec Asset Management, an Anglo-South African fund-management company. If the industry does not remember its purpose, he says, which is giving ordinary people a dignified retirement and making sure that the rich hold on to their money, its clients will desert it. In the 1990s, says Kevin Parke, president of MFS, America's tenth-largest and oldest mutual-fund company, based in Boston, some people in the fund-management industry forgot that they are fiduciaries, and that the money they manage is not their own. When a portfolio manager at MFS in Boston says, "I own Intel", or refers to "my fund", he reminds them that the money actually belongs to the client.

But retail investors have as yet made little complaint. In fact, says Mr Ellis of Greenwich Associates, it is remarkable that companies such as Janus and Putnam could have behaved as they did without provoking more capital flight. It was only in the fourth quarter of 2001, about 14 months after the American stockmarket started falling, that people began to take their money out of equity mutual funds. It seems that in matters of investment, people are slow and forgiving, says Mr Ellis.

All the investors' fault

It can be argued that during the bull market fund managers did nothing more sinister than meet investors' demands. Simon Davies, chief executive of London-based Threadneedle, caused a stir recently by seeming to suggest that investors should blame their losses on themselves and their greed, not on the fund-management business. He has since softened his tone, but most asset-management bosses would agree with the original interpretation. Because fund management is a fixed-cost business, says Mr Davies, volume is the holy grail, and there is a huge temptation to offer the latest hot product. Some houses warred internally in the 1990s over whether to stick to their investing principles—which include not buying ridiculously overvalued stocks—or to go with the flow and launch technology funds. Fidelity's former chief investment officer, Robert Pozen, resolutely refused to start an internet fund in 1999, thus helping the firm to keep its conservative and reliable image.

At cocktail parties, says Mr Parke, friends would boast to him that their own personal portfolios had done better than his professionally managed funds. “Why aren't any of your funds up 100%?” they would ask. To stay true to their investing discipline, growth managers such as MFS were forced to own overvalued stocks. “The more you worked on analysing the numbers, the worse you performed,” Mr Parke says, “and the more you thought about what you owned in your funds the worse you felt.” Now that the market has returned to its senses, Mr Parke says he enjoys being a fund manager again.



Will the fund-management business keep offering people what they think they want, even when it knows that it is bad for them, or will it behave more responsibly in future? Certainly, fund managers are unlikely to tell their customers one basic truth—that they would be better off if they put more money into passive funds and stopped chasing big active returns. In the ten years to 1999, index funds returned an annual average of 14.7% to their investors and the S&P 500 gave 12.4%, according to Morningstar, a fund-tracking company based in Chicago, whereas actively managed funds returned 10.9%. Those numbers do not take into account the negative effects of switching. Between 1984 and 2002, according to DALBAR's numbers, passive investors got about 13% a year, compared with 2.7% for those who put their money with active fund managers. Not all money can be passive, of course, because if it were, no one would be making intelligent decisions about which companies deserve capital. But at present there is plenty of room for more.

The passive pursuit of profits

If anyone were able to find active managers who could beat the market year in, year out, it would be institutional investors, ie, pension funds and insurance firms. After all, they have teams of people to work on the problem. But the professionals put more money in passive funds and less in active than do retail investors. In America, institutions have 25% of their money in index-trackers, against 12% for individual investors. In Britain the numbers are 20% and 10%, and in continental Europe 5% and 2%. “We all know that on average we don't beat the benchmark,” says a fund manager at a large Swiss bank, “but active management has been our bread and butter.” People fall in love with companies whose products they buy, he says—and they don't want “all the shit in an index”. Yet they may not fully understand the cost of active fund management.

For the moment, the fund-management business is busy devising products to sell in a bear market. So-called stable-value and principal-protection funds are all the rage.

These offer investors part of the return from the stockmarket, or from other asset classes, as well as guaranteeing to give back at least the nominal capital the punters have put in. According to Lipper, an American fund-tracking company, assets in stable-value funds have risen from $264m to $3.3 billion since the beginning of the bear market, and money in principal-protection funds has grown from $724m to $5.6 billion. They do not come cheap; an investor can pay up to 5.75% of the initial investment in what is known as an “up-front load”.

Some fund managers suspect that rushing out with capital-protection products is not much different from pushing out a new technology fund regardless of whether or not it will make money for customers. Investors could get the same combination of capital protection and investment return more cheaply using simple asset allocation, says Edward Bonham Carter, joint group chief executive of Jupiter Asset Management in London. MFS has decided not to launch principal-protected products, says Mr Parke, who considers the willingness to say no to certain products a strategic strength. The National Association of Securities Dealers has given warning of principal-protection funds' high fees, long mandatory holding periods and possibly low long-term capital gains.

Steven Niemczyk, an investment banker at Morgan Stanley in New York, sees no evidence that retail investors are overtly unhappy with the industry, but he says there could be a latent demand for a better product. People were quite happy buying gas-guzzling American cars in the 1970s, he points out, until Japanese manufacturers offered a superior product. Mr Niemczyk dreams about a new fund-management product customised to the needs of individual clients. It would use sophisticated computer techniques now available to give better risk-adjusted returns. A fund manager with the skills to develop such a product and the courage to invest in it, he says, could transform the industry. For now, though, most fund managers are too busy dealing with today's crises to think up radical ideas for the future.

Hold on to Nurse for Fear of Finding Something Worse, Alexander Jolliffe, Financial Times, Saturday June 21, 2003

Bill Mott's plan to stop running Credit Suisse's income funds presents investors with the old dilemma: should I stay or should I go? writes Alexander Jolliffe.

Fund analysts and financial advisers are telling clients to hold on to nurse for fear of finding something worse - that is, to stay with Credit Suisse's funds for six months while they assess Leigh Harrison, the new manager.

Graham Harrison, managing director at Asset Risk Consultants, which advises private clients about funds, says fund managers do not generate performance alone. Colleagues, analysts and chief investment officers - fund managers' bosses - may all influence the fund's performance. So when your manager walks, the fund may not collapse. "Fund managers don't work in isolation," says Harrison. "Lionising a person and saying he's responsible for performance is not true - it's just a useful hook to hang your marketing on."

Then there is the cost of switching funds, Harrison adds. Some groups charge exit penalties if investors leave within a few years of buying a fund, and almost all companies charge an initial fee when you invest new money. So before switching, you have to be confident that you would get outperformance that more than compensated for the charges. The best option, says Harrison, is to wait for six months to see how the new fund manager invests your money and then decide.

Investors who want to compare the two managers could use the ratings service provided by Citywire, the investment publishing business in which the Reuters agency has a 25 per cent stake. Its analysis shows that Mott outperformed Harrison in the last three years, turning in an average monthly return of 0.55 per cent compared with Harrison's 0.04 per cent. But in the past year, Harrison has bounced back, coming fifth out of 56 in his sector against Mott who came 42nd.

But **Professor David Blake**, professor of financial economics at Birkbeck College, London, warns investors not to pay too much attention to good past performance. He believes it does not persist for long. "If you had a good fund performance last year, it will last for another year at most." He suspects this is because the shares that the fund manager bought continued to perform well, helped by a momentum effect.

However, he accepts the use of active fund management and says there are a handful of star fund managers, and investors should follow them when they move. But to show that their outperformance is caused by skill, not luck, such managers would have to outperform for as much as five years. And he believes it is very hard to find the stars: "It's rather like trying to find a winning lottery ticket."

Many investors would be better off choosing cheap tracker funds: "It would pay the average investor to pick the lowest cost tracker than a high-charging fund with a potential star manager, who turns out not to be a star." The cheapest fund tracking the FTSE All Share index is run by Isis Asset Management, which charges 0.35 per cent a year, according to data company Fitzrovia. The second-cheapest is M&G's at 0.5 per cent.

Börse frisst Rente: Von der Regierung ermuntert, legten Millionen Briten ihr Geld in Pensionsfonds auf Aktien an. Jetzt müssen sie um ihre Altersvorsorge bangen, by John F. Jungclaussen, Die Zeit, Archiv 29/2002

Horten und Sparen - ein Instinkt, so alt wie die Menschheit. Merkwürdig deshalb, dass kaum ein Thema so sehr langweilt wie die Altersvorsorge. Das ist in Großbritannien nicht anders als in Deutschland. Nur einmal, vor elf Jahren, kam das Thema Renten mit etwas Glamour in Verbindung. Damals, im November 1991, fiel der extravagante Großverleger Robert Maxwell vor den Kanarischen Inseln von Bord seiner Motoryacht *Lady Ghislaine* und ertrank in den Fluten des Atlantiks. Bei der Aufteilung der Firma an seine Söhne stellte sich heraus, dass er die Pensionskasse seiner Mitarbeiter geplündert hatte, um 450

Millionen Pfund in sein Zeitungsimperium zu pumpen, das unter einer Schuldenlast von drei Milliarden ächzte.

