



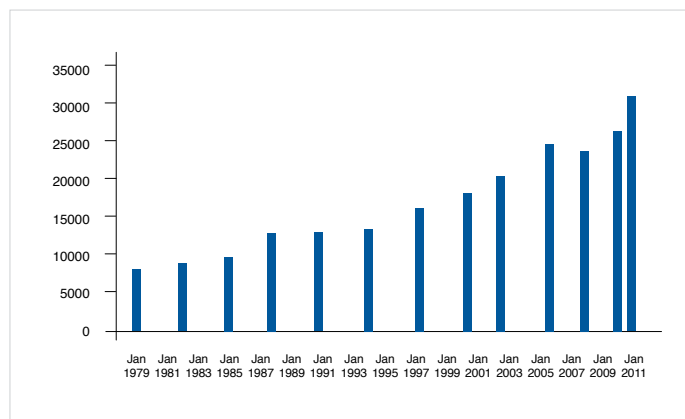
## Defined benefits – leadership required to secure best outcome

By SEAMUS HUGHES



Managing a defined benefit (DB) pension scheme is a lot like managing an insurance business. Leadership is required to bring best practice in insurance risk management to bear on the management of DB schemes, refocusing time and resources to secure a better outcome for members and sponsors alike.

The last three decades have seen pension costs quadruple, an increase which was neither predicted nor funded for and which has left many sponsoring companies reeling under the weight of significant balance sheet deficits and a growing divergence between members' expectations and the resources available to meet these expectations.

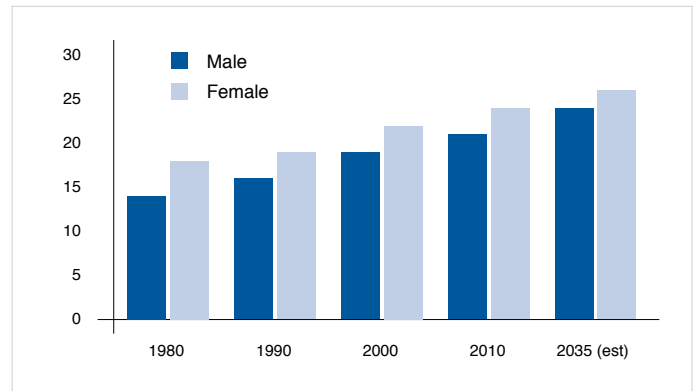


### Cost of €1,000 annual pension at age 65, including 50% spouse's pension and 3% annual increases

Source: Society of Actuaries in Ireland

Three factors have driven this increase in costs:

1. People are living longer. The chart below shows that a male retiring at age 65 in 2010 was expected to live seven years longer than his equivalent 30 years earlier.



### Life expectancy at age 65

Source: Society of Actuaries in Ireland

2. Interest rates have fallen, from around nine per cent in the early 1990s to around two to three per cent today making the cost of providing for future pensions more expensive.
3. Changing regulations have meant that certain benefits which were discretionary have been codified and become commitments.

### DB schemes must restructure or liquidate

There is a 'going concern' principle underpinning all viable businesses. The directors and auditors of a company must reaffirm that principle as part of the annual accounts process. When difficulties arise in business and threaten that going concern principle, it triggers a process that requires companies either to restructure or face winding up.

Many DB schemes are now at a similar juncture whereby the escalating cost of benefits has challenged the going concern assumption. The recent consultation paper, from the Implementation Group of the National Pensions Framework, on the future of DB provision recognises this point:

*"The Irish model of DB pension provision has tended to rely on increases in employer contributions where the scheme experience differed from that assumed. For many DB schemes, employer contributions are now at or above the maximum amount that is sustainable in the present economic climate"*

and goes on to remark that in terms of the outlook for schemes,

*"... if the recent difficulties with the funding of DB schemes persist, it is likely that at some point in time schemes will face the prospect of winding up with what may be a substantial deficit. In these circumstances it is likely that scheme members (especially younger members and those close to retirement) may receive reduced level of benefits."*

The choices for schemes today are therefore clear:

- (a) either restructure the way the pension scheme is managed;  
or
- (b) wind up the scheme (liquidation).

Restructuring of course is the preferable option. The Pensions Board has placed a strong emphasis on the need for any restructure to involve a substantive change in the way risks are managed. Many people have interpreted this as simply a requirement to reduce equity risk, but this misses the point. What is needed is a better process for proactively managing all risks in a pension scheme, and an approach which concentrates, not simply on the risk of failure but, more commercially on 'the risk of not succeeding'. This 'higher order' approach considers certain risks to be acceptable (even necessary) to optimise the probabilities of success.

