

Media Comments 2011

Blake's progress, *December Retirement Strategy*, By Gregor Watt, *Money Marketing*, December 2011

Cass Business School's David Blake has an abundance of views on the state of the pension arena and his belief that there are fundamental problems in the DC model should stir up plenty of debate Report by Gregor Watt



Dr David Blake has an optimistic outlook for the future of UK pension provision and predicts that the race to the bottom for occupational pension schemes will eventually be reversed to end up in a position where employees will once again be members of good quality pension schemes that are able to provide decent levels of income in retirement.

The bad news for those of working age is this is going to be at least 30 years in the future and will only come about once the full extent of the nation's lack of savings has been experienced.

Blake is director of the Pensions Institute at Cass Business School, the first specialist academic research centre focusing on pensions. He has not arrived at this conclusion overnight but says the extraordinarily rapid erosion of quality pension schemes in the last 15 years will lead to sharp and severe fall in pension income that has not been properly appreciated by the general public, while politicians are fundamentally ill equipped to deal with such a long-term, structural problem.

The erosion of final-salary schemes has left DC pensions as "the only game in town". But Blake says current DC plans are fundamentally flawed.

"Given that DC is the last game in town, DC has got to be well designed. And it is not, it is simply not well designed."

Blake recently co-authored two reports on optimal investment strategies for DC which laid out much more efficient ways of dealing with different types of saver. He suggests that engaged, well informed, active decision-makers should delay saving until they reach 35 when earnings start to peak and from then on should save

significant levels, while lower paid, financially less literate and less disciplined should save regularly from a lower age but should adopt much more conservative investment strategies.

However, he says a paper he wrote three years ago sums up the overall problems with DC much more effectively.

“You’ve got to work backwards, like an airline journey. It is no good going to the airport and saying to the airline ‘I want to fly somewhere. They are going to ask you ‘where do you want to fly?’ Do you say I don’t know, I just want to get on the plane?”

“You need to know where you are going to end up, you need to know how much fuel you need to put in the airplane, you need to know all about wind speeds at different altitudes in order to end up where you want to end up. and that requires that you work backwards.”

He says the same process needs to be applied to DC schemes.

“It has to be designed from where do you want to end up? How long are you going to spend in retirement? When do you plan to retire? What standard of living do you want in retirement? Therefore, what size fund do you need to have built up by the time you want to retire. And then working backwards, what combination of contribution rate and investment strategy give me a very good chance of accumulating that sum. Nothing of this is happening at the moment.”

Another significant problem with DC schemes is the lack of understanding of the risks involved by scheme members themselves. This leads to all sorts of misunderstandings about investment risk, contribution rates and annuity risk to name just the most obvious ones.

Blake cites an anecdotal conversation between two friends comparing the pension schemes. When they get to contribution rates one says, “I pay £100 a week into my scheme” while the second says “What, I pay £200 a week. Why is my scheme costing twice as much as yours?”

More seriously, Blake says the sharp drop in employer contributions, combined with low personal savings rates and poor investment strategies will lead to “19th century levels of poverty” and only following that will we start to see a recovery in the quality pension provision.

He says: “The Baby Boomers look as though they may be the most favoured generation in history. It looks as though the generation following the baby boomers could be experiencing that return to 19th century poverty in old age. Only then will they turn to their children or grandchildren and say ‘make sure your company has got a good pension plan’, only then when those people go to look for jobs and the first thing they ask is, ‘what is the pension like?’”

The introduction of auto-enrolment and Nest will not offer much respite, as Blake says the contribution rate and investment strategy, in common with other DC

schemes, is inappropriate and the fact it is Government backed could lead many people to think they have their pension needs taken care of.

“In a way Nest, although it is quite a nice idea, could set a very false impression.

“Nest is providing a standard which is a very modest one. To be fair to Adair Turner, whose idea this was as it came out of his Pensions Commission of 2005, he did say this is only going to provide 15 per cent of the pension of the average worker. The state pension is going to provide a percentage, their private sector pension is going to provide another element and you are expected to make you own arrangements on top of that.

“But most people won’t see that. They will say this is a Government pension plan, we were auto-matically enrolled onto it, and we are getting a few pounds a week in pension. We thought we have a pension plan.”

Blake has a particular issue with the contribution rates set out by auto-enrolment.

He points to behavioural finance and the Save More Tomorrow plans in the US.

The two features of the Save More Tomorrow plans were, first, auto-enrolment and, second, auto-escalation and Nest does not have the second bit, the auto-escalation.

“With Save More Tomorrow, you would put your annual pay rise of 3 per cent into the plan, then you put the next annual pay rise in and then the next and the next one. In four years, you have 12 per cent contribution which is beginning to look right.

“We have only got the 3 per cent plus the employers bit. We don’t have the auto-escalation.”

If this was a case of just a few people undersaving, it may be manageable but when the problem starts to affect the majority of the population, it becomes a systemic problem and a major problem for the Government. If a small number of people don’t save for their retirement, it is not a problem. The rest of us can say, ‘That is very unfortunate, we can pay a bit extra in taxes for you and you can have a decent pension’. Or the rest of society can say ‘Tough luck, you should have been aware of this, you spent your money when you were young, you should have worked this out, you are on your own’.

“But if everybody does not save for their pension, this becomes an aggregate, systemic problem, which the next generation of taxpayers is going to have to bail out.”

Using compulsion or increasing the state pension could alleviate the problem but Blake says this does not get rid of the problem.

“That nationalises the problem and that is not the British model. The British model is to provide a very modest first pillar state pension and for you to make your own arrangements. We know the problems of the Continental model, the Germanic model which is very high state pension and very little private sector pension, we know from what we’re seeing in Europe that this leads to national debt.

“The real problem, not just in Britain but in Europe and North America, is the national debt. If you take into account the unfunded state pension, debt is two or three times the official level and it is much more in Europe because of his unfunded promises. At least we’re not as bad as that.”

The design of the British political system also prevents pro-active measures to deal with the problem from being taken.

“Because politicians can’t think beyond the next election, our political system is not designed to solve long-term problems that we are now being confronted with, serious long-term problems not only in terms of population size, not only in terms of pensions, in terms of demographics or in terms of climate change, the government can’t deal with these problems.”

A good example of this lack of foresight is the increase in longevity. The row over the recent changes to the state retirement age for women could be set to be played out again and again. Blake refers to a graph in a recent piece of Pensions Institute research which shows that every official Government estimate of life expectancy since 1966 has significantly underestimated actual longevity increases. The result is that while official Government spending predictions look more presentable, another increase in the state pension age is “unavoidable”.

Blake says the statistics show life expectancy has increased by a steady two and a half years every decade since 1840 and this is showing now sign of altering. But it is not just Governments who get life expectancy very wrong. Blake says individuals estimations of life expectancy is almost invariably linked to their parents life expectancy.

“People think they are going to live only as long as their parents, so they don’t factor in the two and a half year a decade improvement in life expectancy that they will enjoy over their parents. That is equivalent to at least seven or eight years longer than their parents.”

This inaccurate assessment makes the decision of how and when to move into retirement a very difficult one for pension savers.

The options to solve these problems are limited. Education about the size and scale of the problem are one option but the possible avenues to bring this about are limited.

Blake says: “Another interesting area is advice because you have got this problem of regulated advice versus generic advice. The Government knows that financial education is terrible and it is trying to do something about it in terms of improving school leavers and school children. It also has the Money Advice Service which is providing generic advice on the internet.

“There will be a section of the population who say if you have a reliable website, it will really be very useful to them but for most people, the Money Advice website will be as useful as a very simplified website on astrophysics.”

“Not many people trust financial advisers while the consensus view is the sources of advice you would trust most is family and friends, although whether family and friends have the right type of advice. Then the next one down is the employer so really it ought to be the employer that provides advice as there is the £150 a year limit which is for tax free advice as long as it is generic advice.

“A lot more has to be done around the employer and the provision of long-term advice and communication.”

This brings the conversation round to having the right type of pension scheme to give advice on.

Blake says: “We gave up something very precious in this country, our final-salary pension schemes. 150 years of development of pension schemes in this country disappeared in 10 or 15 years without an inch of protest. That is one of the most remarkable transitions that I have personally seen in my lifetime and I cannot believe that it was given up so easily.”