Jetzt berichten die Titelseiten englischer Zeitungen erneut von Pensionskassen. Allerdings aus anderem Grund. Die Börse kracht, der Kapitalismus kriselt und mit ihm das System der kapitalgedeckten Altersvorsorge. Seit Ende der achtziger Jahre haben britische Arbeiter die Möglichkeit, auf eine staatliche Rente zu verzichten und stattdessen auf eine betriebliche Altersvorsorge zu bauen. Arbeitgeber und Arbeitnehmer zahlen dann im Schnitt jeweils zehn Prozent des Jahreseinkommens in einen Fonds ein, der dem Arbeitnehmer ein festes Einkommen für seinen Lebensabend garantiert.

Doch jetzt, im freien Fall der Aktienmärkte, funktioniert das System nicht mehr. Die Fonds, die über 800 Milliarden Pfund investiert haben, weit über die Hälfte davon in Börsenwerte, stehen vor dem Zusammenbruch. Der Pensionsfonds von British Telecom (BT) etwa, mit 25 Milliarden Pfund und über 100 000 Einzahlern der größte im Lande, hat nach Angaben der Investment Bank JP Morgan durch die Entwicklung auf den Aktienmärkten Schulden von 4,2 Milliarden Pfund angesammelt. Der Fonds des Energiekonzerns BP steht mit drei Milliarden Pfund in der Kreide, und die Rentenkasse von Rolls-Royce schiebt einen Schuldenberg von 392 Millionen Pfund vor sich her.

Darunter leiden zum einen die Unternehmen. Solange BT, BP und Rolls-Royce nicht Pleite gehen, bleibt der Rentenanspruch ihrer Belegschaft erhalten. Für die Konzerne kann das teuer werden. Kein Wunder, dass bereits 44 Prozent aller Unternehmen ihre *final salary schemes* für neue Mitarbeiter geschlossen haben.

Darunter leiden zum anderen aber auch die Angestellten. Denn als hätten die Unternehmen die Krise vorausgesehen, haben in den vergangenen Jahren zahlreiche Unternehmen das System ihrer Rentenkassen auf durchaus legale Weise verändert. Nun entscheidet der Arbeitnehmer, wie viel Prozent seines Einkommens er einzahlen will - laut einer Studie der Unternehmensberatung KPMG durchschnittlich fünf Prozent des Nettolohnes. Und der Arbeitgeber verdoppelt dann den Einsatz. Der entscheidende Unterschied ist: Nun trägt der Arbeitnehmer das Risiko. Die Auszahlung im Rentenalter ist nicht garantiert. Mit wie viel Geld der Rentner im Alter lebt, hängt davon ab, wie viel er bereit ist einzuzahlen und wie sich die Rendite an den Finanzmärkten entwickelt. Wohlstand im Alter wird börsenabhängig.

Großbritannien droht nun eine Schwemme verarmter Pensionäre. Erst hatte der Aktienmarkt ihre Ersparnisse kolossal vermehrt - um sie jetzt mit einem Mal zu verschlingen. Der Vorsitzende des Gewerkschaftsverbandes TUC, John Monks, spricht schon von "Millionen von Sozialfällen".

Statt Rente nur ein Taschengeld

Schon heute leben im Vereinigten Königreich überdurchschnittlich viele alte Menschen in Armut. Von den elf Millionen Rentnern müssen rund zwei Millionen mit der staatlichen Mindestrente auskommen, die gerade von 75,50 Pfund auf 98 Pfund in der Woche angehoben wurde, was knapp 600 Euro im Monat entspricht. In britischen Großstädten kann man davon kaum leben. Age Concern, die Interessenvertretung der

Alten, startete zudem kürzlich eine Kampagne, um auf die "inakzeptablen sozialen Missstände" in britischen Altersheimen aufmerksam zu machen. Dort fristen über 100 000 Sozialhilfeempfänger ihren Lebensabend mit einem Taschengeld von weniger als 10 Pfund in der Woche.

Kurz, selbst bei hohen Börsenkursen konnte das britische Rentensystem nicht vor Armut schützen. Und nun? "Die Zündschnur an der Rentenbombe wird immer kürzer", sagt ein Beamter des Ministeriums für Arbeit und Renten. Schuld daran ist aber nicht allein die Aktienkrise. "Das System der kapitalgedeckten Rentenabsicherung basierte auf einer Reihe von falschen Annahmen", erklärt **Professor David Blake** vom Renteninstitut an der University of London. "Zu lange ging man nicht nur von zu hohen Renditen aus, sondern auch von einer zu geringen Lebenserwartung."

Die Realität ist anders: Erstens bringen Aktien und Anleihen im Schnitt viel weniger als die zehn Prozent Rendite, mit denen Rentner und Pensionsfonds in den vergangenen Jahren stets rechneten. Und zweitens werden die Menschen immer älter - und sind daher länger auf Rentenzahlungen angewiesen.

Noch dazu hat die Regierung der Rentenmaschine unbewusst eine Menge Sand ins Getriebe gestreut. Seit dem Fall Maxwell erließ sie eine Reihe von Gesetzen, um Wiederholungstäter abzuschrecken und die Arbeitnehmer zu schützen. Diese zusätzlichen Auflagen aber trieben die Verwaltungskosten der Rentenkassen nach oben - und senkten somit den Ertrag, der für Auszahlungen übrig blieb. Zudem führte Schatzkanzler Gordon Brown vor fünf Jahren die Besteuerung von Dividenden ein, die in die Pensionsfonds zurückfließen. Das hat der Regierung zwar satte fünf Milliarden Pfund jährlich eingebracht, aber nach Ansicht des Vorsitzenden der Vereinigung der britischen Industrie, Digby Jones, konnte "die Größenordnung dieser Belastung für die Unternehmen nur so lange versteckt werden, wie die Börsenkurse stiegen und die Zinsen nicht fielen".

Schließlich wollte die Regulierungsbehörde der Wirtschaftsprüfer auch noch eine Regel einführen, wonach die Unternehmen die Gewinne und Verluste ihrer Pensionsfonds mit in ihre Bilanz aufnehmen müssen. In Zeiten der Börsenbaisse und der deshalb verschuldeten Rentenfonds verschlechtert das die Bilanz der Mutterkonzerne erheblich. Was dann wiederum auf die Aktienkurse schlägt - und die Pensionsfonds in noch tiefere Schwierigkeiten stürzt. Diese so genannte Regelung FRS17 geriet so unter Beschuss, dass sie jetzt erst einmal verschoben wurde.

Jedes fünfte Pfund fürs Alter

Am grundsätzlichen System der Selbstvorsorge will die britische Regierung jedoch nach wie vor nichts ändern. Die Mehrheit der britischen Arbeitnehmer wird auch in Zukunft ihre Altersvorsorge an den Finanzmärkten verdienen. Ein von der Regierung in Auftrag gegebener Untersuchungsbericht schlug diese Woche vor, die Pflichtrente wieder einzuführen, um gerade junge Arbeiter dazu zu bringen, schon frühzeitig für ihren Ruhestand zu sorgen. Auch die Anhebung des Rentenalters wird zunehmend lauter diskutiert. Die sonst so reformfreudige Regierung gibt sich gegenüber derart radikalen Vorschlägen jedoch verschlossen. "Wir müssen das Bewusstsein der Bevölkerung dafür wecken, rechtzeitig Vorsorge zu treffen", sagt Arbeits- und Rentenminister Andrew Smith lediglich.

Den britischen Bürgern und künftigen Rentnern bleibt damit nur ein Ausweg: Sie müssen mehr sparen. Viel mehr. 15 bis 20 Prozent des Nettolohnes sollte jeder Arbeiter nach Meinung des Vorsitzenden der Vereinigung der Pensionsfonds, Peter Thompson, jeden Monat auf die hohe Kante legen, "um seinen Lebensstandard im Alter auch nur annähernd beibehalten zu können". Der ehemalige Staatssekretär im Ministerium für Arbeit und Renten, Frank Field, bringt es auf den Punkt: "Spare mehr, oder lebe in Armut."

Börsenkrise hin oder her, die Zukunft der britischen Renten liegt also auf dem Aktienmarkt - und in zunehmendem Maß bei jedem Einzelnen. Womit sich Premierminister Tony Blair einmal mehr als würdiger Erbe seiner konservativen Vorgängerin Margaret Thatcher erweist. Als 1912 erstmals jeder Brite über 70 ein Anrecht auf eine bescheidene Altersversorgung erhielt, bemerkte der junge Winston Churchill, Thatchers politisches Vorbild: "Wir geben nicht vor, den Ertrinkenden an Land gezogen zu haben. Wir haben ihm eine Rettungweste angelegt." Ein knappes Jahrhundert später müssen Millionen von Briten abermals kräftig strampeln, um im Alter nicht zu ersaufen.

