

‘The real returns of private pensions’

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Real Return of Private Pensions

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Report Catalysts

- European Commission White Paper – An Agenda for Adequate, Safe and Sustainable Pensions – February 2012
- OECD report – Pensions Outlook 2012 – June
 - Governments can't afford to pay for state pensions
 - Citizens must work longer
 - Private pension provision the preferred option
 - However OECD says those who have made provision received 'paltry' returns

Report Catalysts

- We decided to investigate these ‘paltry’ returns
 - in Europe with a focus on the experience in
 - Denmark, France & Spain
- Related issues
 - Is the information available and clear enough to make informed investment choices?
 - Do citizens have an adequate level of financial literacy?
- The short answers to the above are Yes, No & No!

Scope & Method

- To decompose the sources of return
 - Inflation
 - Asset Mix
 - Asset Performance
 - Charges
 - Taxation
 - Portfolio manager/advisor competence

Country Profiles 2011

Denmark				
Occ. Pension Assets	€116.5bn		Pension Assets as % of GDP	49.7%
Life Insurance Assets	€162.1bn		Life Ins. Assets as % of GDP	68.1%
Working Population	2.9m		Dependency Ratio	24.9%
Net average replacement ratio of State pension				94.5%
France				
Occ. Pension Assets	€58.4bn		Pension Assets as % of GDP	2.9%
Life Insurance Assets	€1,494.0bn		Life Ins. Assets as % of GDP	74.3%
Working Population	28.7m		Dependency Ratio	25.7%
Net average replacement ratio of State pension				60.8%
Spain				
Occ. Pension Assets	€83.9bn		Pension Assets as % of GDP	7.9%
Life Insurance Assets	€189.0bn		Life Ins. Assets as % of GDP	17.8%
Working Population	23.1m		Dependency Ratio	24.7%
Net average replacement ratio of State pension				84.5%

Sources – IPE, OECD & Eurostat

Inflation

- Persistent problem
- Currently low by historical levels

	Long term	2011
Denmark	4.0%	2.75%
France	7.3%	2.57%
Spain	6.0%	2.34%
EU 27	NA	2.95%

- But government deficits and debt on the rise

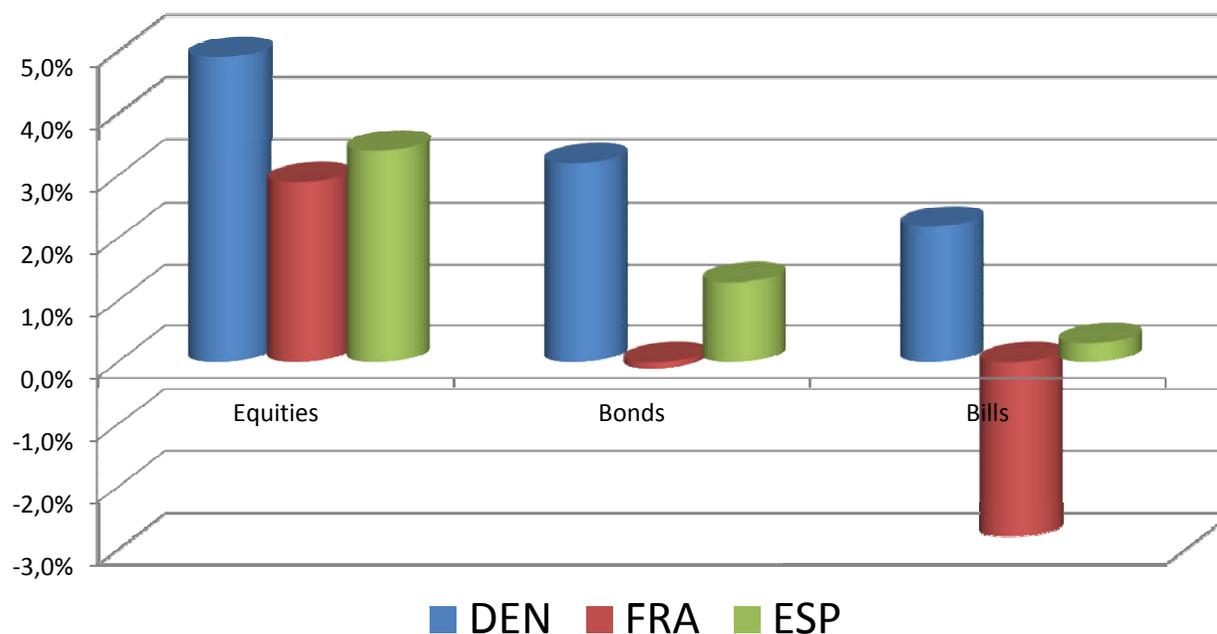
Inflation

- Conclusion
 - Inflation a real threat to wealth
 - Unlikely to stay at current low levels
- Recommendation
 1. Governments ought to issue (readily accessible) index linked bonds, targeted at pension savers to protect retirement savings

