9 April 2008

Investment Issues

Society of Actuaries in Ireland – PRSA Forum

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Background – trends among institutional investors

Buzzwords in pension fund terminology

1. Know your risks relative to what you're funding for
2. Hedge 'unrewarded' risks:
   - If I'm not getting paid for them, why take them
3. Diversify 'rewarded' risks:
   - Diversification gives me something for nothing
4. Be much clearer on overall risk tolerances
5. Where I am taking risk, how can I get the maximum return for that risk

Can any of these themes be applied in a simplified way to the world of PRSAs?

Agenda

- Applying IAPF Investment Guidelines to PRSA Actuaries
- Compliance
- Beyond compliance(1) – maximise quality of product
- Beyond compliance(2) – maximise quality of communications

IAPF Investment Guidelines for Defined Contribution Trustees

Launched 31 March 2008 with strong Pensions Board endorsement

1. Trustees should **formally discuss investment matters** at least annually (including their compliance with these guidelines)
2. Trustees should **take expert advice** in relation to investment issues unless they are satisfied that they already have the necessary skills and information
3. Trustees should ensure that they **comply with all relevant investment regulations**. If necessary they should seek confirmation from their investment advisors.
4. The responsibility of trustees in defined contribution schemes is to provide a **reasonable range of appropriate investment options** for their members. The range should be formally reviewed at least every three years.
5. Trustees should **consider likely investment needs of members** (including growth, capital protection and income protection) and should measure risk in relation to these objectives and to the likely risk tolerance of their members. In particular, attention should be paid to the requirements of members within 10 years of normal retirement.
6. Trustees should ensure that **sufficient communication** exists to enable members to be aware of the important features of the investment options available to them and should provide for **appropriate default strategies** for members.
7. Trustees should **retain responsibility for high level strategic decisions** in terms of assessing investment objectives, options and default strategies. Trustees may **delegate implementation to others** and should do so where they do not have the necessary skills.

But is this relevant for PRSAs?

IAPF Investment Guidelines for Defined Contribution Trustees

PRSA Actuaries arguably fill a quasi-Trustee role

1. The PRSA Actuary ~~Trustees~~ should **formally discuss investment matters** at least annually (including their compliance with these guidelines)
2. The PRSA Actuary ~~Trustees~~ should **take expert advice** in relation to investment issues unless they are satisfied that they already have the necessary skills and information

Focus and stay informed

3. The PRSA Actuary ~~Trustees~~ should ensure that they **comply with all relevant investment regulations**. If necessary they should seek confirmation from their investment advisors.
   - See slides 7 – 10 on compliance

Cover your ass

These best practice guidelines go beyond the "cover your ass" minimum…

IAPF Investment Guidelines for Defined Contribution Trustees

PRSA Actuaries arguably fill a quasi-Trustee role

4. The responsibility of ~~trustees in defined contribution schemes~~ **the PRSA Actuary** is to provide a **reasonable range of appropriate investment options** for their members. The range should be formally reviewed at least every three years.

5. ~~Trustees~~ **The PRSA Actuary** should **consider likely investment needs of members** (including growth, capital protection and income protection) and should measure risk in relation to these objectives and to the likely risk tolerance of their members. In particular, attention should be paid to the requirements of members within 10 years of normal retirement.

Ensure good product

…they demonstrate the PSRA Actuary's role in developing a top-quality product for customers…

IAPF Investment Guidelines for Defined Contribution Trustees

PRSA Actuaries arguably fill a quasi-Trustee role

6. The PRSA Actuary ~~Trustees~~ should ensure that **sufficient communication** exists to enable members to be aware of the important features of the investment options available to them and should provide for **appropriate default strategies** for members.

Ensure good communication

…and because top-quality product plus top-quality communication equals happy customers…

7. The PRSA Actuary ~~Trustees~~ should **retain responsibility for high level strategic decisions** in terms of assessing investment objectives, options and default strategies. Trustees may **delegate implementation to others** and should do so where they do not have the necessary skills.

Delegate, but the buck stops here

…these Guidelines neatly summarise how the PSRA Actuary fulfils the "dual" responsibility to customers (moral, professional) and employer (commercial) without any unmanageable conflict

Compliance

PRSA compliance requirements
Society of Actuaries guidance

- ASP PRSA-1 Annual Determination and Certificate
- ASP PRSA-3 Remuneration Information
- ASP PRSA-5 Transfers from Occupational Schemes
  - Nothing of note for today's discussion

- ASP PRSA-2 Product Information, covering:
  - Preliminary Disclosure Certificate
  - Statement of Reasonable Projection
  - Two main objectives of provision of this product information:
    - Projections that are "fair, clear and not misleading"
    - Projections that "allow comparisons between different PRSA providers"
  - Responsibility lies with the PRSA Actuary to advise the provider if they believe that any other information is needed within the Table of Benefits to ensure compliance with the above

Anything missing from a typical Table of Benefits?