Investors are told: prepare for Equitable to go bust, Maria Scott, personal finance editor, The Observer, Sunday November 17, 2002

Policyholders with Equitable Life must be prepared for the possibility that the insurer will go bust, leading financial advisers warned this weekend.

Tom McPhail, a pensions specialist with adviser Hargreaves Lansdown, said: 'Equitable investors have to be prepared for the possibility of insolvency. It looks awful. The general consensus is that this is the endgame.'

McPhail's comments followed an announcement by Equitable Life on Friday that pensions being paid to 50,000 with-profit policyholders would be cut by as much as 20 per cent next year - the latest of a series of cuts to policyholders' funds but the first cuts to pensions already being paid.

In a statement with the firm's interim accounts, also published on Friday, the board said it was confident that 'with careful management' the insurer would remain solvent. But it warned that external factors such as volatility in financial markets might jeopardise its ability to maintain solvency at the Financial Services Authority's required minimum margin.

It is understood that the FSA would allow Equitable to continue in business even if it breached this margin, but it would require its directors to restore the margin. This would probably involve further cuts to policyholders' funds, but analysts fear Equitable's finances could deteriorate to a point where it could not meet a series of guaranteed payments it must make on policies. At that point the regulator would have to recommend that the firm go in to administration.

Professor David Blake, director of the **Pensions Institute** at Birkbeck College London, said: 'Policyholders should have been prepared for the worst all of this year.'

There was a limit to how long Equitable could keep cutting policyholders' returns to shore up its finances. It could reach a point when it could not cut further without slicing into guaranteed elements of investors' funds.

Insurance industry analyst Ned Cazalet said: 'The society is very vulnerable to external forces. It wouldn't take much of a puff of wind to knock the thing over.'

The Solvency of UK Life Offices, Money Box, BBC Radio 4, 29 June 2002 (Transcript of interview with Paul Lewis)

LEWIS: One of the major effects of falling stock prices which are now a third down on their peak at the start of the Millennium is that insurance companies may actually become insolvent, have too little money to meet their obligations to savers. Now most major companies are already using the promise of future profits to bolster the paper value of their funds now. On Friday the Financial Services Authority stepped in to help by reducing the reserves insurers needed to cope with a fall in stock markets. It's the third time in a year the FSA has helped them cope in this way. So how close are Britain's major insurance companies to insolvency? **Prof. David Blake** is head of the **Pensions Institute**. Prof. Blake how bad are things for insurance companies?

BLAKE: Well they're pretty bad at the moment for certain companies like Equitable Life, Norwich Union, Friends Provident and Pearl which have used extensive future profits in order to boost their balance sheets. Other life assurers with low free assets - these are the surpluses in their funds, once the free assets have run out then they are technically insolvent - are Pearl, Sun Life and Scottish Mutual. So a whole range of well known names are pretty close to the edge at the moment.

LEWIS: And what about using future profits to boost your reserves now? - it's a sort of mirror image of what WorldCom's being accused of isn't it? - is it really straightforward and honest to do that?

BLAKE: Well not really. It's double counting the future. It's counting future revenues twice. That's one way in which life companies have boosted their balance sheets. Another one is to try and get liabilities off their balance sheets using reinsurance contracts. So those have been the two mechanisms, very much like Enron style accounting, in which the life offices have tried to massage their figures.

LEWIS: Well we've mentioned two companies there - WorldCom and Enron, both of which have collapsed in spectacular fashion in connection with Britain's insurance companies where we all rely for our savings and our pensions. Should we really be worried? Should we be taking our money out of these companies?

BLAKE: Well that depends on how close you are to retirement. If you're relatively young you do not have to worry since markets do recover, they recover quite spectacularly out of recessions. Although we've had three years of bad returns, we can expect the markets to recover.

The problem is if you're relatively close to retirement and you're forced to buy an annuity in the near future, then not only has the value of your pension pot fallen, but the annuity rates that you're getting are also very poor, so you could find yourself with a double whammy here when it comes to actually buying your pension annuity.

LEWIS: David Blake thanks very much for talking to us.

Firms bank on the future, FT Your Money 26 June 2002 and FT Adviser, 27 June 2002

FOUR leading insurers would fail the FSA's first solvency rule of thumb if future profits were ignored.

The insurers have resorted to using future profits to avert solvency problems caused by falling share prices.

Particularly affected are those insurers with a large amount of with profits or endowment business, where obligations towards policyholders with guaranteed bonuses have been partly financed by shares.

The FSA said it was still considering whether insurers should be able to continue using future profits after the practice came under fierce criticism in the wake of the Equitable Life fiasco.

An FA investigation found that on the FSA solvency test of rquired minimum margin of solvency, Royal London, Scottish Mutual, CGNU Life and R&SA Life & Pensions would fail the regulator's first solvency rule of thumb if their future profits were not taken into account.

If firms score under 200 points, the FSA's first line of defence, the regulator puts firms under closer scrutiny, including requiring them to give quarterly updates.

Below 100 points they are insolvent on a required minimum margin measure and would have to close to new business.

Taken as an average of the 17 largest insurers the required minimum margin has fallen from 340 points in 2000 to 232 in the year ended December 2001, excluding future profits.

Abbey National Life and R&SA subsidiary Sun Alliance & London, breach the 200-point level even with future profits taken into account. Scottish Mutual, which has just received a £150m injection from parent Abbey National, was only four points above it.

The insurers said they were still trading above the minimum regulatory requirements despite further falls in share prices since the figures were compiled.

The news came as a separate study from Nottingham University showed that 20 top with profits providers were using future profits to bolster their solvency position.

Professor David Blake, director of the **Pensions Institute** at Birkbeck College, London University said: "The chickens are coming home to roost.

“It is not possible to use equities to cover guarantees when equities underperform bonds.”

John Lister, deputy actuary at CGNU said: “Using future profits gets you some time rather than being forced into selling equities in a falling market.”

Deborah Fowler, press officer at the FSA, said: “We monitor solvency as part of our ongoing supervision. The key thing is for firms to keep above the minimum requirement.”

How Labour failed to hit the blackspot, The Observer, Sunday June 16, 2002

It has been five years since Labour came to power with the promise of bringing millions of the poor and excluded back into the financial fold. Colin Cottell looks at whether the government has delivered and marks its performance in key areas out of 10

Banking

Most people take having a bank account for granted, but up to 23% of people don't have one. This means major disadvantages in settling bills, handling cheques, getting access to credit, and obtaining information about financial products. "Having a bank account is the gateway," says Sue Edwards, a social policy officer at the National Association of Citizens Advice Bureaux.

The penny really dropped for the government with the 1999 report, Access to Financial Services. This found that traditional accounts, with overdraft facilities and high charges, often don't meet the needs of those on low incomes.

Since then the government has cajoled the often reluctant high street banks into providing no-frills bank accounts designed to meet the needs of those living on between £51 and £150 per week.

According to the British Bankers' Association, there are now three million of these basic bank accounts, and they are becoming more popular. During 2000, 254,000 such accounts were opened, while 104,000 were upgraded to normal accounts. The BBA says that the figures should rise significantly.

Basic accounts have many of the facilities of normal bank accounts, but do not normally provide a chequebook, or a conventional overdraft facility. They have been given a boost by plans to pay benefits by automated credit transfer starting in 2003. This will include a benefits encashment option at post offices.

Although there is more choice, it is difficult to get hold of a basic account, Edwards says. "Customers are often given wrong information. Banks are not advertising their basic bank accounts and information is kept under the counter, often only available for those who ask."

Sharon Collard, from the Personal Finance Research Centre at Bristol University, questions whether they will be effective in reducing long-term financial exclusion: "The issue is whether people "unbanked" in the past actually do use the account, whether they progress to other accounts, or whether the account is left dormant."

Some progress has been made in allowing individuals without passports or driving licences, such as the homeless, to open a bank account. However Derek French of the Campaign for Community

Banking Services says that the government cannot take the credit: 'This was down to market and media pressure, and a more open attitude taken by banks.'

And he remains critical of the government's record overall. "Around 2,000 branches have closed since the beginning of 1997," he says. "The government talks a lot about financial exclusion, but seems unable to deal with the effects of branch closures on older people, on those without their own transport in rural areas, and on communities."

Score: 6. Despite basic bank accounts, the number of people without a bank account has hardly changed since Labour came to power.

Pensions

Too young, too hard-up, or too old - before the government's flagship stakeholder pension was launched in April 2001, the reasons why around five million people hadn't got round to taking out a personal pension had been clearly identified. Predominantly those earning between £10,000 and £20,000 a year, they faced a retirement of penury, dependent on the state.

Although more than 685,000 stakeholder pensions had been sold, and almost 317,000 employer-designated schemes had been set up, by the end of January, many experts say that the stakeholder hasn't delivered. "The great unpensioned haven't really been captured," says **Professor David Blake** of the **Pensions Institute** at Birkbeck College. "Most will have been transfers set up by high net worth individuals and their partners."