Blake says it is possible to design good quality DC schemes to replace the pension schemes that have been lost but seems mostly resigned to the fact that it will take a very long, difficult retirement for a whole generation before any real attempt is made to revive good quality pension schemes.

“You can design a DC plan that with a high degree of probability, but not certainty, will replicate these final salary plans and give someone a decent standard of living in retirement.

“Someday someone is going to say why don’t we introduce that. It is going to be in about 30 years time and they will think they are great originator - although you and I will know we thought about it now.

“It is going to take a generation finding themselves in extreme poverty, finding that they cannot go on strike because there isn’t a generation behind them that is going to bail them out, finding that they can’t believe this could have happened and then saying at least we tell our children or grandchildren that they must not do what they did.” “If every-body does not save for their pension, this becomes an aggregate, systemic problem, which the next generation of taxpayers is going to have to bail out’

Why you need more 'risky' equities in your pension pot, By John Greenwood, Your Money, Daily Telegraph, 26 Nov 2011

Wealthier employees are being shoehorned into unsuitable pension arrangements that expose them to too much risk when they are young, but invest much too cautiously as they hit retirement.

That is the finding of a report from Cass Business School in London, which examined the strategies adopted by typical defined purchase pension schemes across Britain.

The report, *Optimal Funding and Investment Strategies in Pension Plans*, by Professor David Blake, concludes that the one-size-fits-all nature of default funds in workplace money purchase schemes means millions of higher-rate taxpayers are investing in the wrong types of assets throughout their lives.

For Prof Blake, the problem centres on the fact that default funds assume that everyone in them is going to use all their pot to buy an annuity on the day they retire. While this may be the right solution for the majority of people, who cannot afford the risk or advice costs of income drawdown, for a substantial minority a 100pc switch out of equities is unsuitable.

Research from the Pensions Policy Institute shows that 25pc of defined contribution pension savers over 55 have sufficient assets to consider income drawdown, yet anyone planning to do so should not be entirely invested in bonds.

Existing default funds are not just unsuitable for wealthier pension investors, but they expose people of all income groups to too much risk in their late forties and fifties, says the report.

Prof Blake said: “The problem with default funds is they start switching people out of equities too late, but, when they finally do so, it happens too fast and it goes too far.”

With money purchase pension schemes, it is the individual who is exposed to stock market risk. To avoid the risk that a 30pc drop in the stock market the day before you retire translates to a 30pc drop in pension income, as happened to some individuals in 2008, most pension funds operate an automatic de-risking system. This gradually switches tranches of your fund out of equities and into bonds, gilts or cash. This process, called “lifestyling”, usually happens in the five or 10 years preceding your stated retirement date.

Prof Blake’s research concludes that the switch away from risky assets should start much sooner, gradually moving investors out of equities when they are in their late forties. But rather than reaching retirement age 100pc invested in bonds, wealthier people should still have between 20pc and 50pc left in equities.

Andy Cheseldine, of pension consultancy LCP, said: “Lifestyling only works for the 80pc of people who are going to end up buying an annuity. It is a very blunt instrument and if you know that you will not be buying an annuity when you retire with the whole of your fund, then you should not be 100pc in bonds or gilts when you reach retirement age.”

Beware the default fund

Default funds have stayed in the thrall of the cult of equities long after years of good performance stopped masking poor asset allocation.

Investment experts agree that equities are absolutely the right asset class for younger investors because they have historically returned more on average than bonds for longer periods. But over shorter time investment horizons the chances of them outperforming fall.

The Barclays Equity/Gilt study has been collecting data on the relative performance of different asset classes since 1899. Of the 94 discrete 18-year periods since the end of the 19th century, equities outperformed cash for 93 of them and beat gilts on 83 occasions.

But consider a 10-year time horizon and you don't have to look far to find cash and gilts outperforming equities. In the so called "lost decade for equities", the 10 years to 2010, UK equities generated on average a return of 0.6pc a year, compared with 2.4pc for gilts and 1.1pc for cash.

Prof Blake argued that while equities were expected to outperform, the risk they will not do so grows as the investment horizon shortens. For this reason investors need to start moving at least some of their assets into bonds in their mid to late forties.

"Depending on how risk averse you are, you should have between 20pc and 50pc of your fund in equities on the day you retire," he said. "This is because you are going to live for possibly another 30 years, so want to attempt to achieve some of the higher potential returns available from equities."

Rather than plain vanilla equity funds, Prof Blake preferred diversified growth funds that offer access to a range of growth asset classes such as property, currency, infrastructure, private equity and debt as well as traditional equities, which are designed to give equity-like performance but with lower volatility.

Once in income drawdown, investors should continue the strategy of taking risk out of their portfolio gradually.

This is because the nearer you approach your likely age of death, the better rate of return you get from an annuity, making annuities increasingly attractive compared with income drawdown. This effect, known as "mortality drag", means your investments have to return around 6pc a year by age 75 for your drawdown pot to keep pace with what an annuity would pay you. By age 80 the figure is a difficult-to-achieve 7.4pc.

Most experts agree that this strategy is pretty close to the sort of solution that wealthy people paying for professional advice would receive.

Andrew Herberts, investment director at Adam Investment Management, said: "Dr Blake's approach more or less describes what we do for our clients at the moment."

Another advantage of phasing annuity purchase in this way is that it reduces the risk of buying one at the bottom of the market. "Making a once-in-a-lifetime switch into an annuity at age 65 is not optimal because you could be at the bottom of the interest-rate cycle," said Prof Blake. "Phasing your annuity purchase hedges you against that interest-rate risk."

Billy Burrows, a director of Better Retirement Group, said: "If you want to phase your annuity purchase, there are two ways to do it. If you already have several pension policies, you can use them to buy annuities one at a time.

“Alternatively, you can put your entire fund into a low-cost Sipp and take chunks out as and when you want to. Another advantage of waiting is that the older you get, the more chance you can get an enhanced annuity on grounds of ill health.

“And you will find it easier to pass on the assets still in your Sipp in the event that you die. But you will face a cost each time you transfer money from your Sipp, as well as the cost of advice on your annuity purchase.”

Defined contribution pensions are risky enough as it is – so it is worth making sure you are taking risks only when it is in your interests to do so.

Longevity asset class 'compelling opportunity' – conference, by Chris Pantelli, Global Pensions, 12 Sep 2011

GLOBAL - The development of longevity as an asset class continues to grow as longevity risk becomes increasingly recognised, experts believe.

Delegates at the Longevity 7 conference in Frankfurt, Germany last week heard how longevity markets could provide investors with the opportunity to earn attractive returns.

David Blake, conference chairman, professor of pension economics and director of the Pensions Institute at Cass Business School said: "Longevity risk is an increasingly important risk to recognise, quantify and manage for both pension plan and annuity providers, as well as for governments and individuals. Getting the right trend improvements in life expectancy is the key both to managing this risk and to creating an asset class acceptable to investors to buy into.

"However, this has proven to be difficult to realise in the past; even official agencies have systematically underestimated previous mortality improvements. Pension plan and annuity providers are beginning to question whether longevity is a risk they should be assuming on an unhedged basis, and the capital markets are beginning to offer solutions for managing and unloading longevity risk."

Société Générale managing director and head of insurance and pension solutions Jeff Mulholland added: "The opportunity to relative trade the micro-longevity and macro-longevity markets is becoming compelling.

"With spreads likely to tighten in the micro-longevity market due to market forces, investors will have the opportunity for potential mark-to-market gains over time, whilst the amount of longevity risk that needs to be hedged globally suggests macro-longevity spreads may widen over time, leading to opportunities for returns for investors who trade longevity."

Amy Kessler, a retirement expert at Prudential's (Pramerica in the UK) Retirement division said the UK was leading the way in pension plan de-risking.

"Progress in the UK has been driven by regulation, accounting transparency and risk awareness among pension schemes that has led to dramatic changes in risk

management and governance. Many of the same catalysts for change are arriving in the US today," she said.