PRSA compliance requirements

Focus on the projections of benefits (ASP PRSA-2)

Amount of contribution paid per month	*Retirement income payable for life from age 65 if contributions start from age:*				
	20	30	40	50	60
€50	€ per month	€ per month	€ per month	€ per month	€ per month
€100	€ per month	€ per month	€ per month	€ per month	€ per month
€200	€ per month	€ per month	€ per month	€ per month	€ per month
€400	€ per month	€ per month	€ per month	€ per month	€ per month

THESE ILLUSTRATIONS ASSUME AN INVESTMENT RETURN BEFORE RETIREMENT OF (RATE)% PER ANNUM AND INFLATION OF (RATE)% PER ANNUM. THESE RATES ARE FOR ILLUSTRATION PURPOSES ONLY AND ARE NOT GUARANTEED.

ACTUAL INVESTMENT GROWTH WILL DEPEND ON THE PERFORMANCE OF THE UNDERLYING INVESTMENTS AND MAY BE MORE OR LESS THAN ILLUSTRATED."

Fair, clear and not misleading?

Projections allow use of an assumed investment return without any illustration of <u>extent</u> of investment risk or <u>impact</u> of investment risk

PRSA compliance requirements

Focus on the projections of benefits (ASP PRSA-2) – suggestions

- Extent of investment risk – "how reasonable is that assumption?"
- Impact of investment risk – "if growth was 4% instead of 6% what would my required contributions look like?"

Pension Fund Real Returns (net of CPI)				
	35 years p.a.	25 years p.a.	15 years p.a.	5 years p.a.
To end 2007	+4.9%	+8.7%	+7.5%	+6.9%
To end 2002		+7.7%	+7.0%	-2.1%
To end 1997		+5.9%	+13.1%	+18.7%
To end 1992			+7.7%	+5.4%
To end 1987			+2.2%	+15.7%
To end 1982				+2.4%

Amount of contribution paid per month	*Retirement income payable for life from age 65 of contributions start from age*				
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Using rate of (x-2)%

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Balance to be found:
"More information simply creates confusion" or
"The only way of conquering fear is to confront it – beginning with education"

PRSA compliance requirements

Focus on ASP PRSA-4 – Investment

- ASP PRSA-4 states that the default strategy:
  - Should fulfil reasonable expectations of typical contributor
  - But these expectations will be primarily determined by communications received from the PRSA provider
  - Is not intended to be risk free

Communications fair, clear and not misleading?

  - Is expected for the most part to target annuity purchase at retirement
  - Is required to take into account the estimated outstanding duration until retirement

Lifestyling in <u>all</u> default strategies?

  - Is to be reviewed at least every five years
  - Needs to incorporate:
    - Adequate asset diversification (within asset classes)
    - Adequate control of concentration risk
    - Adequate arrangements for pricing, liquidity and cash holdings

UCITS pooled funds etc

Maximise quality of product

Setting a default investment strategy

Framework for setting a strategy

Think on behalf of a "typical PRSA contributor"

Assess the risks and set objectives

↓

At different stages of the individual's career

Agree the amount of risk that should be taken

↓

Efficient mix of asset classes. Types of equities? Types of bonds?

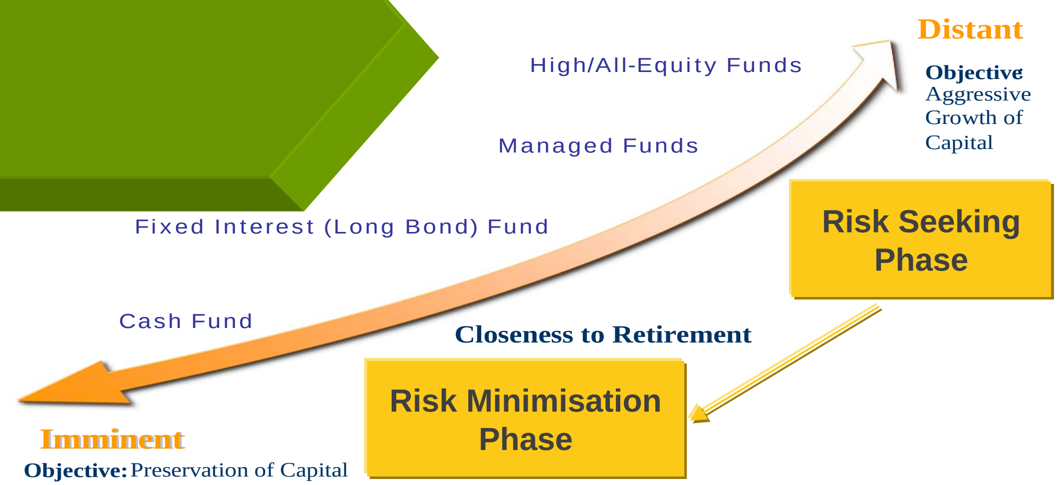
Identify the investment strategy that takes that risk in an optimal way

