Pension Funds, Risk Allocation and Alternative Investments

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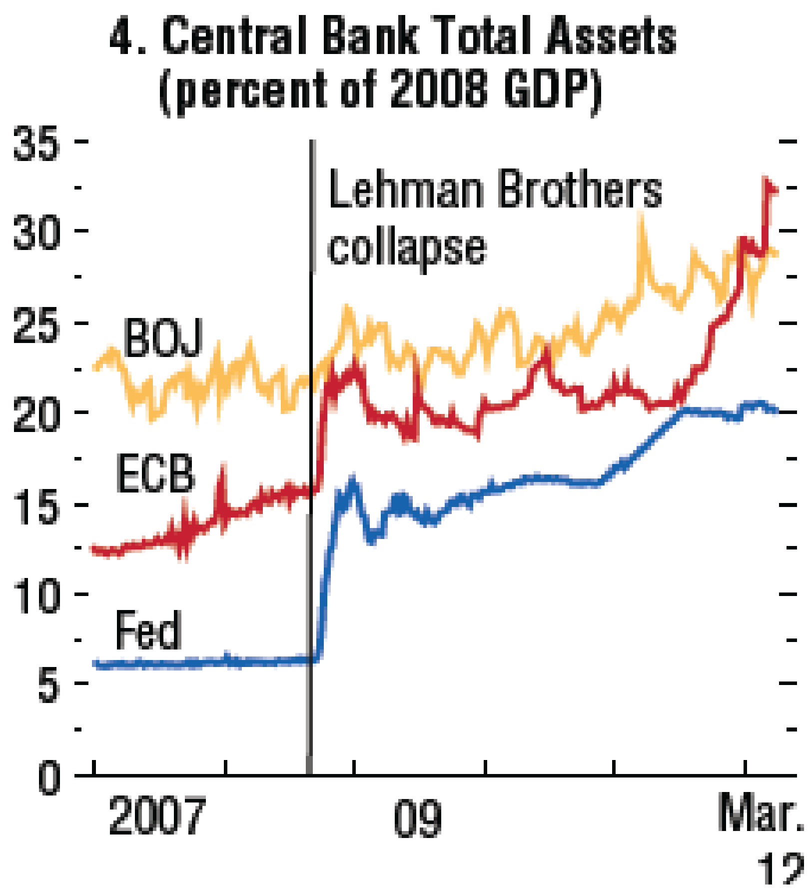
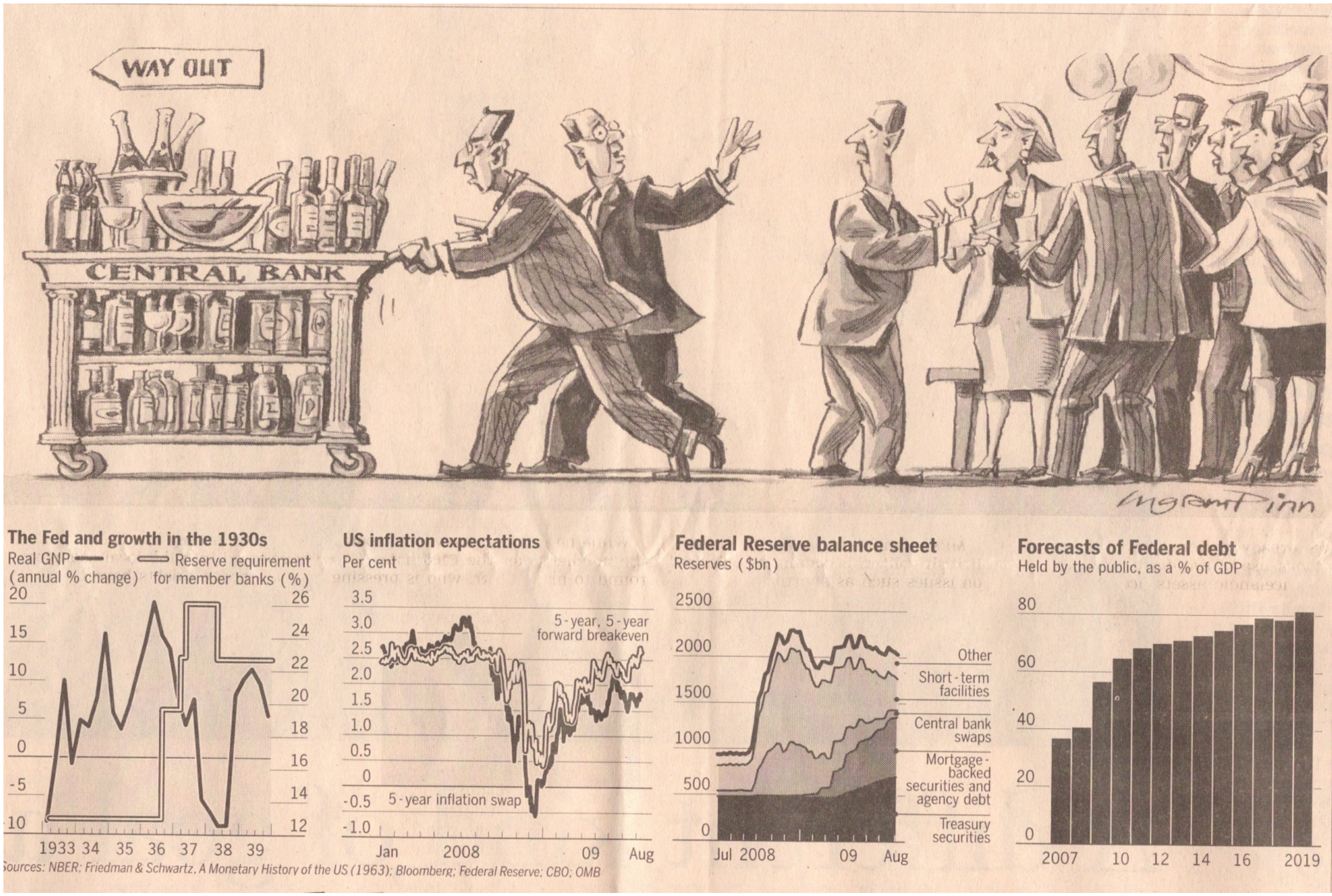
Average Implied Volatility STOXX50
24 months to maturity options

