

A global pensions problem

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EXPERIENCE AND QUALIFICATIONS

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20 years ago pensions rarely made the headlines. In fact, one of the few pension-related front page stories in the early 1990s in the UK related to the unsavoury antics of Robert Maxwell, who had squandered the pension pots of thousands of Mirror Group pension scheme members. Over the last ten years, however, pensions have become a mainstream issue as we all have come to understand that providing for our old age is going to be much more expensive than we expected.

There are two main reasons why concerns over pension provision have intensified and put the topic almost daily onto the front pages of national newspapers. First, most industry experts agree that we can no longer rely on equity investment to generate the funds needed for us in our old age. Even those who believe that equity returns might get us all across that retirement finishing line with decent pensions admit that we will face intense volatility along the way; significant enough to test the resolve of even the most ardent adherent of the cult of the equity. The second factor is longevity. For instance, in the UK, for more than 150 years, each generation has lived longer than the previous one. As a rough rule of thumb, every ten years our average life span has increased by two to three years. As an increasing proportion of us make it into our 90s – and since pension plans make a promise of a payout for life – it is fair to say that we have a problem.

This is not just a problem for the sponsors of defined-benefit (DB) pension plans. Members of defined-contribution (DC) schemes – who need to set aside enough in their plan to achieve their desired income at retirement – also face challenges, as does the government, which needs to find ways of funding state pension provision. This isn't, however, a challenge that the UK faces alone. Across the developed world, governments and policy makers are struggling to come

up with a pension mechanism that will allow their citizens to retire in comfort and at a price that is affordable.

Approaches to pension provision

There are a number of approaches to providing for retirement, and most developed countries use a mixture of all of them: a so-called three pillared approach. First, DB occupational pension schemes – where the risk of provision lies with the scheme sponsor – are common across most OECD countries. 20 years ago this was the dominant form of private-sector pension provision in the UK¹, but today an increasing number of employers are offering DC plans, where the risk lies firmly with the individual². Indeed, DC has been the dominant form of occupational pension provision in the US for many years. The second of the commonly used approaches, is private pension provision, which is a private version of an occupational DC scheme, in which again the risk of shortfall lies with the individual³. Finally there are a variety of state and public-sector schemes that fall into two broad categories. These comprise pensions that are funded, i.e. where a pool of assets has been set aside to meet the pension promise. Effectively these are public-sector equivalents of private-sector DB schemes. The second category, and arguably the most controversial, is those that are unfunded. This is where the embedded pension promise is underpinned

1. Indeed, the past provision of generous occupational DB pension schemes means that 25% of the UK population owns 58% of claims on UK pensions, whilst those aged 35 to 74 own a gargantuan 88%. Source: David Willetts, *The Pinch: How the Baby Boomers Took Their Children's Future - And Why They Should Give It Back*. February 2010.

2. In the UK for instance, this risk is highlighted by the fact that 16% of employers in 2009 either cut or ceased payments to their DC scheme or stopped promoting their DC scheme in an effort to stem its take up. Source: Punter Southall, February 2010, based on a survey of 340 companies. This was against the backdrop of the average employer DC contribution being a meagre 6% of salary. (continued on next page)

CHART 1 PENSION ASSETS AS PROPORTION OF GDP

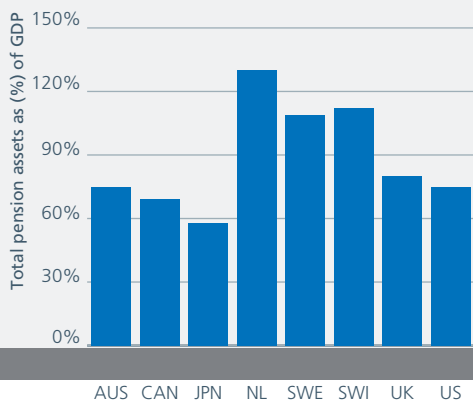
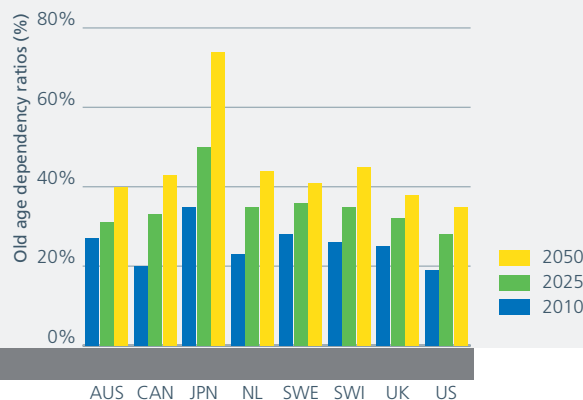