"As US pension plan sponsors face these changes, there is broad recognition that their current risk position is unsustainable. While affordability remains an issue, techniques used in the UK for reducing and transferring risk have crossed the pond."

Raimond Maurer, professor of investment and pension finance at Goethe University, and co-organiser of the conference, added: "In the twentieth century, state-organised pension programmes shouldered the lion's share of financial provision for the elderly. In the twenty-first century, however, retirees are likely to depend very heavily on privately organised funded old-age protection, such as private occupational pension plans and life annuities.

"Yet, the financial institutions that are supposed to supply these products, such as pension funds and life insurers, face substantial difficulties in managing systematic longevity risk. One possible solution to this problem might be the transfer of a reasonable proportion of this longevity risk to the capital markets. This, however, requires investors to accept longevity-linked instruments as an appealing asset class."

Academics say wait until 35 to save, By Moira O'Neill, Investors Chronicle, 6 September 2011

Rational investors should wait until they are 35 to start saving in a pension to maximise their standard of living over their lifecycle, according to academics at London's Cass Business School. But their surprising conclusion runs counter to conventional wisdom which argues people should start saving into a pension scheme as early as possible so as to benefit from the greatest possible compounding of investment returns.

For example, Smart Sally and Dumb Dan, both age 21, start their first job where they receive the same salary. During the first week at work, they attend a seminar where they learn about the benefits of participating in their employer's pension scheme.

Smart Sally decides to start saving £100 from each month's salary. Dumb Dan, however, wants to wait until he is older before starting to save. If we assume an annual rate of return of 6 per cent, Smart Sally accumulates approximately £16,700 after 10 years. Dumb Dan starts saving at age 31, and like Smart Sally, decides to save £100 a month. By age 65, the retirement account of Smart Sally (who continues investing her £100 a month) would be about £253,000, while Dumb Dan's account balance, started 10 years later, would be about £132,000. The aim of the story is to demonstrate that starting young is incredibly beneficial.

In contrast, Cass's paper, based on "optimal" lifecycle financial planning behavior, found that, "surprisingly, it is not optimal for individuals to start contributing to a pension plan until several years into their career. This is because individual's incomes are initially low and they are better off consuming their incomes rather than saving from them."

Investors should instead focus on large contributions after the age of 55. The academics say: "Workers are better off consuming their initial low incomes, rather than saving them. As an individual's income grows a worker can save more comfortably for his or her retirement. For a male worker with a typical career salary profile, the optimal contribution rate increases steadily from zero before the age of 35 to around 30-35 per cent after the age of 55.

The problem is that Cass's idealised theoretical model won't work in practice for most investors. Even Professor David Blake, director of the Pensions Institute at Cass, admits: "I doubt that most people would have the will power to maintain such high contribution rates towards the end of their working lives".

For a start, not everyone has a salary that rises during their working life. Plus, many professionals who would expect to be high earners during later life are unexpectedly made redundant in their 50s.

I don't want to get too gloomy but there are so many life risks to wait until you are in your 50s to start setting aside considerable sums. Along the way you may face divorce, redundancy, death, major injury or health issues, or leaving work/cutting down on work for a period to bring up a family or care for a relative. Plus, Cass's model doesn't take into account the emotional strain of trying to play financial catch up in your 50s - or the risk that your 50s are a 'bad' decade of low or zero growth in world stock markets.

Plus, is 35 really the ideal age to start saving for retirement? A separate study by Standard Life reveals that financial and emotional commitments peak between 35-44 years of age when people spend on average £1,160 a month on financial commitments including mortgages, children and debt, and think about them for 45 minutes every day. Thirty-something parents may not suddenly be able to find extra money to save in a pension - it may have been easier to put money aside at 25.

Finally, bear in mind that investors usually get better with experience as they learn from their mistakes. So making some mistakes in our 20s could pave the way for a more successful investment career in later life.

Academic study questions traditional approach to retirement planning, Engaged Investor, 6 September, 2011

Trustees should consider more personalised arrangements to 'one size fits all'

Two new studies from the Pensions Institute at the Cass Business School have questioned the conventional wisdom of designing defined contribution (DC) pension plans purely for rational, life cycle financial planners.

The studies called for a more tailored approach to pension planning, based on two models of real-world investors: normal investors, who have behavioural biases which affect their investment decisions, and the more rational investors, who are likely to make more impartial financial choices.

Professor David Blake, who led the study, believes that there are “inherent problems with default funds”, because investor profiles “vary too much from person to person for one default fund to fit all circumstances.”

However, Blake does not believe that a vast range of fund options is the answer. Rather, he advocates “a very small number of well-defined choices”.

Three factors were identified which trustees should take into account when designing DC pension plans: salary profile, attitude to risk, and personal discount rate, or the preference for current versus future consumption.

The study recommends that an optimum investment strategy for rational investors should consider an age-dependent contribution rate, whereby workers spend their low initial incomes, then save a higher proportion of their income as it grows over time.

Switching from equities to bonds as members approach retirement would be based on past investment and salary growth, rather following a default path. Assessing the risk individual members are willing to take ahead of retirement would determine the amount of equities to be held in the portfolio, rather than it automatically being reduced to zero.

To counter the dual loss and risk aversions of normal investors, the fund’s equity weighting should be increased if the fund marginally underperforms, and decreased if the fund is slightly above target.

Trustees should consider these findings with interest, especially as auto-enrolment will likely prompt a review of many companies’ current pension schemes. These new suggestions may achieve a better overall outcome for scheme members, accounting for their individual investor profiles.

Rational pension saving ‘highly unlikely’, by Daniel Billingham, www.pensionfundsonline.co.uk, 6.09.2011

New [research](#) from Cass Business School’s Pensions Institute suggests clued-up defined contribution (DC) pension savers would be best served by avoiding saving for their retirement until the age of 35 as well as continuing a high-risk approach of holding equities after retirement.

Intriguingly, other [research](#) recently released by the business school indicates that pension funds could please their savers by moving out of high-risk equity assets as soon as their pension pot begins to grow too quickly.

The novel suggestions have emerged as part of an attempt to analyse DC investment strategies under the developing discipline of behavioural economics. This seeks to challenge the assumption -which has been the foundation of economic modelling for decades - that individuals always act ‘rationally’ by looking to maximise their personal financial returns.

It is suggested that a completely rational DC saver would not put a penny into their

pension pot before the age of 35 as they would be better of investing in their 'human capital' by spending money on holidays and cars, for example.

Professor David Blake, who led the Cass Business School research, told *Pension Funds Insider* "When you are young, your income is low, but you recognise that it will be much higher when you are older, so it is optimal for you to spend whatever you have. Any saving you do will be short term in nature, such as saving up for your next summer holiday."

The optimal approach also recommends a 100% initial equity investment and the retention of equity holdings after reaching retirement as phased annuities are taken.

Reality bites

The rational saving model relies on a steep increase in pension saving between the ages of 35 to 55, up to a sizeable 30-35% of salary to compensate for the absence of savings when you are young. Nevertheless, Blake concedes that "very few people would have the willpower to maintain this very high savings rate."

Blake explained: "Our analysis of the ideal rational strategy assumes you are a highly proficient life cycle financial planner who has all the skills to work out the optimal strategy yourself. The percentage of the population which has those skills is actually quite small."

The second paper issued by the Pensions Institute team looks at which DC strategies are most suited to a very different hypothetical saver, with a high level of loss aversion. The researchers have concluded that these fretful savers would be logically ideally suited to a target-driven investment strategy, where funds go equity heavy if they are below a savings target and switch into low-risk bonds if they are above target.

Blake says that the wildly differing investment strategies followed by DC pension savers shows that they are a diverse bunch. He adds that "pension plan designers have to look carefully at the kind of people that are joining their schemes. There are those members who focus on long-term retirement outcomes and others who monitor their portfolios too frequently and panic every time they make a loss. It's important for providers to recognise the difference between the latter group of 'human' investors who suffer from a behavioural bias called loss aversion and the former group of rationally-driven 'econs' - to use the terminology from the (influential behavioural studies) book *Nudge*".

Nudge describes 'econs' as ideal rational human beings, who economists have rather unrealistically assumed for decades always look to make optimal economic choices and rarely act impulsively. The book believes that people should be subtly encouraged to make rational choices by making the best choice the easiest option.