Very aggressive unconventional monetary policies on both sides of the Atlantic



Moeten we ons zorgen maken over inflatie?



Overwegingen bij Pensionsystem Redesign-1

- Hogere pensioenleeftijd onvermijdelijk
  - Regeerakkoord voorstellen grote stap id goede richting
    - gradueel 65=>67
    - daarna koppeling aan demografie
- get ready for a more volatile world
  - onvoorwaardelijke garanties bestaan niet
- risk sharing: waarom risico's delen, en met wie?
  - habit formation, inflexible spending components
  - risk pooling
- welke schokken ***kunnen*** door delen afgevlakt worden?
  - demografie veranderingen zijn voor iedereen en permanent
  - inflatie heeft veel mean reversion (ECB credibility, Monetary policy overshooting)
  - Fin mkts have some LT mean reversion
- => Deel financieel, inflatierisico intertemporeel (uitsmeren)
- => demografische schokken snel verwerken

Overwegingen bij Pensionsystem Redesign-2

- Risk Sharing VEREIST Intergenerational Fairness:
  - groepen moeten niet ex ante (voorspelbaar) beter af zijn buiten het systeem

- STAR akkoord extreem fout: verwacht portefeuille rendement als discontovoet leidt tot:
  - veel te vroege indexatie, ten koste van jongeren
  - onbeheersbare prikkels tot risico zoekend gedrag
  - “invaren” gaat EVRM problemen geven
  - Perverse compensatieregeling AOW

- Kamp’s voorstellen steeds meer in de goede richting

- Regeerakkoord deels curieus
  - waarom aftoppen fiscale faciliering boven 100 kE: onnodige complexiteit
  - verlaging pensioenopbouws percentage valse besparing

Investment challenges for retirement

- individual life cycle saving and asset allocation
  - who should take risks when?
- intergenerational risk sharing
  - when is risk sharing useful?
- Alternative investment opportunities and pension funds
  - Structured Products
  - Private Equity
  - Hedge Funds
  - regulatory threats
- The future of investing for retirement

Risk Taking and Age: generational accounts and asset allocation

- Young have large human capital, little financial capital
  - human capital may rise initially but declines with age and becomes zero at retirement

- So the young should save, but should they also load up on risk in their financial wealth?

- The value of pension funds
  - trade on wholesale markets => lower costs/higher pensions
  - offer risk sharing possibilities not open to individuals
    - over individuals (collective DC)
    - over generations (collective DB systems)
  - Mandatory participation
    - protects individuals against behavioral inconsistencies
    - allows insurance markets to function

Should the young take on more risk?

- Yes in general BUT

- Is labor income related to stockmarket returns?
  - yes for entrepreneurs…..
  - macroeconomics: long term income shares are relatively stable
    - variance is in aggregrate growth, not income shares

- Is labor supply flexible enough?
  - hours worked & marginal tax rates
  - flexible retirement age & L-market for elderly workers
  - policy challenges: labor force participation of elderly workers
    - productivity and age: some empirical surprises

- Flexibility of spending commitments and risk taking

Pension funds and risk taking for the young

- L-markets are becoming more flexible, marginal tax rates lower (but this cabinet…) => take more financial risks early on (or in “young” pension funds)

- Should pension funds play a bigger role in financial planning?
  - resist the siren songs of politicians, do not subsidise distressed banks by buying mortgages above market prices
  - reverse mortgages?
  - saving for future healthcare through pensions?