### Towards better management

It should come as no surprise that the above named consultation paper is effectively importing best practice ideas from the insurance industry when it puts forward options for the future of DB provision. (See David Kingston's article later on the contrasting approaches to risk taken by insurance companies and pension schemes.)

We invite you to change the way you are looking at the DB question. Here is one set of perspectives to get you thinking:

- DB schemes are largely in run-off, in deficit and in real danger of being wound up, with catastrophic consequences for members.
- Even after negotiating benefit reductions and increased contributions, earning some excess investment returns is still required if schemes are to deliver on their objectives.
- Few companies can justify and / or afford to provide an open-ended covenant supporting their DB scheme. In fact, many are drawing a line in the sand and being explicit about an absolute limit on additional contributions.
- Someone must take the lead in putting in place a management framework which has, at its core, the management of the 'risk of not succeeding'.

And here is how some organisations are responding:

- Companies are taking a leadership role and devoting more resources to the question of how best to manage the pensions issue.
- They are changing their perspective from viewing pensions as a line item on the P&L account and balance sheet to viewing it as a wholly-owned 'insurance business', whose beneficiaries are their current and past employees.
- They are giving a senior person within the company the responsibility and resources to work with trustees and put a more effective framework in place to ensure the insurance business is effectively managed, and the risk of not succeeding for their members is minimised.
- A significant part of that work has meant addressing the current spend on consultants, advisers and administrators by reducing and redistributing it such that it is focussed on:
  - (a) proactively managing the risks in the 'insurance business'; and
  - (b) looking for opportunities to make step changes that reduce the long-term financial strain on the company while also improving the security of member benefits.

Trustees are welcoming this move as it is a significant help to them in their fiduciary roles.

For more information on this topic please contact our office at 01 634 4510 or by emailing either Seamus Hughes [seamush@acuvest.ie](mailto:seamush@acuvest.ie) or John Tuohy [johnnt@acuvest.ie](mailto:johnnt@acuvest.ie).

## Pensions versus insurance – a contrasting approach to risk



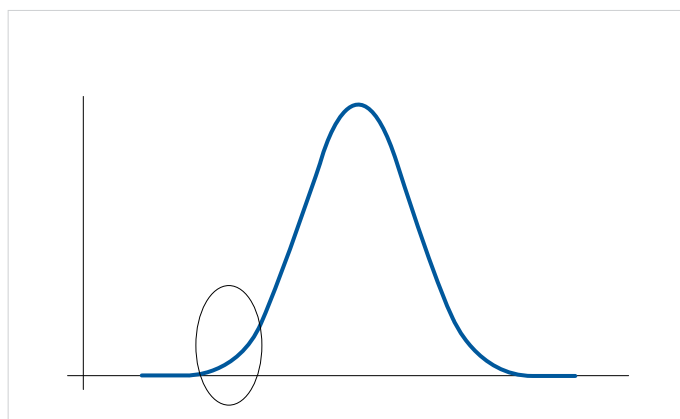
By **DAVID KINGSTON**

The recent White Paper on funding standards for Irish defined benefit pension funds has highlighted the different approaches to risk and reserving for pensions and insurance. The essence of the paper is that pension funds should change to the insurance method. What lies behind this argument?

Let's look at the principles behind the current approaches to risk and reserving in the two areas. For insurance companies, reserves are calculated on a basis of focusing on a range of outcomes, with the actual reserve figure being based on a very low possibility of not being able to meet all obligations. This method is currently undergoing some change under the EU's Solvency II directive. In essence this means that the level of reserves held will cater for 99.5 per cent of all outcomes. Thus there is, in theory at least, a one in 200 chance that an insurance company will fail financially.

The principles behind this can be summarised as:

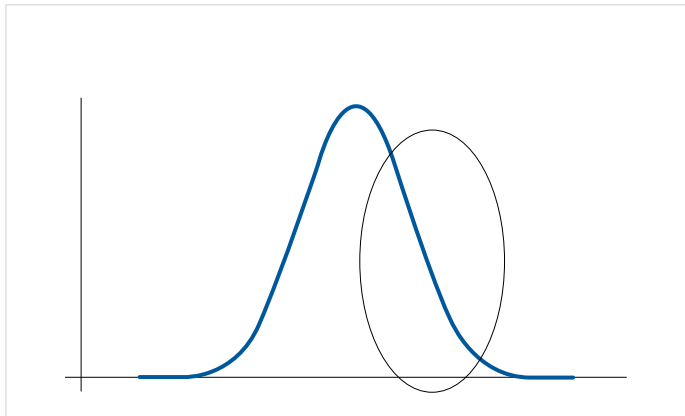
- (a) Strong risk-management based modelling;
- (b) Very few insurance companies will go bust; and
- (c) Assets and liabilities will be closely matched – assets will be assumed to be invested in risk-free instruments.