The Department of Work and Pensions is putting a brave face on it. "It is a good start. It is a long-term product. We are happy with that. It has stimulated sales of other pensions," said a spokesman. The Department believes that stakeholders are popular among construction and building workers, though they admit they have no real idea who is taking them up.

But John Ellis, director of public affairs at the Life Insurance Association, says people switching from other schemes is exactly what it had expected.

"It is not a bad product, but not for the people the government intended," he says. Those on low incomes often have a lack of money to put into a pension, Ellis adds. "There needs to be a lot more effort, including incentivising; probably a degree of compulsion - a lot more than the government has been able to do."

Blake offers some comfort. "I give it a high grade in terms of design and long-term benefits of simplicity, transferability, charges and value for money. But in terms of the take-up of the target group, because of the cost to stakeholder providers of going out to employers, inevitably that is less successful."

Score: 5. Falls down on targeting, and public awareness. A recent survey by Mori for Age Concern shows that the stakeholder message has not got through.

Savings

"Saving for a rainy day" has never been as common as the government would like. Around a third of us are without any formal savings. And six out of 10 households living on less than £150 a week have no savings at all. In response, the government launched individual savings accounts (Isas) in April 1999.

Within months, the Building Societies Association had expressed concern. "All the evidence suggests that despite good intentions, they became so complex that they have by and large missed the target entirely. There is a strong possibility that those who do not currently save will be deterred rather than encouraged by the complexity of the Isa."

The Treasury begs to differ. A spokesman said: "Isas have been a success story - over 12 million investors with Isas, around one in four adults; over £74bn put into Isas since they began. Isas are starting to change savings habits, reaching groups such as young people, women, and lower-income taxpayers who were under-represented in Peps and Tessas."

But Collard, at Bristol University's Personal Finance Research Centre, says that many early fears have been borne out.

'The FSA Consumer Panel Survey shows it has not really hit its target market,' she says. 'We know who is taking up Isas. It is more of the higher income, financially literate groups.'

The government has also put forward a number of new ideas. Child Trust Funds (the so-called baby bond), a tax-free savings account set up for all new babies, due to begin in April 2003, and the Savings Gateway have been given a cautious welcome by anti-poverty groups. Kate Green, director of the Council for One Parent Families, welcomes the Child Trust Fund, but says that 'the poorest lone parents will find it impossible to make regular contributions'.

Score: 3. Encouraging the hard up to save is a thankless task. The better off look set to prosper.

Contents insurance

Those who live in areas of highest crime tend to be those most likely not to have contents insurance. According to the Association of British Insurers: "Around one in four households, six million people, do not have contents insurance and there has been very little change in the past 10 years." So what has the government achieved?

Not much, says Sue Edwards at Nacab: "Though beginning from a very low starting point, the government has not done what is needed."

However, Edwards welcomes the work done in promoting the idea of insurance with rent. This involves the local authority or social housing landlord in both the delivery of insurance and the collection of premiums. It allows tenants to deal with an organisation with which they have an ongoing relationship, and to pay for insurance at the same time as rent in a way they are comfortable with.

It is also potentially cheaper to arrange insurance collectively rather than individually. However, "take up is not always very good," says Edwards.

The ABI say it recognises that those living in areas with high crime rates are caught in a Catch-22 situation of not being able to afford the high premiums. Nevertheless, 'We are keen to insure as many people as possible.'

Score: 6. Many who find it difficult to make ends meet see contents insurance as optional, and too expensive. Government needs to be more vigorous in promoting insurance with rent schemes.

Credit

Financially excluded households don't put credit cards, bank loans and the like at the top of their priorities. But there are times when, for all of us, borrowing is unavoidable. And having to fall back on the non-status market - where lenders will take on those avoided by mainstream lenders - or illegal money lenders means that at such times as many as three million people pay over the odds, with many getting into long-term debt.

The government's big idea has been a major review of credit unions. According to the FSA's report In or out?, "They are seen as open to low-income groups, encourage small scale saving, provide low-cost credit, and can be a bridge to other financial services."

However, Guy Palmer, director of the New Policy Institute, says that at the moment the credit union movement is too small to make much difference.

He also questions whether, as credit unions grow "they can maintain their focus on low income groups, or whether, having to make a profit, they become more like banks." Credit unions protest that they are for everyone, not just the financially excluded.

Palmer also supports extending the Social Fund to include those in low paid employment. "Unlike other areas of financial exclusion you cannot get the private sector to address the issue because it is not profitable, the social fund offers a potential solution," he says.

However, financial services providers also need to produce products attractive to the third of households who don't use high-street credit, argues the FSA.

"People on the margins of financial services need to borrow small amounts for short periods of time - usually to make ends meet, or to buy essentials. They want to have an arrangement, whereby the loan is repaid in fixed amounts each week. Mainstream providers do not have the products to match these needs."

Score: 4. Government expectations of credit unions are unrealistic. They failed to secure funding for the Central Services Organisation, which was to have encouraged broad-based development of credit unions.

Time to seek life beyond Equitable?, Maria Scott, The Observer, Sunday May 12, 2002

The misery for Equitable Life investors seems never to end. Having agreed reluctantly to a deal aimed at stabilising the insurer's finances, policyholders now hear talk of the company's potential insolvency.

Chief executive Charles Thomson admitted last week that solvency margins were thin. Hours later, **David Blake**, director of the **Pensions Institute** and professor of financial economics at Birkbeck College, London, said Equitable's with-profit fund was 'close to being technically insolvent'.

In a report commissioned by the Equitable Members' Action Group (Emag), Blake concluded that the firm's finances faced a renewed strain due to guaranteed returns it must pay on policies representing around 75% of its funds.

These are a different set of guarantees from those that sparked the crisis that forced Equitable to shut up shop. But they are guarantees nevertheless, and are now emerging as a drag on its finances which, say policy holders, had not been spelt out before. Well, not in terms that anyone could readily understand, anyway.

Paul Braithwaite of Emag is now seeking election as a policyholders' representative to the Equitable board at the annual meeting on May 27.

He has proved an impassioned and dedicated champion of policyholders' interests. But many will have no stomach to fight on. They have been failed by regulators, possibly by the new management as well as the old one, and have no way of knowing the future of Equitable's finances.

Those wanting to shed the worry have little choice but to head for the exit and damn the expense.

Equitable fears panic exit, Maria Scott, personal finance editor, The Observer, Sunday May 12, 2002

Panic is spreading among Equitable Life policyholders, according to financial advisers, following reports suggesting the insurer is on the brink of insolvency.

Fresh evidence of Equitable's weakness is expected to emerge this week with publication by Companies House of its latest financial returns, filed by the Financial Services Authority late last week.

The FSA said the firm was solvent and in a better position than a year ago, before policyholders agreed to a deal capping the potential cost of the guaranteed annuity rate pensions behind its problems.

But Ned Cazalet, an independent insurance analyst, expects the figures to show that its solvency margins were slightly thinner than before the compromise deal.

Cazalet said the FSA used a different measure for solvency from his own. 'We are confident that when we see the returns there is going to be little meaningful difference between the liabilities and excess capital.'

A report published on Friday by **David Blake**, professor of financial economics at Birkbeck College, London, said Equitable's battered with-profit fund was 'close to being technically insolvent... The fund could not take many more negative returns.'

This followed an admission by Equitable chief executive Charles Thomson that the margins were relatively thin. However, responding to Blake's report, Thomson insisted it was solvent, but added: 'We've never hidden the fact that the position is not particularly strong.'

Advisers said Thomson's comments had provoked calls from investors seeking help in withdrawing money from Equitable, despite a new 14 per cent exit charge.

Graham Hooper of Holden Meehan said: 'Clients just want to get out. People think, "This is unravelling".'

I C No Free Lunch: The Truth About Past Performance - Our Stock Market Commentator Examines Past Performance, Investor's Chronicle, Mar 15, 2002

Twenty-odd years ago I read the novel by Anthony Powell, A Dance to the Music of Time. The narrator recounts the progress through life of his friends and others. Characters disappear off his radar screen for years at a time. Turning up again, their situation has often been improbably transformed. At the time I took this to be dramatic licence. Now, I see that it wasn't.

I had two surreal conversations this week. The last time I met Jim, he was owning up to $100,000 of losses from day trading. He had sold his house to feed his habit - fortunately, he has few personal ties. Jim was sure he was about to crack it and get rich. I despaired. At least he still had his job. Jim is a doctor.

Was. A few days ago I got an update. Jim has cracked it. He's made $50,000 in the past six months. He has resigned his job and is talking to some Americans about running a $30m hedge fund.

Jim hasn't cracked it. He is merely experiencing the flow of human fortune. It comes between ebbs.