CHART 2 OLD AGE DEPENDENCY RATIOS



SOURCE

Chart 1: UBS GAM 2008.
 Chart 2: UN February 2010. See <http://esa.un.org/UNPP/index.asp?panel=2>.

by tax revenues. These are referred to as pay-as-you-go (PAYG) schemes, as current pensions are simply paid out of current tax revenue. The Italian pension system is an almost entirely unfunded one, which means that the majority of pensions are paid out of tax receipts.

In whatever way pensions are supported, at the end of someone’s working life there needs to be either a pool of assets or sufficient tax revenue to make good the pension promise. This will be easier if either a large pool of assets has been built up over the years, or if there is a large and young working age population relative to the pensioner population. Let us look at the first issue. Chart 1 shows the total pension assets for a selection of developed economies as a proportion of each country’s GDP. The UK system is rather poorly funded when compared to its Dutch equivalent. Perhaps surprisingly, the funding level in Japan is rather weak. The Japanese have been saving assiduously for many years, yet their funding level is well below that of the US.

The old-age dependency ratio

The ratio of over 65s to the total population in an economy is known as the old-age dependency ratio. Improvements in

longevity, coupled with a significant decline in birth rates across the developed world, means that the dependency ratio is rising. Chart 2 shows the ratio for a number of countries, along with projections for the years 2025 and 2050.

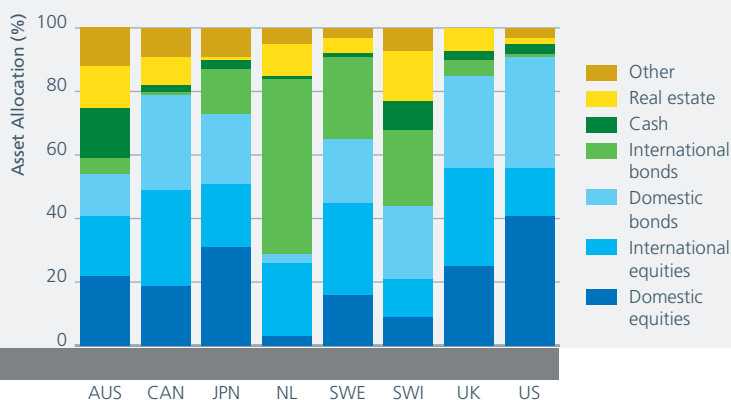
As Chart 2 shows, at 35%, Japan has one of the highest old-age dependency ratios in the developed world. Worse still, by 2025, it is expected to be 50%, and by 2050 an unprecedented 74% - that is, for every 100 people in Japan, 74 will be over the age of 65. Just imagine the queues at the post office!

The chart also shows that the increase in the dependency ratio is not confined to Japan. In the UK, it is projected to increase from 25% today, to 38% by 2050. Italy, meanwhile, has an old-age dependency issue that is almost on the scale of Japan’s. By 2050, 62% of Italians will be over 65. And with Italy having a predominantly PAYG pension system, by 2050 a very small Italian working population will be supporting a massive number of pensioners, not to mention their own children too.

This is in stark contrast to the old-age dependency ratios across Asia (ex Japan). In this region, the current dependency ratio

- (continued from previous page)
 Source: Aon February 2010. Moreover, a number of US companies with UK subsidiaries have begun to consider linking their DC contribution rate to their profits, as many companies already do in the US. In addition, 24% of employers expect to “level down” their DC contributions to the 3% NEST (the National Employment Saving Trust – the UK government implemented auto-enrolment pension scheme to be introduced in 2012 for around 9 million low to middle-income earners who are not members of an occupational pension scheme) contribution level, while 15% suggest they may close their schemes in favour of NEST. Source: Association of Consulting Actuaries, January 2010.
- This risk of shortfall is a combination of falling investment returns and lower annuity rates. For instance, a contribution of £100 gross per month made over 20 years into an averagely performing balanced managed fund would currently only produce an annual income of £2,452 from a resulting pensions pot of £40,749, against £8,998 from a pot of £103,914 a decade ago. Source: This is Money, February 2010.