Next year's introduction of auto-enrolment in workplace pensions also relates to behavioural economics. The reforms are an example of the 'nudge economics' that the book promotes, and of which UK Prime Minister David Cameron is a self-confessed fan.

Blake advises, as a result of the research, that a single default fund should not be seen as a catch-all option for all DC savers.

“When it comes to the optimal investment strategy for a DC pension plan, three factors – salary profile, attitude to risk and personal discount rate – need to be taken into consideration,” he says.

“These factors vary too much from person to person for one default fund to fit all circumstances. But ‘humans’ do need to be nudged towards the investment strategy most suitable for their personal characteristics and away from one that overtrades their portfolio in a forlorn attempt to avoid short term losses.”

The latest research builds on a growing amount of insight into savings behaviour as the increasing switch to DC pensions places risk on employees rather than employers to save for satisfactory retirement outcomes. The government-backed NEST retirement scheme is basing its default investing strategies on research that states its target group of young low-income earners “is largely loss averse and exploratory research suggests that responses to investment loss are likely to be negative and strongly emotional.”

Challenge age-related assumptions, By Jane Fuller, *FTfm*, 29 August 2011

It is always comforting to read headlines that confirm one’s prejudices.

“Dumping equities in later life does not suit everyone” – *FTfm* July 25 – was such a headline. David Blake and Douglas Wright, professors at Cass Business School’s **Pension Institute** in London, argue that retirees should sell bonds to buy annuities and keep a significant equity holding until much later in life.

First, the concept of moving from full pay to no pay is out of date: people in their 60s and 70s still have “human capital”, or earning capacity. They will increasingly have to use it since fewer of them will have generous occupational pensions. Second, their outgoings on mortgages and children are falling – positive for both cash flow and risk appetite.

Changes in individual perceptions matter because the “baby boomers”, born between 1946 and the mid-1960s, have started to reach retirement age, or the age when assumptions begin in the savings and investment industry.

These assumptions were already questionable. Andrew Smithers, of Smithers & Co, says the data on demographics and financial market trends show no correlation; and nor do changes in demographics affect savings rates. For instance, in the past couple of decades household savings rates have plummeted in both the US and Japan, despite their divergent demographic profiles. Factors that overwhelm the demographics include trends in asset prices.

But there is another reason why simplistic age-based assumptions should be treated with scepticism. Professor Richard Scase, of Kent University, says the baby boomer

generation has changed every market it has moved through, from pop music to technology, but it has not done this as a lumpen mass.

His message is that age is a poor predictor of behaviour. It is better to think of people as “lifestyle tribes”, based on their attitudes, affiliations and financial state. Who would have predicted in the 1970s that “old” people would go to rock concerts? Or would research their diseases on the internet with the intention of influencing, or supplementing, their medical treatment?

What might this mean for investment trends? It should start to undermine the conventional wisdom that has driven money out of equities and into bonds. This will take time because other factors continue to drive asset allocation towards apparently low-risk securities. The latest example is the regulatory imperative, under new capital and solvency rules, for banks and insurers to increase their holdings of “quality”, “liquid” assets.

Disruption of the trend is most likely to be triggered by default on “risk free” assets. Don’t forget there are many routes to this outcome, including inflation and currency devaluation as well as writedowns and adverse changes in terms.

The inflation/deflation debate comes into this and is linked to the relentlessly negative press for Japan’s “lost decade”. A 1-2 per cent return on 10-year (and highly liquid) government bonds looks much better when prices are falling than the current negative real yield being offered in the UK, for instance. The high inflation/low growth of the 1970s felt worse, particularly for older people, than the Japanese approach to post-bubble deleveraging.

The self-reinforcing circle in Japan has been for public debt to replace private debt. Domestic savers have been prepared to fund the latter because they were getting both a real return on the assets and the social security that they wanted from the state. But important counter-inflationary forces, notably Chinese labour and a peace dividend, have run out of steam. If the bull market in government bonds ends, that would provide a nudge towards at least a more eclectic choice of assets. After all, if the interest rate on top-rated bonds starts to rise, the present value of liabilities in retirement accounts will fall, especially if inflation exceeds indexing caps.

So in western economies with a high level of social security and public debt, and a higher chance of inflation, the ageing cohort will be more likely to keep earning as the state and other benefit providers under-deliver, or even break promises. As investors they will seek assets that retain capital value. They may also increase borrowing by remortgaging their homes, joining the young in keeping private sector debt up, alongside attempts to curb public debt.

What might those baby boomers released from the shackles of risk-free investment pop into their equity portfolios? Income stocks with balance sheets stronger than their governments’ perhaps, alongside a few flutters on businesses that provide what they want: generic drugs, hearing aids, mobility devices, concerts and cruises, and web-based financial planning.

Jane Fuller, a former financial editor of the Financial Times, is co-director of the Centre for the Study of Financial Innovation

New study weighs most appropriate DC investment strategies, By Matt Ritchie, Pensions Age, 05/09/2011

New research from the Pensions Institute at Cass Business School has sought to identify the best funding and investment strategies for defined contribution investors, modelling the behaviour of both “rational” life cycle financial planners and investors who do not act in a fully rational way due to behavioural biases.

In the study on fully rational investors, the research found that an age-dependent investment strategy taking into account an individual’s human capital and financial wealth is a better approach than so-called ‘deterministic lifestyling’, which automatically switches from equities to bonds over a pre-set period prior to retirement.

In addition, the research identified three factors people should take into account when designing their DC pension plans.

The factors were: their human capital, as represented by their salary profile over their career; attitude to risk; and the preference for current versus future consumption.

Professor David Blake said the study highlights the inherent problems with default funds, as the key factors “vary too much from person to person” for one default product to fit all circumstances.

“But we don’t need hundreds of different funds either – people shouldn’t be overwhelmed by choice – a very small number of well-defined choices will suffice.”

The second study looked at how members could optimally invest if they suffer from the “most significant” behavioural bias, risk aversion.

Researchers recommended a new target-driven approach to counter loss aversion. A ‘threshold’ strategy was identified as the best approach under these circumstances.

This strategy would see the weight in equities increased if the accumulating fund is below a set interim target, but decreased if the fund is above target.

When close to each target, the plan member has the lowest equity weighting in order to minimise the risk of a significant loss relative to the target. However, if the fund is sufficiently above the target the equity weighting is increased, since the risk of the fund falling below the target is considered to be acceptably low.

As retirement approaches the overall equity weighting begins to fall and the value of the fund is ‘banked’ by switching to lower risk investments, assuming the fund is on target.

Professor Blake said the risks of the traditional deterministic lifestyle strategy appear to be much higher than generally understood, so for DC plan members seeking greater

certainty in retirement planning, the investment strategy adopted over time needs to be far more focused on achieving the specified target replacement ratio.

Although the loss aversion framework has “much to recommend it”, implementing the strategy would be difficult.

“Nevertheless, in practice, it should be possible to tabulate the optimal asset allocation in terms of member profile characteristics (such as age and occupation) and values of the key state variables. Financial advisers would then be able to advise on the appropriate investment strategy for the coming year.”

Private Pensions: Wait Until You Are 35 To Save, 5.9.2011, A. Valesco, 5.9.2011, www.pensioncalculator.org/7988/news/private-pensions-wait-till-you-are-35-to-save/

According to academics at London’s Cass Business School rational investors should not start saving into a defined contribution (DC) pension scheme until after they reach 35-years-old. A requirement has been suggested that one third of their salary should be saved from the age of 55.

In the past it was suggested that people should start saving for their pensions as soon as they could so that they could benefit from the most compounding of investment returns. However, these new findings are running a counter argument against the older strategy for pension saving.

Research carried out by the business school has also made a suggestion that the government should make the option of saving for a pension a compulsory matter, especially for those workers who are in their mid-30’s and prefer compulsory annuitisation of savings.

DC default funds should consider human capital and financial wealth – Pensions Institute, By Sebastian Cheek, Professional Pensions, 5 Sep 2011

An age-dependent approach to DC default funds, which takes into account a member’s human capital and financial wealth, is better than traditional lifestyling, research shows.