Then I met Cathy, who, in a hard-working and possibly slightly lucky half-a- lifetime, has assembled at least a few tens of millions. Thanks to Cathy's husband, I am now extremely well informed about the challenges of running five houses in four countries. From Cathy, who runs the money, I heard other tribulations. A few days before, representatives of one of the classiest names in fund management had maintained straight faces while telling her how well they had done to lose only 17 per cent of her money last year. Cathy was affronted. This was not what she had been led to expect when the firm signed her up. Where did I suggest she move her money? I almost gave her Jim's phone number.

In the context of this, I was struck by an advert by unit trust firm Artemis, which is doing the rounds at the moment: "The UK's top-performing unit trust manager over three years achieved a remarkable 148 per cent return to investors", compared with a range of -11 per cent to 9 per cent from Fidelity, M&G, Schroder and the rest of the big boys.

All claims about superior investment performance, unless made on behalf of about one dozen people on this planet, are nonsense as to significance. Clearly, they are not nonsense as to fact.

Artemis runs six unit trusts worth a total of less than $500m. Five of its funds are UK funds. The field with which it is comparing itself runs, I would guess, an average of $20bn, invested in every stock market in the world. Is this a valid comparison?

But that's not the half of it. Take yourself to the Artemis website and print off the one-page summaries of each of their funds. Now look at those charts carefully. See how the two biggest funds had very short-lived bursts of phenomenal performance in late 1999. The advert suggests you are looking at three years' performance, but in fact you are by and large looking at six months of performance. The three-year period, in fact, has one or two other good aspects, apart from how well those two big funds did back in 1999.

I bet you this: in two years' time, Artemis will be bragging about its five-year performance. The claim it will make will probably rest in very large measure on its performance during a single six-month period almost five years earlier. And in 10 years time... Autif, the cheerleader for the unit trust industry, is currently fighting a bit of a battle with the Financial Services Authority about the significance of past performance statistics. It has taken on a tough job. One of its recent publications said research by finance professor **David Blake** supported its contention that these statistics are significant to prospective investors. "I think you could say they overcooked my conclusions," Professor Blake told me.

The only thing that everyone does seem to agree on, rather awkwardly from Autif's standpoint, is that bad unit trusts stay bad. Aha! That must be why we see all those adverts that say, "Don't buy our unit trust. Our past performance is rubbish and we're going to give you more of the same in future."

If you think I am unduly negative, read No Monkey Business by Stuart Fowler, a comprehensive expose of the UK retail investment industry. It's heavy going, but it knows where all the bodies are.

Company pensions: End of the party, The Economist, Feb 28th 2002

How bad for employees is the decline in final-salary pensions?

BRITAIN has long taken pride in the size and coverage of its funded private occupational pension schemes. With over £700 billion of assets, they compensate for meagre state pensions. In the past twenty years, they have contributed to a big improvement in pensioners' living standards. But in recent weeks, a sense of foreboding has emerged about their future, especially for younger workers, as more and more companies decide to change the terms on which they will offer pensions.

Up till now, most pension schemes have offered “defined benefits” (DB). Under a DB scheme, pensions are generally linked to workers' final salaries, replacing a proportion of that income according to the number of years worked with the company. Under this formula, people who work for as long as 40 years for a company can expect to get two-thirds of their final salary. Increasingly, however, firms are favouring “defined contribution” schemes. Under a DC plan, workers have to build up their own pot of money which they must then eventually turn into a pension through the annuity market.

Last year, a tenth of final-salary pension schemes surveyed by the National Association of Pension Funds (NAPF) closed them to new employees. Such closures, including major employers like British Telecom, have not affected existing members. However, in recent weeks, Iceland, a frozen-food retailer, and Ernst & Young, an accountancy firm, have announced plans to close their DB schemes to existing members.

The shift from DB to DC schemes has caused alarm and recrimination in equal measure. Frank Field, the former Labour pensions minister, calls it a “mega-tragedy”. Ken Jackson, general secretary of Amicus, Britain's largest private-sector union, has pointed the finger at Gordon Brown's raid on pension funds in his first budget, saying that it “plunged schemes into a financial nightmare". Chris Daykin, the government's actuary, has spoken about the "self-destruction" of DB pension schemes because of excessive complexity and changes to accounting rules.

A new accounting standard, called FRS17, is undoubtedly blamed by many pension-fund managers. "Our members are telling us that FRS17 is the prime cause why they are changing their arrangements," says David Astley, director of benefits at the NAPF. In the past, companies have been able to smooth the effect of changing market conditions on their pension-fund assets and liabilities, so that they do not feed through immediately onto their books. When FRS17 comes into full effect next year, companies must disclose and recognise the full impact of gains and losses in their pension fund.

However, the real problem is not the messenger but the message. Britain's pension funds have punted heavily on equities for many years. That strategy has paid off handsomely, but it does expose them to greater risk in the short term than more cautious strategies which put more money into less volatile bonds. The bear stockmarket of the past two years has hit pension funds hard and brought home to companies the investment risk that they are shouldering. At the same time they have become more aware of the risk of rising life expectancy at older ages, which increases the cost of a defined-benefit promise.

With the tide flowing against final-salary pensions, the trend towards DC schemes appears unstoppable. This development has aroused concern. Because the company fund undertakes the investment and the company underwrites the promise, DB schemes are generally thought to offer superior benefits to DC ones with much less risk to employees.

So they do—if you work for one company all your life and your earnings rise towards the end of your career. But most people change jobs quite frequently. Someone who changes jobs six times in their life loses 25-30% of the full-service benefits of a final-salary scheme in Britain, calculates **David Blake**, director of the **Pensions Institute** at London University. Yet people can now expect to change jobs more than eight times in their working life, says Simon Burgess, an economist at Bristol University. Individuals whose wages peak early also lose out under DB plans.

Employees with DC plans do not face these risks. Nor will they find their employer changing the terms of their pension arrangements midway through their career. On the other hand, they have to shoulder investment risk and must pay the bill for rising longevity when they come to purchase an annuity.

The fact of the matter is that both DB and DC plans are risky, but in different ways. The real problem with the switch towards DC plans is the level of contributions into them. According to the most recent survey by the NAPF, combined contributions by employers and employees in the private sector into DC plans were 11.6% of eligible earnings compared with 14% into DB schemes.

Yet contribution rates need to rise for both DB and DC plans because of rising longevity and lower expected investment returns. For a man to ensure a two-thirds final-salary pension at the age of 65, contributions into a DC stakeholder plan now need to be 24% of earnings from the age of 25, calculates Deborah Cooper of William M. Mercer, an actuarial consultancy. Arguably, this is an unrealistic objective, since very few people in DB plans achieve a two-thirds final-salary pension. But many actuaries would advise that contribution rates of at least 15% are now necessary to secure a decent retirement income.

To achieve this, more effective savings incentives for lower-income workers are essential, argues Ros Altmann, a pension-fund specialist. DC schemes should also offer better-designed investment choices. More can be done to improve the annuities market, she argues. The way forward is not to lament the demise of final-salary schemes but to make DC plans work.

I C Market Strategy: Pitfalls In The Pensions Changeover - Defined-contribution Pension Schemes Are Good For Workers – As Long As They Are Not Just A Pay Cut In Disguise, Investors Chronicle, Feb 22, 2002

The shift from defined benefit (DB) to defined contribution (DC) pension schemes might be better for workers - and worse for companies - than generally supposed.

To see why, consider the difference between a DB and DC scheme. In a DC scheme a worker's pension depends upon investment returns, whereas in a DB scheme, it depends upon his final salary.

David Blake, of the **Pensions Institute** at Birkbeck College, London, has said this means a DB scheme is essentially a DC scheme combined with an exchange of options, with the exercise price set at the level of the fund required to pay the salary-related pension.

If investment returns are poor in a DB scheme, workers can exercise a put option against the scheme's sponsor, compelling them to pay the gap between the fund's market value and its exercise price.

But if investment returns are good, the sponsor can exercise a call option against the worker, and recoup the surplus of the fund's value over its exercise price.

Until recently, this exchange of options was a better deal for companies than for workers. Because investments rose faster than salary-linked payments for much of the 1980s and 1990s, companies exercised their call options against workers, and got fund surpluses or contribution holidays for themselves. Workers would, therefore, have been better off in DC schemes.

Much better off, according to US research. Andrew Samwick and Jonathan Skinner, of Dartmouth College in New Hampshire, have estimated that in the mid-1990s the average expected benefits of DC scheme members in the US were two-and-a-half times higher than the expected benefits of DB members, for the same contributions. "DC plans can strengthen the financial security of retirees", they concluded.

You might think recent falls in stock markets, and the emergence of pension funds deficits such as ICI's, have changed all this.

Not entirely. These falls, and the consequent deficits, might be only temporary. In the long run, the stock market should rise faster than wages, with the result that pensions' surpluses should be the norm. If so, DC schemes should offer better returns than DB ones.