CHART 3 DEFINED BENEFIT PENSION SCHEMES -
ASSET ALLOCATION AS AT END-2008



SOURCE
UBS 2009.

is 10%; by 2050 it is projected to be 27%. These projections are, however, based on a range of assumptions that include future fertility and immigration rates. If people start to have larger families again, or if immigration turns out to be higher than anticipated, these trends could be reversed, but only very slowly.

Asset allocation

The challenge of solving the pension problem may lie in asset allocation, particularly with regard to national structures where saving for a pension features heavily. Chart 3 shows the DB asset allocation breakdown for a range of pensions markets. The first point to notice is that most of these pensions markets have a significant allocation to equities, with the exception of Switzerland. Pension funds in the US have the greatest faith in equities, with 56% of the total invested in the asset class.

Perhaps the most interesting feature of the chart is the higher allocation to bonds in the Netherlands, Sweden and Switzerland; here the total allocation is 58%, 46% and 47% respectively. As indicated in Chart 1, the pension systems in these three countries have the highest degree of pension funding relative to GDP. We should also note the

sizeable Swiss allocation to property – an asset class with fixed-income characteristics. Taken together, the allocations in these countries suggest that they are focused on protecting their current, relatively strong, funding positions, while other, less well-funded pension systems are having to rely more on an ‘equity kicker’ to produce the cashflows that will enable them to meet future pensions⁴.

Chart 3 also reveals the international nature of most holdings. For example, only 25% of UK pension fund assets are invested in UK equities – in 1998 this figure was 51%. The Netherlands has the most international portfolio: only 6% of Dutch pension assets are invested in Dutch bonds and equities. While this small allocation to Dutch equities is not surprising given the size of the market, the low allocation to Dutch bonds is probably a consequence of the advent of the euro. This effectively gives Dutch pension schemes access to a much wider pool of government and corporate bonds without the associated currency risk. This is evidenced by the fact that, in 1998, before the introduction of the euro, domestic bonds constituted 35% of Dutch pension holdings.

4. All DB schemes must achieve two objectives in order to deliver on the pensions promise: to ensure their deficits don't widen any further and to ultimately close those deficits. In order to achieve these objectives, adopting the "correct" asset allocation is key.

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Contrast this with the massive home bias in US pension fund holdings. 76% of US pension fund assets are allocated to either US equities or US government and corporate bonds. To some extent this reflects the size of these markets. However, as the international exposure of pension schemes around the world has increased, the US system has changed relatively little. In 1998, 83% of US pension fund assets were invested in US equities and bonds. Ultimately this represents a sizeable bet by US pensioners on the performance of the US economy.

The aggregate pension fund asset allocation strategy varies from country to country depending on the level of funding and the size of the domestic markets. But there is no guarantee that any of these strategies will secure the pension benefits of both current and future pensioners. The market must bear in mind that, while funding might be insufficient at the moment across the developed world, some funding is better than no funding. On current trends, at some stage soon, the pension burden on the Italian population may be completely overwhelming.

A possible answer

Unless we experience an equity bull market to rival those of the 1980s and 1990s, it seems likely that pension providers in the developed world will have to come to terms with a harsh reality: the generous pension

promises of the past, can only be sustained in the future if people work longer.

This trend has already begun, both formally and informally. For example, the state pension age is being raised in the UK. The government plans to increase the state retirement age for men from 65 to 66 in 2026. It will then rise to 67 in 2036, and to 68 in 2046. Meanwhile, under current government proposals the state retirement age for women will rise from 60 to 65 between 2010 and 2020.

But retirement ages are rising informally too. In the US, there has long been talk of the grey workforce phenomenon. As US citizens approach retirement and realise that their pension will not be sufficient to sustain them in retirement, they have either delayed their retirement or have taken on part time work during retirement to supplement their pensions. In recent years, this phenomenon has also been seen in Japan and the UK.

Gradually governments, corporations and individuals are realising that to build up sufficient funds to live comfortably in retirement for 30 years, takes more than 40 years of work and saving. Within the next 20 years, a retirement age of 75 for men and women will be seen as the norm, rather than the exception, across most developed economies.

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KEY POINTS:

- Today the issue of pension provision often makes headline news.
- The pension problem is not one that the UK faces alone.
- Pension frameworks vary from country to country but the goal remains the same: to meet the pensions promise.
- Funded systems have the potential for meeting some of the pension promises.
- Ultimately the demographic burden will mean that people in the developed world will have to prepare themselves to retire later than previous post war generations.