Two studies by the Pensions Institute at Cass Business School identified three factors which should be considered when designing DC plans: a member's human capital as represented by their salary profile over their career, their attitude to risk, and their preference for current versus future consumption.

The [first study](#) - led by Pensions Institute director David Blake, alongside Cass senior lecturer Douglas Wright - looked at members considered ‘rational life cycle financial planners’ who choose the investment strategy which maximises the expected utility of the pension fund value at retirement.

It found an age-dependent annual contribution rate, in which employees wait until they are several years into their career before starting to contribute, would better serve these members' interests.

It said for a male worker with a typical career salary profile, the optimal contribution rate increases steadily from zero before the age of 35 to about 30% to 35% after the age of 55.

The research also found an age-dependent investment strategy through 'stochastic lifestyling' to be optimal. The strategy begins with 100% of the contributions in equities or a diversified growth fund before the equity weight is reduced prior to retirement. However, unlike traditional lifestyling this does not occur at a predetermined point but is dependent on what has been happening to equity returns and labour income.

Cass said stochastic lifestyling is justified by recognising the importance of human capital - defined as the present value of lifetime labour income - and treating it as a bond-like asset since it generates a fairly predictable labour income stream which depreciates over the member's working life.

It added the findings have implications for the popular model of single 'one-size-fits-all' default investment strategies, which do not have the flexibility to accommodate these personal factors.

Blake said: "This study highlights the inherent problems with default funds. When it comes to the optimal investment strategy for a DC pension plan, three factors - salary profile, attitude to risk and personal discount rate - need to be taken into consideration.

"These factors vary too much from person to person for one default fund to fit all circumstances. But we don't need hundreds of different funds either - people shouldn't be overwhelmed by choice - a very small number of well-defined choices will suffice."

The [second part](#) of Cass's research looked at the optimal default strategy assuming that 'human' investors have so-called behavioural biases that restrict them from investing in a fully rational way.

It examined how they would optimally invest if they suffer from the most significant behavioural bias, namely loss aversion.

'Wait till you are 35 to save', By Steve Johnson, FTfm, 5 September 2011

Rational investors should not start saving into a defined contribution pension scheme before the age of 35, but should set aside a third of their salary from the age of 55, according to academics at London's Cass Business School.

The findings run counter to conventional wisdom, which argues people should start saving into a pension scheme as early as possible so as to benefit from the greatest possible compounding of investment returns.

The Cass research also suggested governments should consider making pension saving compulsory for workers beyond their mid-30s, and favour compulsory

annuitisation of pension savings, in order to push people into making rational decisions.

“There is a huge amount of irrational behaviour,” said Professor David Blake, director of the Pensions Institute at Cass, and co-author of two separate papers alongside colleague Douglas Wright and Yumeng Zhang of Legal & General Investment Management.

“If auto-enrolment does not work [in the UK] we will have to go to compulsory contributions.”

The [first paper](#)*, based on “optimal” life cycle financial planning behaviour, found that, “surprisingly, it is not optimal for individuals to start contributing to a pension plan until several years into their career. This is because individuals’ incomes are initially low and they are better off consuming their incomes rather than saving from them.”

Instead the “optimal” contribution rate “increases steadily from zero prior to 35 to around 30-35 per cent after age 55”. However, Prof Blake added, “I doubt that most people would have the willpower to maintain such high contribution rates towards the end of their working lives”.

The paper determined that 100 per cent of early contributions should be invested in equities (or a diversified growth fund), with bonds being introduced later. However, the rational investor should still have a 20-50 per cent exposure to equities at retirement, when the bond holdings are sold and “phased annuitisation” should begin.

The [second paper](#)** examines how real people diverge from rational behaviour. It found that most people rotate to a more conservative asset allocation too soon and that if an individual’s pension pot is sufficiently above target, people ramp up their level of risk, in the belief they have little to lose.

*[Age-Dependent Investing](#)

**[Target-Driven Investing](#)

UK pensioners caught up in market turbulence turn to QROPS, by George Prior, Daily Telegraph, 18 August 2011

A stock market in turmoil is leading expat pensioners and those nearing retirement to transfer their pensions offshore, say financial experts.

“The markets are being battered and trillions are being wiped off global share prices,” says Andrew Oliver, senior managing partner of deVere Spain, part of the deVere Group, the world’s largest independent international financial consultancy group.

“Around 60 per cent of an average pension fund is invested in shares, so the current situation affects many people’s financial futures. What we’re witnessing is most concerning for those with personal pension funds and on the cusp of retirement.”

At the beginning of August the FTSE 100 fell by more than 10 per cent in one week. Eight million Britons have their pension fund invested in schemes where the pension is linked to how markets are performing.

The market's volatility has led to an increasing number of people opting for an offshore pension.

“The trend is soaring as more and more Brits learn about the benefits of transferring their pension. With daily reports of leading companies having high percentages wiped off, anyone in the UK who is planning to retire abroad, or who is currently living outside Britain and collecting a pension there, should consider a Qualifying Registered Overseas Pension Scheme (QROPS),” says Mr Oliver.

Introduced several years ago, QROPS are overseas pension schemes where the fund is no longer subject to [HM Revenue & Customs](#) rules.

Financial advisors say that in these uncertain financial times one of the key advantages of QROPS is the ability you or your advisor has to switch funds easily if the current ones are under-performing.

In addition, the range of different funds available is considerably wider than a typical UK scheme, and you can turn your fund into cash at any time. It is these cornerstone features which many insist give those with a QROPS a more extensive set of options.

Tax benefits

Traditionally, those moving abroad for more than five years have sought advice on QROPS for tax purposes.

Professor David Blake, director of [The Pensions Institute](#) at [Cass Business School](#) explains: “Since you can greatly reduce, if not avoid altogether, the tax you have to pay on your pension pot, you can avoid paying back the tax relief during the accumulation phase of your pension plan.”

Tax on death in Spain for example is zero, compared with levels of 55 per cent in the UK. This means there are more funds to leave to your loved ones. Similarly, through astute tax planning you may well end up paying much less income tax on payments.

“There are tens of thousands of people who have already moved to places like Spain, and have left their pensions in the UK, who should seriously take a look at their arrangements to see if they are paying too much tax,” affirms Mr Oliver.

Those with a QROPS can also take a tax free lump sum of at least 30 per cent, whereas those with a typical UK pension are restricted to 25 per cent.

The lack of annuity is another big plus for many. “In the UK, with many funds below £150,000 you're effectively forced to invest in an annuity – due to fund size. This limits how your wealth can be passed on to beneficiaries, but with QROPS you are not obliged to buy an annuity, allowing freedom to invest in other areas which may give a greater return,” says Oliver.

Professor Blake adds: “If you spend the money too quickly and the pension fund runs out before you die, you can then come back to the UK and claim welfare benefits.”

Currency risk minimised

British people living abroad and collecting a pension in sterling are at the mercy of fluctuating exchange rates and will often incur charges for converting their pension funds into local currency.

“Over the last two years we’ve advised thousands of British expats who have seen the drop in the value of the pound against the euro mean that they’ve lost, in effect a third of their income. This, naturally, has an adverse affect on the quality of their lives,” says Mr Oliver. “But a QROPS can help put an end to this.”

Jackie and Kenneth Barton, like hundreds of thousands of Britons, permanently reside on Spain’s Costa del Sol. They managed to secure an enhanced income after taking advice from an experienced personal finance expert to transfer their pension offshore.

“QROPS, which are backed by the British government, have made a big difference to our lives as we have more disposable income,” says 67 year-old Jackie. “We can now do more of things we love – like playing golf and taking the grandchildren out.

“The exchange rate dropping, the plummeting house prices meaning properties are unsellable, and now the markets spiralling out of control, mean that many of our friends have had to make huge day-to-day cutbacks.

“Whereas once we all used to go out for dinner and drinks once a week, many of them simply can’t afford it now. We now see them less and less, maybe going for dinner once a month,” she says.

Investors snap up real estate, By Sara Silver, FTfm, 15 August 2011

Investors fleeing the volatile bond markets are pushing the prices of “trophy” real estate assets so high that yields are barely keeping up with inflation in some developed economies, according to Partners Group, a Swiss investment house.