Setting a default investment strategy

Stage 1: assess the risks and set objectives (for the typical PRSA contributor)

Life-cycle objectives for a PRSA contributor

- Capital growth
- Annuity protection
- Capital protection

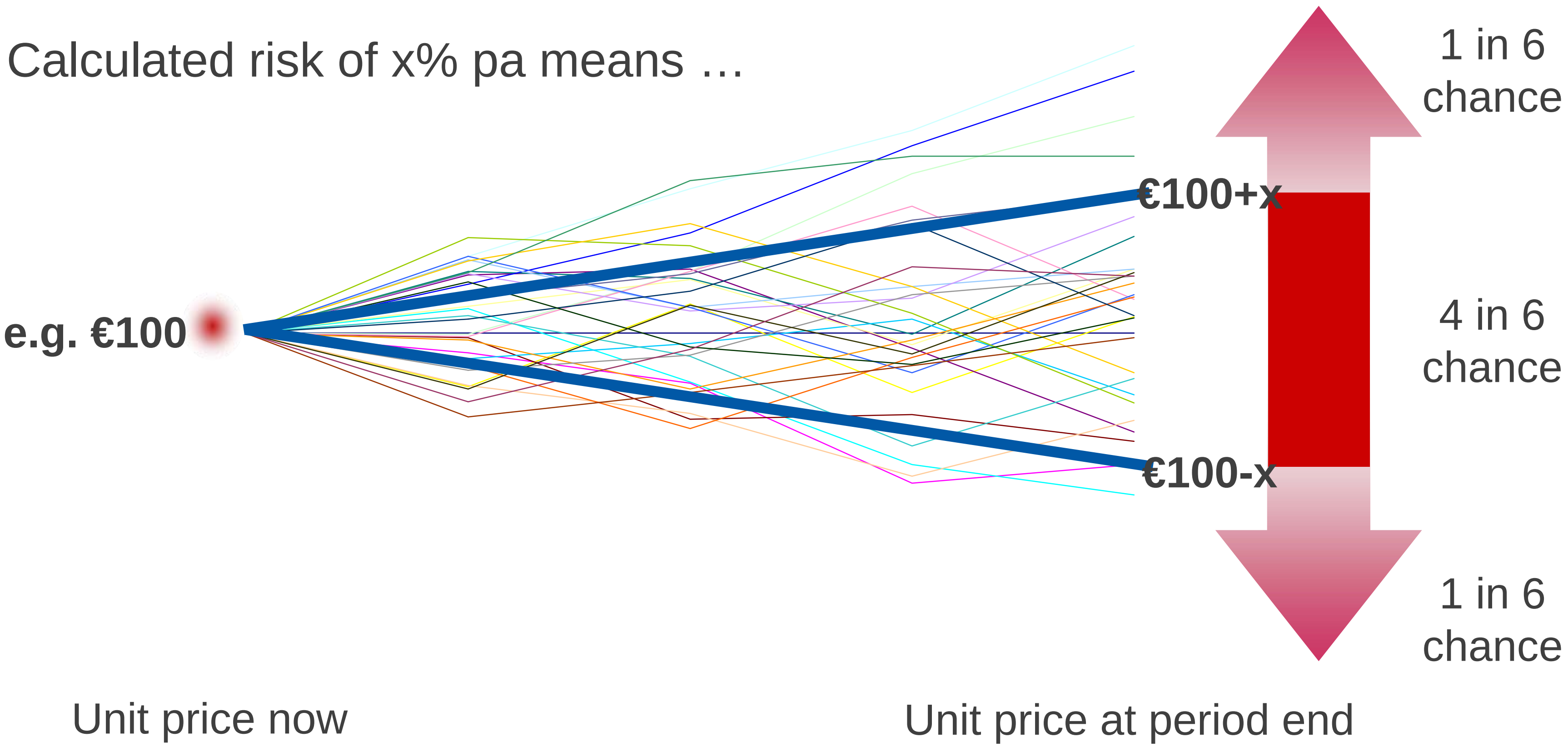


Further implicit objective for a PRSA contributor

- Minimise risk for the target level of return

Setting a default investment strategy