The reason for this lies in one of the so-called stylised facts about economic growth - that over the long run wages and profits grow at the same rate as national income; if this were not the case, wages would eventually account for either all of national income or none of it.

This suggests wages will rise by around 5 per cent a year. However, economists at the London Business School say we should expect equity returns of roughly 7.5 per cent a year - a 5 per cent gilt yields, plus a risk premium of around 2.5 percentage points.

If this is right, the trend of much of the past quarter-century - for share prices to rise faster than wages - should continue. Therefore, DC schemes which invest mainly in equities should over the long run pay out better pensions than DB schemes, which are linked to wages.

Workers should gain from the switch from DB to DC schemes. And companies will lose out, because pension fund surpluses should no longer be possible.

There's another reason why the switch will benefit workers. Mr Blake says the average worker changes employees six times in a working lifetime. Because the transfer value of DB pensions is often poor, this, he estimates, causes a loss equivalent to over a quarter of the full-service pension.

All these gains to workers come at a price, however. The shift from DB to DC schemes transfers investment risk from companies to workers.

There are three different types of risk here:

> - Market volatility. Since June 1999 the All-Share index has fallen 15 per cent while annuity rates have barely changed. As a result, a DC scheme member whose assets were entirely in equities would have suffered a 15 per cent loss in his retirement income simply by retiring now rather than three years ago.
>
> - Annuity rate risk. Since 1994, gilt yields - on which annuity rates are based - have ranged from 9 per cent to 4.1 per cent. DC scheme members' pensions are sensitive to big swings in interest rates.
>
> - Fund manager risk. Mr Blake estimates that the gap between long-run returns on the best and worst UK equity unit trusts is 4.1 percentage points a year. Over a working lifetime, this implies a 320 per cent difference in one's pension pot.

All this makes DC schemes sound very risky. However, they are safer in one sense than DB schemes. The latter expose members to the risk that their pension incomes - which are typically a fixed nominal amount - will be eroded by inflation. A DC plan can protect pensioners from this by allowing them to buy an inflation-proofed annuity.

What's more, DC schemes need not be any riskier than DB ones.

In principle, our contributions to such schemes could be used to buy deferred annuities, the value of which is related to our prospective final salary.

If we could do this, DB and DC schemes would be identical. But we cannot.

However, this means DC schemes are risky to workers only because financial markets are underdeveloped. As Robert Merton, a Harvard-based Nobel prize- winner, said in an early study of such schemes: "If financial markets were complete then of course the choice of pension plan would be irrelevant."

It follows that there are ways to reduce the riskiness of DC schemes.

Obvious solutions are to diversify across assets and fund managers, and to allow workers greater freedom to decide when to retire. Less obvious answers include better markets for deferred annuities, and allowing older workers to buy guaranteed products, which give investors exposure to rising stock markets but protection against falls. These are poor value for many investors, but they are a good deal for those who are especially averse to big losses, which is often the case for people approaching retirement.

Despite this there is one risk which DC schemes cannot avoid so easily - the danger that the stylised fact about long-run economic growth will be wrong. Maybe wages will rise faster over the long run than profits and equity prices. If this happens, DC schemes will pay lower pensions than DB schemes. There is no obvious solution to this problem – except that one's wage is partly a hedge against this disaster.

If all this makes the comparison between DB and DC pensions sound easy, there are three complications.

One is the potentially important impact upon work incentives. In a DB scheme, a worker's pension depends upon his final salary, whereas in a DC scheme it depends upon his lifetime earnings, as these influence the level of contributions. So DB schemes might give employees a greater incentive to work hard in order to get a high end-career salary. If this is right, the shift to DC schemes could reduce productivity and output, and make everyone poorer.

A second issue is fund charges. Individual DC schemes, says Mr Blake, "have much higher operating costs" than DB schemes. Occupational DC schemes tend to have lower charges, but some of these make it hard for individual members to control investment risks themselves.

Finally, of course, there is the question of how much you put into your pension. All the above assumes that the switch to DC schemes does not change the level of contributions. But it does. A recent survey by benefit consultants Towers Perrin found that only 6 per cent of companies pay more than 10 per cent of workers' pay into DC pension schemes, whereas almost 70 per cent pay more than 10 per cent into DB schemes. For some companies, a shift to a DC scheme is just a way of cutting pay.

In fact, though, the amount you - or your employer - put into your pension is the most important issue of all.

"The greatest impediment to having a decent pension in retirement is inadequate pension savings made by people during the working lifetime," says Mr Blake. "Yes, the type of pension scheme matters, but the level of pension savings matters most of all."

Economists versus accountants

The main cost to companies from switching from a defined benefit (DB) to a defined contribution (DC) scheme, for a given level of contributions, is not an out of pocket cost, but rather the risk of foregoing a gain - namely, losing the possibility of fund surpluses and contribution holidays.

Economists call foregone gains opportunity costs. To them, such costs are just as important as out of pocket costs; the £10 lying on the pavement which you do not pick up is as much a cost as the £10 that falls out of your wallet.

To accountants, however, the two costs are very different. Out of pocket costs are measured, but opportunity costs are not.

This (false?) distinction can affect (distort?) companies' choices between DB and DC schemes.

To see why, imagine a company is choosing between a DB and a DC scheme. The worst thing that can happen with a DB scheme, it figures, is that the stock market fails to rise, and so we have persistent fund deficits, which we have to top up. However, the worst thing that can happen with a DC scheme is that the market rises sharply, and so we don't get fund surpluses.

To an economist, these costs are similar. To an accountant, though, they are different. Fund deficits under a DB scheme will show up in the accounts. But fund surpluses foregone under a DC scheme will never appear.

This asymmetry means accountants will regard DB schemes as more expensive than DC schemes - even though to economists they are not. And this, in turn, gives companies an incentive to switch from DB to DC plans. To economists, though, this incentive is a mere illusion.

The luck of the manager, by Dickon Reid, Investment & Pensions Europe, Jul 2001

Whether good fund managers are genuinely skillful or simply luckier that others is always going to be highly subjective. Ask an outperforming active manager and they're likely to attribute it to skill; ask a poorly performing one and it's more likely to be a poor run. The **Pensions Institute**'s series of lectures 'Fund manager performance: skill or luck?' gave, among others, two academics time to disclose the findings of recent research.

And the conclusions? Some of those active managers with an unwavering belief in their abilities are perfectly justified; many more, however, have luck rather than any inherent skill to thank. **Allan Timmermann**, professor at the University of California, presented new research on star performance among fund managers and the question of pure luck versus genuine skill in US mutual funds. His findings concluded the performance of the top 1–10% of funds is not a result of sampling variability, otherwise known as luck, neither is the performance of the bottom 1–10% of funds down to bad luck. In other words, those managers on top of the pile have every reason to feign superior skills while poor performers claiming a bad run are fooling themselves (and possibly their clients). However, the research also concludes that the most extreme funds' performance may in fact be down to luck.

According to Timmermann, performance distribution varies according to the investment objective. Strategies sampled included aggressive growth, growth, growth and income and balanced or income. With aggressive growth he found the worst performance may be down to chance although superior performance could not be attributed to it, genuine skill exists. As is the case with superior performance within the growth funds. With growth and income the performance of the top 1% can be explained as a fluke and for balanced and income it is genuine skill producing outperformance.

David Blake, professor of economics at the UK's Birkbeck University, spoke on performance clustering and incentives in the UK pension fund industry. By using data from over 300 funds Blake's presentation quantified a link between fund inflows and past relative performance. Of greater concern is that underperforming US mutual funds appear to take on risk in the second half of an assessment period if they have underperformed in the first half. Blake also compared US funds with UK funds and found the latter underperformed the market average but to a lesser extent than the US funds. US funds have a far wider dispersion of returns than their UK counterparts. According to the research, large funds tend to underperform smaller ones although Blake stressed there is no systematic link between fund size and total portfolio excess return. Of interest was the link between size and past performance – 15% of the quartile containing the smallest funds were in the quartile of worst performing funds, 32% of the quartile containing the largest funds were also in the quartile of worst performing funds.

Other findings included a narrow dispersion of returns around the median manager. There is also underperformance by the median fund manager relative to the market and an outperformance relative to the peergroup. Blake attributed this to a lack of incentives from the fee structure, a tendency to measure performance relatively rather than absolutely and to a concentration in the industry- in the UK the top five fund managers have 80% of the market, in the US, the same figure is 14%.

Roger Urwin, Watson Wyatt's head of investment consulting, took the existence of skilled managers as given and spoke about the best means of attaining sustainable alpha. Highly skilled active managers exist but are rare creatures requiring time and resources to track. "There is skill out there, it's just very difficult to find it though," he said. A common error when selecting managers is mistaking luck for skill. We are all subject to in-built biases in the governance process and managers tend to be chosen according to non-financial as well as financial criteria. A strong brand can lead to a somewhat self destructive bias – a good name attracts assets and greater assets under management can dilute performance, so the argument goes.