Asset Mix

- Long-term historical return data

Real returns Equities, Bonds & Bills
1900 to 2011



Asset mix

- Real assets out perform debt assets
 - Real assets have a share of the economy
 - Debt assets are monetary contracts
- Equities are more volatile > risk
- Equities don't perform well under mark-to-market accounting
- Bonds are lower risk, but can fail to give a real return

Asset mix

- Data on asset mix poor
- Pension funds have potentially very long investment horizons
- They can afford to absorb risk for extraordinary opportunity
- Regulation favouring debt instruments
- Which is reducing expected real returns

Asset mix

Weighted returns						
		Govt Bills	Govt Bonds	Private Bonds	Equity	Total
Denmark	2001	0.01%	0.33%	0.70%	2.44%	3.51%
	2007	0.01%	0.77%	0.50%	2.31%	3.62%
	2010	0.01%	1.57%	0.40%	1.46%	3.43%
France	2001	-0.01%	-0.01%	0.70%	1.44%	2.53%
	2007	-0.01%	-0.02%	0.50%	1.36%	2.13%
	2010	-0.01%	-0.05%	0.40%	0.86%	1.39%
Spain	2001	0.00%	0.48%	0.40%	1.25%	2.16%
	2007	0.00%	0.34%	0.70%	0.89%	1.91%
	2010	0.00%	0.34%	0.50%	0.64%	1.53%
						Source: EuroFinuse

Asset mix

- Conclusions
 - Pensions in the shadow of insurance companies
 - Back door financial repression?
- Recommendation
 2. We urge policy makers to design a distinct regulatory framework for the pensions sector
 - Opportunity to take risk
 - Cognisant of saver's declining risk appetite and liquidity

Asset performance

- Equity markets
 - Absolutely appalling!
 - Probably the most eventful decade in the history of finance
 - Dot com, Worldcom (2001/2)
 - Credit crisis (2007/8)
 - Loss of confidence in government crisis (2010/11)
 - Paradox, fundamental value of equities up, prices down

Asset performance

- Bond Markets
 - Work in progress
 - Difficulty in securing total return data
 - Expected outcome
 - Flight to quality and dispersed experience across EU
 - Denmark seen as quality, low debt, low yields
 - France hanging on to quality – just!
 - Spain, loss of confidence

Asset performance

- Conclusions
 - Investors demand a higher risk adjusted return
 - The long term belief that government bonds are a risk free asset has been challenged
- Recommendation
 - Conclusion supports previous recommendation of distinct regulatory regime for pensions

Charges

- Charges can consume up to 23% of a saver's original investment over an 11 year period
- Disclosure in the pensions sector is not often required
- Spain has a cap on pension charges, but 'possibly' not on intermediary commissions
- Studies on the development of the Key Investor Information Document (KIID) for UCITS reveal that financial literacy is very poor

Charges

- Three scenarios – nominal returns:
Scenario A – zero costs,
Scenario B – a 0.81% ongoing charge without entry or exit costs
Scenario C – a 4% entry charge and 1.71 ongoing fee

Return scenarios under different fee structures							
	2000	2001	2003	2005	2007	2009	20011
Scenario A	€10,000	€8,453	€6,883	€9,827	€12,287	€9,298	€9,531
Scenario B	€10,000	€8,379	€6,726	€9,465	€11,586	€8,685	€8,607
Scenario C	€10,000	€7,964	€6,287	€8,687	€10,335	€7,638	€7,190

Charges

- Conclusions
 - Almost no transparency for pension vehicles
 - Charges in the region of 2% and greater
 - Financial literacy is very low, suboptimal decisions
- Recommendations
 3. KIID style disclosure for pension sector
 4. As a matter of urgency raise financial literacy
- Outcome
 - A transparent market forces competition!

Taxation

- Taxation has a similar impact on wealth as investment charges
- It can by its incidence cause distortions in investment behaviour
- We believe there should be tax relief on contributions (with limits) and accumulation of pension schemes
- As saving is deferred consumption

Taxation

- The three country experience
 - Denmark
 - Contributions deductible, return on assets tax of 15.3%
 - Tax on nominal returns, reduces real returns by 1/3
 - France
 - Tax levied on nominal life insurance income at 23%
 - With declining interest rates real returns now negative
 - Spain
 - Limited tax deductibility on contributions

Taxation

- Conclusion
 - As with charges disclosure very poor
 - Incidence of taxation varies between states
 - Danish regime materially erodes real return
 - French appears to remove the possibility of real return
- Recommendation
 5. Pension schemes need to receive favourable tax treatment (or at the very least not punitive) in order to encourage private provision

Portfolio manager/adviser competence

- Conclusions
 - Fairly confident that regulatory regime assures fit and proper people to manage investments
 - More concerned that the advisers being motivated by fees rather than suitability
 - Regulatory arbitrage between MiFID and IMD
- Recommendation
 6. Regulation needs to consider how to fairly compensate advisers so that they provide suitable advice

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