The trend is pushing institutional investors to look farther afield into developing markets for property and other investments in “real” assets.

Prices for elite properties in the US, UK, Germany, France and Japan have surged as investment flows in the first half of 2011 approach those seen near the 2007 peak, according to Partners. That has pushed yields as low as 3-4 per cent, barely keeping ahead of inflation in some developed countries.

“Many institutional investors have been tactically shifting some of their fixed income allocations to real estate,” said Stephan Schäli, head of private equity at Partners. “Over the last year, [investors] have been looking for safety and yield and trophy assets were perceived as offering that, but yields have been so low that inflation leaves them on risky footing.”

Luba Nikulina, global head of private markets at Towers Watson, a consultancy, said: “The megacities are overheated. We are seeing quite a lot of demand for trophy properties, so people need to move to secondary-type assets.”

David Blake, a professor at London’s Cass Business School, added: “It’s easy for funds to go overweight on these asset classes, because risk is being underestimated as a result of poor pricing transparency.

“If everyone piles in at the same time this will lead to a speculative bubble. There isn’t enough of this stuff globally in countries with stable political systems, where you have the confidence that you can invest and then later get your money out.”

Those investing in prime locations include the Canada Pension Plan Investment Board, which has increased its holdings of unlisted assets, such as real estate, from 8.8 per cent to 31.6 per cent of its portfolio in the past five years.

In the last fiscal year alone, the fund invested in two midtown Manhattan skyscrapers, a 25 per cent stake in a London retail development next to the 2012 Olympics site and a 42.5 per cent stake in a portfolio of prime Australian industrial properties.

Partners, which manages €20bn (\$28.5bn) in private investment programmes, is advising institutional clients to concentrate instead on mid-sized cities in Asia and Latin America where property yields can be a full percentage point higher than in the larger cities.

While the latest market turmoil, driven in part by the ongoing eurozone debt crisis, a downgrade of US debt and jitters over France’s credit rating, is unlikely to change the long-term strategy of pension funds, it only adds to pressure to switch some money out of fixed income into other asset classes.

Many institutions are now said to be looking at less-familiar asset classes such as private debt, but are cautious about making moves.

“What we tend to see is that it’s those investors who already have exposure to real estate and infrastructure equity are the ones willing to move into debt,” said Sanjay Mistry, head of private debt at Mercer, a consultancy.

Mr Mistry said investors were being drawn in by a shortage of bank financing to replace what Mercer estimates are \$150bn in European collateralised loan obligations, financial vehicles created in the run-up to the 2008 crash, which expire this year and next.

Longer life expectancies eat into returns, By Sara Silver, FTfm, 1 August 2011

A private bank is cautioning clients against investing in life settlement funds, saying longer life expectancies eat into projected re-turns, and the funds carry more risk than disclosed.

Arbuthnot Latham issued a recent report highlighting what it called the “structural pitfalls” of these funds, which contain US life insurance policies sold on before the

holder dies. The UK private bank said certain of these funds failed to recognise that people are living longer each year and the rich outlive the poor, which further diminishes the returns of funds holding life insurance policies worth more than \$1m.

While the report did not name the funds it criticised, it did say they were being heavily marketed to UK independent financial advisers. These advisers may not be aware of the contentious valuation methods or the risks, such as using cash from new subscribers to meet monthly premiums on the policies they hold.

“Although many of these life settlement funds retain recognised accountancy firms to audit their numbers, after reading the fine print, one learns that the valuation process is ‘the sole responsibility of the directors/management’ of the fund”, the report says.

Ned Cazalet, independent analyst, said investors must pay close attention to how funds account for life expectancy. “The key question is what are your assumptions and how much slack have you built in to allow for people living longer?”

Professor David Blake, director of the **Pensions Institute** at the Cass Business School, said the industry had a “vested interest” in inflating the values of policies, giving more money to the policyholders and to the providers and brokers receiving cuts worth up to half of the total return.

“If you told investors that policyholders are going to die in five years instead of two, that undercuts returns and the premise that investors would get paid back quickly, and that’s why the industry is discredited”, he said. “But these models can be improved and it can be a valid asset class in future.”

Dumping equities in later life does ‘not suit everyone’ By Ellen Kelleher, FTfm, 25 July 2011

Could it be that the popular practice of fine-tuning one’s pension by ditching racy assets after a certain birthday is a poor investment strategy? A pair of professors from Cass Business School’s **Pension Institute** argue this point in a new report.

Bluntly put, the idea that investors should migrate away from equities and buy bonds before they hit the final stretch leading up to their retirement party is bogus, claim David Blake and Douglas Wright in *Optimal Funding and Investment Strategies in Defined Contribution Pension Plans*. Such an approach – which is the blueprint for the creation of target date funds in the US and lifestyle default funds in Europe’s defined contribution schemes – fails to factor in the investment performance of people’s pension pots, their feelings about risk-taking, or any projected increase to salaries. “You can’t just use a specific age . . . as a mechanical trigger to determine when to shift out of pension assets into an annuity,” says Prof Blake.

The professors’ thesis is that investors should favour bespoke approaches to the management of their pension pots and steer clear of funds that shift out of high growth assets and into low-growth ones at a set time. The key to their method hinges on assessing the value of your “human” capital (or earning power in layman’s argot) and your “financial” capital before deciding whether to shake-up your investment portfolio.

Their research comes as more European companies move to shift the burden of retirement to employees by doing away with defined benefit schemes and introducing defined contribution ones. The default funds under DC plans often incorporate a shift into bonds over the five or 10 years ahead of retirement. Nest, the National Employment Savings Trust, for example, has sent a clear message to the UK personal pensions industry by adopting target date funds as the basis of its default option for auto-enrolled pension savings. Managers of target date funds adjust risk exposures as investors approach one or a series of dates at which they need their money. “The difficulty Nest faces is that it’s very unlikely that two people in different occupations who join Nest at the same time with the same age will have the same optimal investment strategy throughout their lives. In other words, there is unlikely to be a single optimal default fund for all individuals of the same age,” laments Prof Blake.

Profs Blake and Wright also believe the way investors look after their investment portfolios during retirement could be improved. Upon reaching one’s golden age, a superior investment strategy would be to cash out of bonds and use the proceeds to buy an annuity.

Equities, meanwhile, should be kept in the hope that their value would increase, the two academics argue, suggesting savers should hold 20-50 per cent in equities at retirement.

“The optimal strategy would be to switch out of the bonds you are holding and into an annuity on the day you retire,” says Mr Blake.

“Each year, you should sell a bit more of your equity holdings and add to your annuity holdings. Eventually you reach an age where you should annuitise the rest of the portfolio.”

The academics’ arguments seem compelling in theory, but industry analysts argue there is scant evidence to suggest they would take hold in practice.

Vince Smith-Hughes, head of business development at Prudential, says his clients prefer to sell the contents of their pension funds in one go and buy an annuity and he does not believe their habits will change.

“It’s difficult to alter behaviour,” he concludes.

Death Derivatives Emerge From Pension Risks of Living Too Long, By Oliver Suess, Carolyn Bandel and Kevin Crowley, May 17 2011 (Bloomberg)

Goldman Sachs Group Inc., Deutsche Bank AG and JPMorgan Chase & Co., which bundled and sold billions of dollars of mortgage loans, now want to help investors bet on people’s deaths.

Pension funds sitting on more than \$23 trillion of assets are buying insurance against the risk their members live longer than expected. Banks are looking to earn fees from packaging that risk into bonds and other securities to sell to investors.

The hard part: Finding buyers willing to take the other side of bets that may take 20 years or more to play out.

“Banks are increasingly looking to offer derivative solutions,” said Nardeep Sangha, 43, chief executive officer of Abbey Life Assurance Co., a London-based Deutsche Bank unit that helps pension funds manage the risk of retirees living longer than expected. “Making the long maturity of the risks palatable for investors, including sovereign wealth funds, private-equity firms and specialist funds, is the challenge.”

As insurers reach the limit of how much pension-fund liability they’re willing to shoulder, companies such as JPMorgan and Prudential Plc last year set up a trade group aimed at establishing and standardizing a secondary market for so-called longevity risks. They’re also developing indexes that measure mortality rates and securities to let pension funds pay fixed premiums to investors in return for coverage against major deviations from projections.