### Insurance company reserves are set by focusing on up to 99.5% of the worst-case scenarios

For defined benefit pension funds, the previous minimum funding standard stipulates that liabilities accrued will be discounted at a low-risk rate (somewhat higher than that used by insurance companies). Assets will be taken at market value. There is no requirement for matching assets to be held. No extra capital will be required. Thus, if the scheme only passes the minimum funding standard, it has a 50 per cent possibility of meeting its liabilities in full. Contrast this to the principles set out in the

previous paragraph for insurance companies.



### Pension schemes manage by relying on a positive outcome

Why have these different principles emerged? Defined benefit pensions were not always considered guaranteed. For example, an early leaver used to get very little. This approach has changed over the last 20 years with regulators now demanding that promises be met in full under almost all circumstances. Pensions actuaries were slow to recognise this however, and pensions regulators have been much slower than their insurance counterparts in toughening their stance on reserving. Additionally there was the assumption in pension funds that the sponsoring company was a sort of 'lender of last resort' who would bail the fund out if necessary.

The problems with the current pensions scenario seem to me to be:

- (a) Sponsoring companies are no longer prepared (or able) to bail out pension funds in all circumstances; and
- (b) The current prioritisation of benefits means that current recipients are far more likely to receive their benefits than members still in the work force.

There is no doubt in my mind that the insurance principles are the better concept. BUT, for pension funds to get there requires two things:

- Time – probably five years; and
- A change in benefit priorities.

For the latter, I think we need to see a reduction in priority for pensioners – at least for the larger pensions. One current method of doing this is to allow sovereign bond matching for a portion of pensions in payment.

One thing is certain – the present situation where current pensioners are likely to receive all their benefits and future pensioners may receive very little is not sustainable.

## Dynamic asset allocation – an essential investment tool

By **PRAMIT GHOSE**



When I started in the investment business, 25 years ago, movement between asset classes was the key thing people focussed on. In the 1990s, investment consultants became focussed

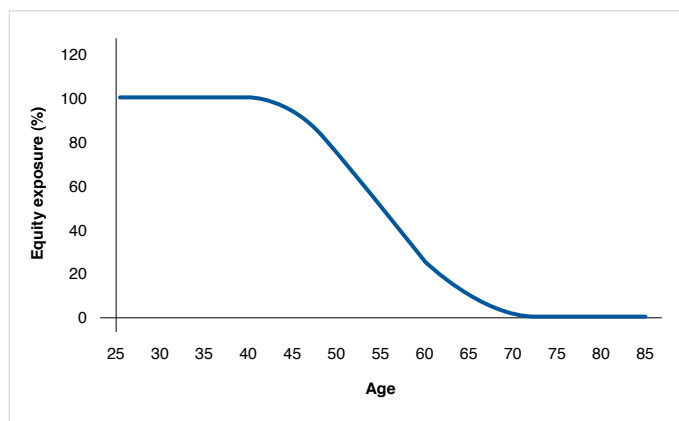
on manager selection and managers became specialists on particular classes, managing to mandates, often without any knowledge of what was going on elsewhere in a fund.

Trustees spent huge amounts of time focused on which manager could add a half per cent extra return to any particular mandate, but the allocation between asset classes was often decided by the actuary and set in stone between valuations. Little or no regard was taken to timing investment switches.

It took nearly a decade for this style to work its way through the system, but the past 10 years saw huge problems caused by the lack of dynamic asset allocation. When your 70 per cent equity holding falls in value by 40 per cent in a year, the fact that your particular manager managed to limit the drop to 38 per cent starts to look immaterial.

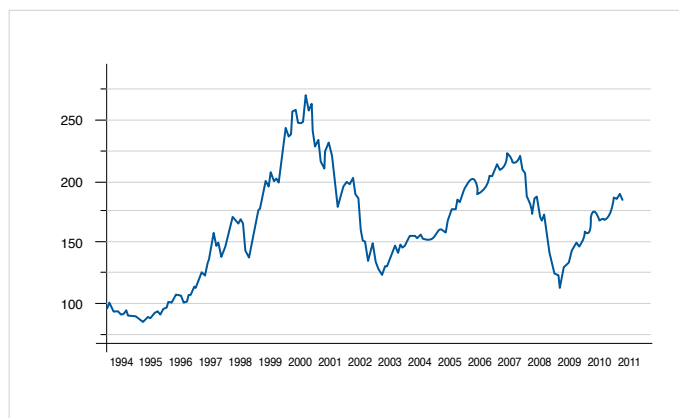
### Dynamic asset allocation and lifestyling

Most people are familiar with the concept of lifestyling, which the chart below illustrates. As individuals approach retirement, the proportion of their funds in growth assets gradually drops so that by the time they retire, all investments are in matched assets.