Urwin criticised the beauty parade as a poor process and one that gives too much sway to what he called the 'human side'. Past performance is often used for selection despite being a notoriously hopeless gauge of future performance, and numerous short cuts – disposing of a manager if a star leaves the team, for example – are used in manager selection when they are totally inappropriate. Solid quantitative research is more predictive and, the choice of mandate is vital and manager correlation is something often overlooked. So although the notion of genuine skill exists, there is apparently an element of luck to fund management. For those erring towards the second category, they can heed Urwin's remark, a quote attributed to the golfer Gary Player who is reputed to have said: "the harder I practice, the luckier I get".

Gordon says saving is good for you, The Economist, Apr 5th 2001

The chancellor of the exchequer wants people to save for the future. Shame, then, that his pensions policy has made it less worthwhile for many.

REMEMBER "stakeholder capitalism"? New Labour's flirtation with the idea of infusing business with compassion survives only in the name of its policy to get workers to take up private pensions. As their origin suggests, "stakeholder pensions", which were due finally to be launched on April 6th, face more than the usual problems of reconciling private and state provision.

Stakeholder pensions are a revamped form of the personal pensions introduced by the Conservatives over a decade ago. Like personal pensions, they allow workers to build up their own pension fund from contributions that attract tax relief. However, they are designed to avoid the flaws of personal pensions—the complexity and high charges on initial contributions which encouraged mis-selling and slashed investment returns. Instead, stakeholder pensions are a standardised, cheap product with a maximum charge of 1% of the fund value. People can use them for their spouses and children as well as for themselves.

David Blake, director of the **Pensions Institute** at London University, says that they offer "a perfectly good replacement for personal pensions for everyone except the super-rich". Frank Field, the minister in charge of Labour's welfare policy until forced out in 1998, says: "I think they will sell briskly, but mainly to people outside the target group." Mr Field believes that the principal beneficiaries will be the wives of high earners.

The government does not want the rich to take them up. Its target group is around 5m workers who will typically be on incomes of between £10,000 ($14,300) and £20,000 a year. Those earning more are generally in an occupational pension scheme, in which they will also benefit from employer contributions. Those on incomes below £10,000 will be better off with the state pay-as-you-go secondary pension, which will be made more generous for very low earners next year.

When the original template for stakeholder pensions was set out in a green paper at the end of 1998, the challenge of attracting the target group appeared difficult but not impossible. The proposals dangled the carrot of rebates from mandatory national insurance contributions which can be paid into stakeholder pensions. They brandished a stick, too, since reforms to the pay-as-you go secondary pension mean that those who do not opt out into stakeholders will eventually get benefits no greater than those payable on earnings of £10,000, even though their contributions will be higher.

But all this was before last year's pensioner revolt. Defeated on pensions at Labour's party conference, Gordon Brown, the chancellor, announced a big increase in the means-tested Minimum Income Guarantee (MIG) for poor pensioners, which is met by topping up the basic state pension. The MIG had been set at £75 a week in 1999, but by 2003 it will rise to £100 for single pensioners. By then it will be linked to a new "pension credit" which will allow poorer pensioners to retain more of their incomes from savings and private pensions. Crucially, future levels of both the MIG and the pension savings credit will be linked to earnings, so they will become more and more valuable in relation to the basic state pension.

The overall effect of all these changes is to make it less worthwhile for the target group of people on modest incomes to invest in stakeholder pensions. Even at last year's MIG levels of just over £78 a week for single pensioners, the commitment to uprate it in line with earnings meant that successive generations of workers would have to save more and more in order to exceed means-tested benefits. For example, a 23-year-old woman entering the workforce this year, who works full-time until she is 65 apart from a five-year break to have children, would need to build up savings of £100,000 in today's money by the time she retires to give herself an income higher than that which she would get from the MIG and associated handouts such as housing benefit. Someone working intermittently would need to accumulate even more.

"On earnings that won't grow beyond £15,000 in today's money, it's probably not worth taking out a stakeholder pension," says Deborah Cooper, a member of a recent Institute of Actuaries task force on pensions. Tom Ross, chairman of the independent Pension Provision Group, which advises the government about pensions, concurs with this view. He says that the target group of low-to-moderate earners, particularly those earning between £10,000 and £15,000 a year, now face “the most horrendous savings choices, ones that are far more difficult than for the better-off.”

The difficulty in making sensible choices boils down to political risk. Will future governments offer an earnings-linked safety net through the MIG? How long will the pension credit last? Although pension savings are the longest-term commitment that people make, governments cannot keep their hands off the arrangements for public provision.

This makes it virtually impossible for those on lowish incomes to plan ahead. For many, the sensible choice will be to put any spare savings in an ISA, where they will build up free of tax and, unlike a pension, can be drawn upon when they like.

If the government has made stakeholder pensions so unattractive that people do not take them up voluntarily, it may decide to make them compulsory. Mr Blake says that “the extension of means-tested benefits strengthens the case for compulsion.” Shaun Crawford of Cap Gemini Ernst & Young, a management consultancy, says stakeholder pensions “will not be taken up in any large numbers until compulsion is imposed”.

The government came close to making stakeholder pensions compulsory in 1998—so much so that the green paper included a reference to “compulsory funded pensions for those earning over £9,000 a year”. What was once an embarrassing slip is likely to become policy in the second term.

Pensions: Means and ends, The Economist, Nov 16th 2000

GORDON BROWN’S mini-budget captured the headlines for his proposals to cut fuel duty and so head off new popular protests. But the package may go down in history for the new direction it has set for state pensions. The government’s new plan takes Britain a long way down the road towards the Australian model of a means-tested state pension. The question is whether this will prove any more tenable an approach than the plethora of reforms of the past 20 years.

There are two key stages in the government’s new pension plan. The first is a really substantial increase in the minimum income guarantee (MIG) paid to the poorest pensioners. At present, this is set at about £11 above the basic state pension of £67.50 a week for a single pensioner. Next year, the basic pension will rise by £5 but the MIG will jump by almost £14. Andrew Dilnot, director of the Institute for Fiscal Studies, says that this increase in the MIG will turn out to be “a key part of what the government has done to the income distribution of the country.” By 2003-04, the gap between the MIG and the basic pension will widen still further to £100 and £77 a week respectively.

The second stage in Labour’s new plan is the introduction of a pension savings credit in 2003-04. This is intended to meet the current objection to the means-tested MIG—that it rewards the spendthrift but penalises the thrifty. Under existing arrangements, pensioners who have saved enough to ensure a weekly income of up to £100 in 2003-04 would lose out, since they would receive the MIG of £100 in any case. With the credit, they will also keep 60p of every additional pound of their original income above £77. A pensioner whose own weekly income is £100, for example, will get £113.80. Pensioners between £100 and £135 also benefit, but to a diminishing extent as this savings top-up is phased out. For example, a pensioner whose own income is £115 will end up with £122.80—only £9 ahead of the pensioner initially on £100.

The new scheme will affect many more pensioners than the 2m who currently get the MIG. When it comes into force in 2003-04, the government expects 5.5m—half of all pensioners—will benefit from the higher MIG and savings top-up. It is designed to address the problem of pensioner poverty and ensure that savings are rewarded. “It will now always pay to save,” said Alistair Darling, the social security secretary, announcing the government’s proposed reform.

Assessing pension changes is always tricky since you have to take into account their impact both on today’s pensioners and on working people of all ages who are planning for retirement. One worry about the government’s plan is that it will prove highly complicated for today’s generation of pensioners. The new system amounts to a massive extension of means-testing in pension provision. The government intends to do away with the weekly means test and replace it with a much less frequent and simpler assessment of income. But **David Blake**, director of the **Pensions Institute** at the University of London, warns that the scheme will add “a further layer of complexity for people who will find it very difficult to grapple with these issues.”

A more important problem with the new pension plan is likely to be its effect on working people. “It will reduce the incentive to carry on working,” says James Sefton, a specialist in generational accounting at the National Institute of Economic and Social Research. In Australia, which already has a means-tested state pension system, “double-dipping” occurs as people retire early, run down their savings and then qualify for the means-tested state pension. The government’s approach “will create the ‘double-dipping’ problem with people taking money out of ISAS (tax-concessionary savings plans) in order to qualify for the means-tested benefit,” warns Frank Field, a former Labour social security minister and an opponent of means-testing. “These are not teething problems, they are of the essence of the means-tested approach.”