Swiss Reinsurance Co., the second-biggest reinsurer, sold the world’s first longevity bond in December in what it called a “test case” to sell risk to the capital markets.

‘Run Dry’

Goldman Sachs, based in New York, and Deutsche Bank in Frankfurt have set up insurance companies that promise to pay pensions if retirees live beyond a certain age. They typically receive a portion of the pension plan’s assets in return. The banks, along with Morgan Stanley, Credit Suisse Group AG and UBS AG, are looking for ways to offer this risk to investors.

“Ultimately, reinsurance capacity for longevity risks will run dry, and that’s why it’s imperative that as the market grows and develops it is able to bring in new types of risk-takers,” Sangha said. “The obvious channel is the capital markets.”

Medical advances and healthier lifestyles have made predicting life spans more difficult for pension funds. Life expectancy in the U.K. is increasing by one to three months every year, according to Dutch insurer Aegon NV. Every year of additional life expectancy typically adds as much as 4 percent to future pension requirements, Aegon said in a report in March. Aegon reported last week that first-quarter profit fell 12 percent as the company set aside money to cover the risk of policyholders in the Netherlands living longer than expected.

Glaxo Transfer

Pension funds can hedge against life-expectancy risk by transferring assets to an insurer or other counterparty that promises to pay some or all of the future liabilities. Last year, GlaxoSmithKline Plc, the U.K.’s biggest drugmaker, became the 10th FTSE 100 firm to buy insurance on about 900 million pounds (\$1.5 billion), or 15 percent, of its U.K. obligations. That means Prudential, the U.K.’s largest insurer, rather than the pension fund, will pay some GlaxoSmithKline pensioners should they live longer than expected. Most longevity risk transferred from pension funds is held by insurers.

Regulators are just beginning to focus on the new products. “We’re seeing more and more sophisticated mechanisms being offered,” said Bill Galvin, CEO of the U.K.’s Pensions Regulator. “From a regulatory perspective, we are concerned to ensure that trustees understand the extent to which longevity risk has been passed from their scheme and the precise shape of any residual risk.”

‘Early Days’

The Frankfurt-based European Insurance & Occupational Pensions Authority isn’t reviewing longevity transfers, said Sybille Reitz, a spokeswoman for the organization, because “the market is still in its early days.”

The U.K. is the world’s biggest market for insuring pension liabilities after a change in accounting rules in 2004 forced companies to include pension plans on their balance sheets, increasing the volatility of earnings. Since then, 30 billion pounds of liabilities have been insured, about 3 percent of the total outstanding, according to estimates by Hymans Robertson LLP., a London-based pension consultant.

Banks and insurers completed a record 8.2 billion pounds in longevity-risk transfers last year. Goldman Sachs-owned Rothesay Life Ltd. sold the most pension-plan insurance in 2010, while Deutsche Bank’s Abbey Life completed the biggest swaps deal.

Longevity Risks

With \$17 trillion of the \$23 trillion in pension-fund assets worldwide exposed to longevity risks, according to Zurich-based Swiss Re, investment banks see this as an opportunity to create a new market for those willing to bet on life-expectancy rates. If pensioners die sooner than expected, investors profit. If they live longer, investors must compensate the pension fund for the additional costs it faces.

Investors may be attracted to such bets because longevity trends aren’t linked to movements in equities, bonds or commodity markets, said **David Blake**, director of the **Pensions Institute** at Cass Business School in London, who has worked with JPMorgan on the derivatives.

The complexity and risk involved in longevity assets with timelines of more than 20 years means banks are looking to create bonds that offer 5 percent to 9 percent in annual returns, according to Guy Coughlan, former head of longevity structuring at JPMorgan. Returns as high as the “mid-teens” are possible, he said.

‘Structural Problems’

Investors remain unconvinced. Not knowing whether a bet on a group of pensioners’ life spans is correct for decades prevents hedge funds such as London-based Leadenhall Capital Partners LLP from entering the marketplace. “There are big structural problems with the longevity market,” said Luca Albertini, CEO of Leadenhall, which has \$120 million under management and invests in insurance-linked securities such as catastrophe bonds used to help cover hurricanes and other extreme risks. With clients able to withdraw investments only every month or quarter,

“the only way I can invest is if the market is truly liquid,” he said. “No one has proven that to me yet.”

Subprime mortgages sold in the past decade were the genesis of the biggest financial meltdown since the Great Depression. Investment banks passed the risk of borrowers defaulting to the capital markets by packaging, or securitizing, the loans into bonds and selling them to investors and one another.

‘Fully Collateralized’

Collateralized debt obligations were created and sold in such volume that when mortgage holders defaulted, governments in the U.S. and Europe had to bail out the financial system. Banks are now looking to investors in much the same way to securitize the risk of pensioners living longer than expected.

Securities based on life expectancy don’t hold the same risks as those linked to subprime mortgages because they are “fully collateralized,” minimizing the risk from a counterparty failing to meet its obligations, Coughlan said.

Cass Business School’s Blake said it’s unfair to compare the securitization of mortality expectations to the subprime-mortgage market. “Subprime was highly leveraged,” Blake said. “This is different.”

Still, longevity transfers expose investors to the credit risk of issuers for many years. Once a pension fund agrees to transfer its assets in return for protection against pensioners living longer than expected, they are tied into a long-term contract that can be difficult to unwind, said David McCourt, senior policy adviser at the U.K.’s National Association of Pension Funds. That means the insurer, bank or hedge fund that a pension plan chooses to deal with is important, he said.

‘No Going Back’

“There’s a massive counterparty risk,” McCourt said. “People say insurance companies don’t go bust, but they do. We’ve seen AIG and investment banks going under like Lehman. There’s a lot of pressure on the trustees to make sure they’re comfortable the deal is right because there’s no going back.”

Pension funds outside the U.K. also remain hesitant. APG Algemene Pensioen Groep NV in Amsterdam, which manages 277 billion euros (\$396 billion) of assets for seven pension funds, “will not do transactions to actively hedge longevity risk,” according to Harmen Geers, a spokesman for the firm. “The market is unbalanced, since there are no natural counterparties to take up a risk of that size in absolute terms,” Geers said.

Life Settlements

There has been less interest in the U.S. because regulatory pressure on pension funds hasn’t been as intense as in the U.K., said Pretty Sagoo, director of structuring at Deutsche Bank in London.

In the U.S., investors can bet instead on life expectancy through so-called life settlements. Rather than exchanging assets and liabilities with a pension plan, the life-settlement market allows investors to buy insurance policies from individuals and pay the premiums until that person dies. Investors then receive the death benefits.

The secondary market for U.S. life settlements began in the 1980s when the AIDS epidemic led some patients to sell their insurance policies to pay for treatment. The industry was valued at \$2 billion in 2001 and, once it became regulated, quickly grew to a maturity value of \$35 billion by 2009, according to Conning & Co., a Hartford, Connecticut-based research firm.

Goldman Sachs-owned Rothesay Life, started in 2007, was the biggest pension liability insurer in the U.K. last year after insuring 1.3 billion pounds of liabilities from the British Airways Plc pension plan. The largest swaps deal was completed between Deutsche Bank's Abbey Life unit and Bayerische Motoren Werke AG's U.K. pension plan.

Q-Forward Swaps

Rothesay Life CEO Addy Loudiadis was the architect of a Goldman Sachs deal in 2001 that allowed Greece to mask its indebtedness, according to London-based Risk magazine. Sophie Bullock, a spokeswoman for the firm in London, declined to comment on Loudiadis's involvement in Greece and said she was unavailable to comment.

Goldman Sachs isn't part of the new industry group, the London-based Life & Longevity Markets Association, preferring to develop the market alone, according to Tom Pearce, managing director of Rothesay Life. Pearce said it won't be easy trading a security linked to life expectancy. "Clearly, if there was a capital market solution that would be helpful for the market generally, but there are some challenges," he said. "The biggest challenge is selling these very long-term risks to shorter-dated investors."