Lifestyling is a valid approach, protecting individuals against market volatility at the time they need it. However, experience has illustrated two key flaws with the process:

1. Contributions peak as exposure to growth assets tail off. Contributions increase as people age, first because salaries tend to increase and second, people tend to save more as the prospect of retirement approaches. This lack of exposure to risky assets will not be a concern if assets have done well, but will pose a problem if assets have failed to perform.
2. In a prolonged bear market, people will be forced into an automated switching programme after receiving little return on investments (for example, see below). The chances of disappointment are therefore huge.



For these two reasons, the next few years will see a lot of very disappointed people at retirement.

If you take a more flexible and dynamic approach to switching from growth to conservative assets however, both problems can be avoided.

## Using dynamic asset allocation to de-risk investment strategies

Ten years ago, asset choice for pension funds was straightforward. Today, investment selection has expanded exponentially.

### Asset choice 2000

<b>Equities (Irish and overseas)</b>
<b>Bonds (all Irish)</b>
<b>Property (all Irish)</b>
<b>Cash</b>

### Asset choice 2011

<u>Return-Seeking Assets</u>		
<b>Equities</b>	<b>40-60%</b>	<b>Passive v active Emerging markets Midcap / small cap Fundamental indices</b>
<b>Alternatives</b>	<b>20-40%</b>	<b>Currencies Commodities Hedge funds Absolute return funds Private equity Infrastructure</b>
<b>Property</b>	<b>0-15%</b>	<b>Irish European</b>
<b>Others</b>	<b>0-15%</b>	<b>Emerging market debt Structured notes</b>
<b>Cash</b>	<b>0-20%</b>	
	<b>100%</b>	
<u>Low Risk (Matching) Assets</u>		
<b>Customised Bonds</b>		<b>100%</b>

In addition to the expanding choice, today we also recognise that it is important to look at the individual scheme circumstances when devising investment strategy. To give a couple of examples:

- You must question whether it is appropriate for a company with a stretched balance sheet to move its pension fund portfolio further into growth assets, no matter how good the timing looks. A solution we have used in this circumstance

is to use equities, but with a layer of capital protection to protect against downside risk.

- Another client of ours crystallised a large property gain which put the scheme into a significant surplus. While the traditional advice here would be that this allowed the scheme to take greater risks and maximise on return-seeking assets, we advised the client to lock in those gains and invest in inflation-linked bonds as a hedge against its inflation-linked liabilities, which has proved highly beneficial.

### Track record

<b>Mid 2003</b>	Increase equities
<b>Mid 2005</b>	First steps into commodities
<b>Dec 2007</b>	Reduce equities
<b>Mid 2008</b>	Diversified alternatives programme introduced for return-seeking portfolio
<b>Mid 2009</b>	Add corporate bonds to return-seeking assets
<b>Autumn 2009</b>	Add emerging markets equities module
<b>Early 2010</b>	Remove corporate bonds
<b>Autumn 2010</b>	'Tactical' investments in Irish 10-year government bonds
<b>2010/11</b>	Manage equity reduction programme

The box above sets out some of the dynamic asset calls that we have advised over the last number of years. Not all of them have been right – the move in to Irish government bonds last year turned out to be premature – but added together, the dynamic asset allocation advice has added considerable value to clients in diverse scenarios.

The key, however, with dynamic asset allocation is 'how quickly can I move when the right opportunity comes up?' Many of the situations above posed temporary opportunities. Advice needs to be quickly given and quickly acted upon in order to gain.

Acuvest is a specialist provider of investment services to institutional investors.

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Our services include investment advice and strategy, development and ongoing management of investment decision-making processes, asset allocation, risk management, governance review and management of alternative investments.

#### Range of clients

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**General insurance companies** We provide specialist investment management solutions to general insurance companies.

**Religious congregations and charities** We provide a range of investment advisory, administration and management services to religious congregations and charities.

**Other corporate entities** We work with a variety of companies on specialist projects that utilise our investment and management experience.

For further information including details of the people behind Acuvest see our website at [www.acuvest.ie](http://www.acuvest.ie)

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