Although the pension plan is designed to make saving pay, it may have the opposite effect. Single pensioners whose weekly incomes are between £100 and £135 will have a higher guaranteed level of income and keep a smaller proportion of their own income from saving. “Both effects promote lower saving,” says Mr Dilnot of the IFS. The effects are more ambiguous for pensioners with weekly incomes between £77 and £100, who will gain from their saving where they did not before, but will have less incentive to save because of the income guarantee. However, the impact on overall saving may be low because people in these income groups do not save that much anyway, points out Richard Disney, professor of economics at Nottingham University.

Another worry about the plan is future costs—about which the government has been strangely, maybe ominously, silent. Unlike the basic pension, the MIG and the savings top-up will be linked to earnings. This means that an initial gap of £23 between the MIG and the basic pension will widen by two-thirds to £38 (in 2003-04 prices) as early as 2010 if earnings rise by 2% a year above inflation. This will in turn generate large increases in the savings top-up.

The biggest question-mark over the reform is whether it will prove politically durable. The government has been rattled enough by a pensioner revolt to offer a big inflation-beating increase in the basic state pension in an election year. However, this is supposedly a “transitional” arrangement until the pension credit is introduced: from 2003-04, normal service of indexation to inflation will resume. Half of pensioners will benefit from the new pension plan; but half will not. “It moves the discontent up the income scale to people who won’t qualify and will feel aggrieved,” says Mr Field. Since their votes count as well, we may not have seen the last of “transitional” increases in the basic pension. The new pension plan is designed to focus resources on the poorest. It may end up re-opening the debate over the future of the basic state pension for everyone. That debate may include the question of compulsory saving for a second pension—a further feature of the Australian system.

AS fonds - a model for Europe?, by Rudolf Siebel and Marcus Mecklenburg, Investment & Pensions Europe, Apr 1999

In April last year Germany introduced a new type of investment fund under the German Investment Company Act (KAGG): the so-called ‘Altersvorsorge-Sondervermögen’, or ‘AS’. AS funds are mutual funds which are legally required to invest with the target of pension provision. The AS system is the only ‘true’ defined contribution system which is currently available in Germany, ie which fully releases companies from any liability for biometric risks.

Looking at the performance record of Anglo-American pension funds it is evident that for the purposes of optimum retirement provision it is sufficient to invest 75% of the fund’s assets in equities. At the same time this investment limit ensures that the unit prices of AS funds are less volatile than those of equity funds, thus accommodating the safety concerns of large groups of the population who still regard the volatility of the equity market more as a risk than an opportunity.

Investment companies launching AS funds are required by law to offer retirement savings plans (with a term of 18 years or up to the age of 60). Regular contributions into such a savings plan overcome the timing problem of the equity market for the contributors and at the same time provide the benefit of the ‘cost average effect’, ie when equity prices are high the investor/employee acquires fewer units, when prices are low they acquire more which means that they obtain a favourable average purchase price.

Contrary to what is sometimes claimed - AS funds are not just another investment product but a novel, legally recognised retirement system with the special-purpose AS fund as its key element. Its purpose is to provide an adequate level of retirement income at minimum cost and with maximum safety. Since the law-makers were not bound by any traditional legal structures, it has been possible to design each element of the system in the best possible way.

That AS fonds are organised under the German mutual fund law KAGG - which in many respects is more demanding than the UCITS directive - provides a framework of institutional safety which should help to foster pensioners confidence in the industry. Overall pension provision through the AS fund system offers a similar level of safety as the state pension system. After all, the safety of any pension system depends on the sustainability of the economic factors on which it is built.

The viability of the state pension system is dependent on the continuing existence of a sufficient number of gainfully employed persons who are able to pay for the benefits of the retired population. By contrast, the safety of the AS system depends in particular on the continued existence of profitable companies around the world. This premise is certainly no less likely than the continuance of the pay-as-you-go system which is the basis for the state pension.

The first AS-Funds were launched in October 1998; 34 AS-Funds are currently offered by 17 investment companies. From October 1998 until the end of 1998, these funds had net sales of DM751.1m (E384m) which on an annualised basis is more than total sales of unit-linked life insurance(1). Total assets of AS stood at DM808.4m and total contract values at about DM64bn at the end of 1998.

AS funds offer a variety of different investment styles in order to suit different investor profiles and preferences. Most AS funds tend to be fully invested in stocks up to the 75% limit. On the other hand, there are AS funds catering to the more conservative investor which limit stocks to a low of 25% of assets with the remainder in bonds and units of open-end property funds.

First and foremost, AS can be reasonably expected to have a long-term performance in excess of 8% (2) which is approximately 2.25 times higher returns than what the traditional instruments of occupational retirement systems offer. Because of their bond-oriented investment policy traditional instruments have a long-term average performance of about 6% which means that the use of AS for occupational retirement schemes will produce the same level of retirement income at lower cost for the company.

AS funds furthermore will provide in particular small and medium-sized companies with the most modern state-of-the-art pension system thus creating a level playing field between SMEs and large companies. This is important given the fact that the vast majority of German workers are employed in small and medium sized businesses, the 'Mittelstand'. They allow for the establishment of an occupational pension scheme to which contributions can be paid - depending on the economic situation of the enterprise - either wholly or partly, continuously or temporarily, by the company only or jointly with its employees.

Contributions by the employer and possibly also tax incentives could be made subject to the condition that the employee covers his biometric risks, for instance, by buying an occupational disability insurance and/or a term insurance. This would release companies fully from any liability for occupational disability and survivor risks. The sale of companies would no longer be encumbered by past liabilities such as pension liabilities and liabilities for biometric risks. On the other hand, companies continue to have a choice between conventional instruments of occupational retirement provision and an AS pension fund system based on securities.

At the same system the AS system ensures equal opportunities for all employees. It can be operated without waiting periods. It therefore provides an occupational pension system which is available to all employees (including part-time and short-time employees). The future pension level of an employee is not affected by changing jobs. This is of particular and fundamental importance in view of the current structural changes leading to greater labour force mobility. Under the conventional system it could happen that employees who had contributed for more than 25 years to a supplementary pension scheme lost all their entitlements because they changed to another job.

The employee has legal title to the assets underlying the AS fund units and not, as in the past, just an unspecified claim vis-à-vis the sponsor of the pension scheme. Employees have a maximum freedom of choice during the capital accumulation process because they can switch from one AS system to another. At retirement age employees can freely decide how they want to cover their longevity risk.

A major milestone in the acceptance of AS in the second pillar has been the announcement of the powerful trade union of construction workers, IG Bauen Agrar Umwelt "to form as a subsidiary or sister company of the existing pension fund ZVK a Kapitalanlagegesellschaft which acts as a platform for workers investment in AS funds" for the purpose of additional retirement provision (3).

The introduction of the AS system is a first step towards a fundamental review of the retirement provision system in Germany. In view of their high performance, great flexibility and universality - which makes them eligible both for personal and occupational schemes, AS funds are able to overcome the structural deficits of traditional retirement schemes not only in Germany but also in other countries. This can be achieved without requiring major changes in legislation.

The discussions within the European Federation of Investment Funds and Companies (FEFSI) have made it clear that European AS type funds could be set up in all EU member states on the basis of a European Directive. There would be no need to co-ordinate or harmonise existing laws and regulations as AS funds do not yet exist in the other countries. This approach would be the fastest way to meet the demands of internationally operating companies for a Europe-wide pension fund system. It would, however, require a policy decision - which surely will not be easy to achieve - at EU level on the introduction of a Europe-wide taxation treatment (flat-rate front-end or deferred taxation). The detailed of taxation, ie tax rate or whether tax relief is provided only if biometric risks need to be covered too, could be left to the discretion of the member states. This would make it possible to introduce relatively quickly an Europe-wide pension fund system for retirement provision which would fully meet the needs of companies and employees without having to change the existing traditional systems of retirement provision.

International experts such as Professor **Blake**, director of the **Pensions Institute** at London University, have described the AS system as “the system for the 21st century” and as “a model for Europe”. Modernising the conventional occupational pension instruments and at the same time integrating AS type pension investment funds as second pillar into the occupational pension systems would provide both Germany and Europe with a pension fund system which is leading in the world.

Notes:
1.Estimated new premiums of unit-linked insurance in 1998: DM875.4m (Source: Tillinghast, Cologne).

2. An analysis of the BVI’s savings plan statistics covering all saving plans which invest primarily in German equities shows that after 35 years (and including all costs except for account-keeping fees which are only charged in few cases) 71% of all plans generated a long-term average annual performance between 11.02 and 8.01%. For the other 29% the results were between 7.2 and 8%. This long period of 35 years ensures that practically all stock exchange phases - from bullish trends to flat or bearish trends, even stock market crashes - are included. Nevertheless, even the poorest performer was not below 7.2%. The average annual performance was roughly 8.7%. But normally, the results were clearly above 8 %.

3. Industriegewerkschaft Bauen Agrar Umwelt, “IG Bau will Versorgungslücke mit Tarif schließen” (press release), November 2, 1998.

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