Mortality Indexes

Unlike Deutsche Bank and Goldman Sachs, New York-based JPMorgan doesn't carry any of the risk of pensioners living longer than expected. Instead, it arranges swaps, called q-Forwards, which allow a pension fund to pay a fixed premium to a counterparty based on its members living to a specified age. If members live longer than expected, the counterparty reimburses the fund; if they die sooner, the counterparty profits.

Credit Suisse and JPMorgan have developed indexes that measure mortality rates and life expectancy for the U.S., Germany, the Netherlands, England and Wales. The indexes act as a basis for pricing individual swaps and bonds, according to Cass Business School's Blake, who helped develop them with JPMorgan in 2007. They will help buyers and sellers price derivatives more accurately and give them confidence to trade them, creating a liquid market, Blake said.

Swiss Re sold the world's first longevity bond in December, passing the risk from its own balance sheet to investors. The \$50 million bond, named Kortis, was a "test case," said Alison McKie, head of life and health products at the firm. The bond pays investors a fixed sum from reinsurers for taking the risk that people live longer than projected. If there is a large divergence in mortality improvements between British men aged 75 to 85 and U.S. males aged 55 to 65, investors risk losing some or all of their money, Swiss Re said in December. The bond is rated BB+ by Standard & Poor's.

BNP, Munich Re

Previously, Paris-based BNP Paribas SA and the European Investment Bank, the European Union's financing institution in Luxembourg, created a longevity bond in 2004. A year later they withdrew the notes, which had a maturity of 25 years, after they didn't find a buyer.

Munich Re, the world's biggest reinsurer, hasn't participated in longevity transfers "as the deals we've seen haven't met our profitability requirements," said Joachim Wenning, the management board member responsible for life reinsurance. "The future longevity trend is not easy to predict. If your assumptions are wrong, the cost is high." Nevertheless, the Munich-based reinsurer recently became the 12th member of the Life & Longevity Markets Association.

Lord Myners: till tirelessly calling trustees to action, By Brendan Maton, FTfm, May 8 2011

Paul Myners recalls that when he wrote his Review on Institutional Investment in the UK in 2001, Alan Pickering, then head of the National Association of Pension Funds, described the perception of trusteeship as "community service, not dissimilar to being a scoutmaster or churchwarden".

At the time most UK schemes relied on a handful of active asset managers to run the bulk of their assets in "balanced mandates" – a combination of equities and bonds. Performance targets were similarly to beat a universe of peer pension funds or market indices run by the likes of FTSE, MSCI and Standard & Poor's.

"If you asked a trustee in 2001 about their risk budget, they wouldn't have known what you were talking about," says Lord Myners. "Hermes [manager of the BT pension scheme] was the only organisation taking ownership of investee companies seriously. The cost of buying and selling shares on behalf of the funds received no scrutiny."

When he meets trustees nowadays, however, he says they engage him on matters such as liability-matching, which has come into being as a result of his criticism of peer-group or market index benchmarks.

"Until the Myners Report, pension fund management in the UK had little in practice to do with the structure of pension liabilities," remarked Professor **David Blake** of City University in a 2003 paper on the future of liability-matching. "The Myners Report is going to lead to a radical change in pension fund investment in the UK. In

will come instructions to choose strategic asset allocations that depend on both the characteristics of individual schemes and those schemes' sponsors' attitudes to surplus and contribution risks." Prof Blake's predictions have proven accurate, although they have taken a while to come to fruition. This is because of the cosy nature of the world of occupational pension schemes that Lord Myners troubled. When he nailed his 10 principles for institutional investors over the parish door of pension schemes, he recalls much consternation.

"The reaction was quite hostile; many people were not comfortable with the message, even if it was in line with leading thinkers of the day."

Hostility was certainly drawn from many service providers to schemes, although against the man rather than his recommendations. Perhaps his detractors feel Lord Myners is a hypocrite since he has earned millions in this role himself, first as chief executive then chairman of Gartmore, one of the handful of investment managers mentioned earlier.

In public speaking he happily fires off broadsides when most would keep their powder dry. Only last December he told local authority pension schemes they should be vigilant against investment banks, investment managers, consultants and actuaries who all extract "quite a high rent from pension funds in terms of fees and expenses".

The year before he suggested the bulk of the £4bn (\$7bn) a year pension funds pay in fees to active managers would be better spent improving the monitoring of investee companies.

"I have this reputation for lambasting asset managers and consultants but if you look closely at what I say it is the beneficial owners – the trustees – that I really take to task," he responds.

Lord Myners believes that if trustees acted more like owners, then the national interest would be better served: both enterprises and capital markets would be more efficient.

"You can sum up my report in four words: a call for action. I will relentlessly promote this agenda because the shortcomings we identified cost money in either extra contributions from the sponsor or lower benefits for scheme members."

Risks in public sector pensions, Financial Times, March 21 2011

From Prof David Blake.

Sir, In his article "[The correct pension discount rate](#)" (FTfm, March 14), John Ralfe concludes that public sector pensions "are deferred pay earned as part of a legally binding contract of employment, the equivalent of giving ILGs [index-linked gilts] to be redeemed at retirement". This is not quite correct.

Public sector pensions are equivalent to index-linked longevity bonds, and hence the appropriate discount rate should include a longevity risk premium as well as an inflation risk premium.

David Blake,
Director,
Pensions Institute,
Cass Business School,
London EC1, UK

Swiss Re calls for governments to issue longevity bonds

Lifeandpensionrisk.com February 2011

Governments should look at the example of the inflation derivatives market and launch longevity bonds to establish a market price for the risk, according to Christian Mumenthaler, chief marketing officer at Swiss Re. There is estimated to be about £1 trillion worth of longevity risk contained within UK defined benefit pension schemes alone, but with insurer and reinsurer capacity standing at £10 billion a year, there is a large difference between demand and supply for this derisking tool. One clear solution to this problem would be to offload longevity risk to the capital markets a process Mumenthaler says would be sped up if a market price for longevity was established through a government-backed bond.

Speaking on the sidelines of the launch of the World Economic Forum's Global Risks 2011, Sixth Edition report in London, ahead of the World Economic Forum due to be held in Davos, Switzerland at the end of January, Mumenthaler said issuing longevity bonds should be an attractive option for governments, even with the large amount of this risk they already carry.

"Governments would expose themselves to longevity risk [by issuing a longevity bond], but the - good thing is that we would then establish a price for longevity in the market, because people would be able to observe the difference in the spread between traditional 30-year bonds and longevity bonds and that would create a price for longevity and potentially a capital market," says Mumenthaler.

Despite murmurings from the UK's Debt Management Office at the start of 2010, governments have so far been reluctant to issue a longevity bond. A World Bank-led initiative in Chile last year was not successful due to various issues, such as insurers' concerns about basis risk.

Yet Mumenthaler is determined the concept needs to spread and government reluctance should be overcome in the same way as it did with inflation: "I think this parallel between what they did with inflation and longevity is an interesting one."

However, **David Blake**, director at the **Pensions Institute** and Cass Business School in London and a long-time advocate of longevity bonds, says different approaches are required by governments due to longevity risk being of a two-dimensional nature – incorporating both age and time – as opposed to simply duration with inflation risk.

"The government has a natural hedge in its balance sheet with inflation, since if inflation goes up, wages also go up and taxes go up and this pays for the higher coupons on the inflation bonds. With longevity bonds different approaches are needed," he says.

One of the strategies Blake and Mumenthaler agree on is the importance of partnerships between the state and private sectors with longevity risk mitigation. "Long-term unfunded liabilities created by ageing populations mean fiscal pressures will continue to grow. It is only through true public-private partnerships that we can ensure the related financial challenges are addressed and that increased longevity remains an entirely positive trend for society," says Mumenthaler.

Blake agrees. He says: "Longevity risk-sharing is very much about intergenerational risk-sharing and only the government can enforce intergenerational contracts."

The first public sector longevity hedge was between Swiss Re and the Royal County of Berkshire Pension Fund in the UK in December 2009 for Sfr1.7 billion (£1.1 billion) in pension liabilities. Mumenthaler says the company was in "more and more dialogue" with governments on the issue of longevity derisking, but he declined to comment on any specific public sector deals.