The role of alternative investments: some misconceptions

- Contrary to what the EU commission thinks:
  - hedge funds and PE are not the same
  - neither played a significant role in the credit crisis
  - securitisation did play a role but should not be regulated out of existence

- Because of these misconceptions, there is a regulatory threat that will reduce their attractiveness as investment venues

- But there are problems in all three areas

Regulatory environment:

Trade off: financial stability ~ innovation

- future of structured finance?
  - can play a useful role transferring risk from banks to less leveraged institutions
  - needs public market infrastructure?
  - impact on corporate governance?
  - block abuse by banks

- Regulation more principle based, less rules based?
  - do not fight the last war
  - Financial innovation always a result of interaction new investment vehicles and regulatory structure

- Design the regulation not from individual cases up but from system stability requirements down
  - example: countercyclical capital requirement regime

The Future of Structured Finance

- SF intended to spread risk out more widely, transfer risk from highly leveraged banks to less leveraged institutions and so reduce fragility
- But SF has been used to mask balance sheet risks in a regulatory arbitrage game
- SF products often OTC and therefore hard to value
- Lack of transparency has increased rather than reduced fragility….
- Excessive insurance reduces governance role of debt
- Major rating problems as yet unresolved
  - both methodological and incentive problems
  - need for simpler products
  - realise impossibility of fine-mazed risk ratings
- SF still necessary, but improve market infrastructure:
  - accounting, valuation and reporting standards
  - clearing and settlement institutions

The “originate & Distribute” model undermines the role of debt in Corporate Governance

- Leverage and Corporate Governance:
  - Equity holders monitor in good times
  - Debt holders monitor in bad times

- Stricter rules on equity exposure banks to avoid conflict of interest?

- Securitization undermines corporate governance role debt holders
  - Originator does not care (risk off-loaded)
  - New owner typically far removed from individual loans
    - because of packaging
    - Because of multitude of owners (cf problems US mortgage renegotiations)
    - Because of explicit clauses in SIV’s, renegotiation underlying assets difficult
  - Securitized subprimes see 20% more default than loans held in portfolio

- Solution: allow only partial transfer of risk?
  - but how should it be set up (slices thr all tranches, residual equity tranches?)

Transparency Requirements and the Future of Hedge Funds

- Hedge Funds
  - Promise returns uncorrelated with stockmarket or business cycle
  - Correct mispricing in asset markets
  - Provide liquidity for trade in underpriced assets in good times
  - But withdraw liquidity during crises

- Their risk characteristics difficult to assess
  - Long term volatility *seemingly* lower than S&P
  - But *structure* of volatility different: high risk of extreme events
  - Selling beta-risk after all? So are managers claiming alpha vastly overpaid?

- Transparency requirements fundamentally at variance with their modus operandi
  - Advertising mis-pricing may make it disappear
  - Should they report highly concentrated exposures to their investors?

- Will they too turn into traditional mutual funds?
  - No need to regulate as long as there are no retail investors
  - Movement to take HFs public highly irresponsible

- Regulating hedge funds out of existence will not stop arbitrage activities, Banks will do them “in house”?

- Benefits to PFs not clear, difficult to fit in because of tail risks, lack of transparency

Private Equity mired in controversy

- Promised to resolve governance problems
  - one dominant investor with LT horizon
  - particularly useful in corporate restructuring phase
  - but governance problems recreated when PE goes public?

- Returns mired in controversy
  - recent study:
    - large discrepancy return on investments ~ returns to investors
    - => excessive management fees
    - large funds provide premium to S&P index to investors, small PE funds don’t
  - Other studies do find a liquidity premium (is NOT alpha => management pay still excessive)

- Can play a role for PFs, they have easier liquidity planning
  - but select funds carefully, focus on large players?
  - pay attention to management fees

Risk, Pension Funds and retirement Savings

- Pension funds are irreplaceable tools for private risk management over the life Cycle
  - creeping roll back of collective PFs in “regeerakkoord” unfortunate

- Generational accounts in PFs can help
  - individuals rationalise intertemporal allocation of risk
  - while maintaining benefits of collective market access
  - but keep DB elements for intergenerational risk sharing
    - financial risk MUCH more important than inflation risk in Dutch environment

- Liquidity premia PE opportunity for PFs
  - but careful selection necessary

- Structured products allow PFs to remedy funding gap in banks
  - IF incentive, valuation and regulatory problems SF can be resolved
  - resist moneygrabs politicians eager to rescue banks