Stage 2: agree the amount of risk that should be taken



Q. What's the risk budget for a typical Managed Fund portfolio?

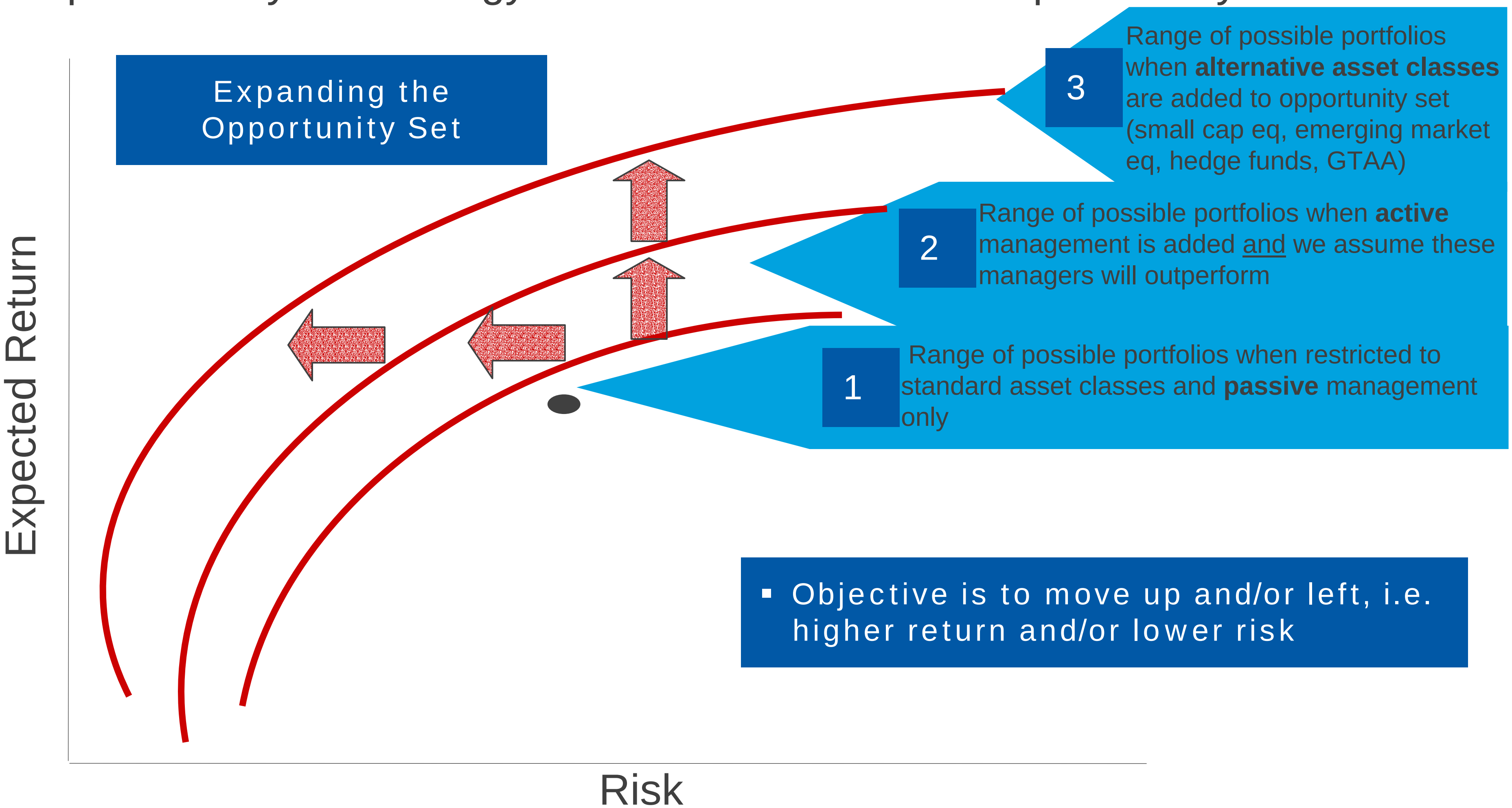
A. Not sure – tactical asset allocation bets by the peer group play a big role

Q. Is there an alternative?

A. Yes – fixed weight benchmarks (possibly with discretion for TAA versus the <u>fixed</u> weight)

Setting a default investment strategy

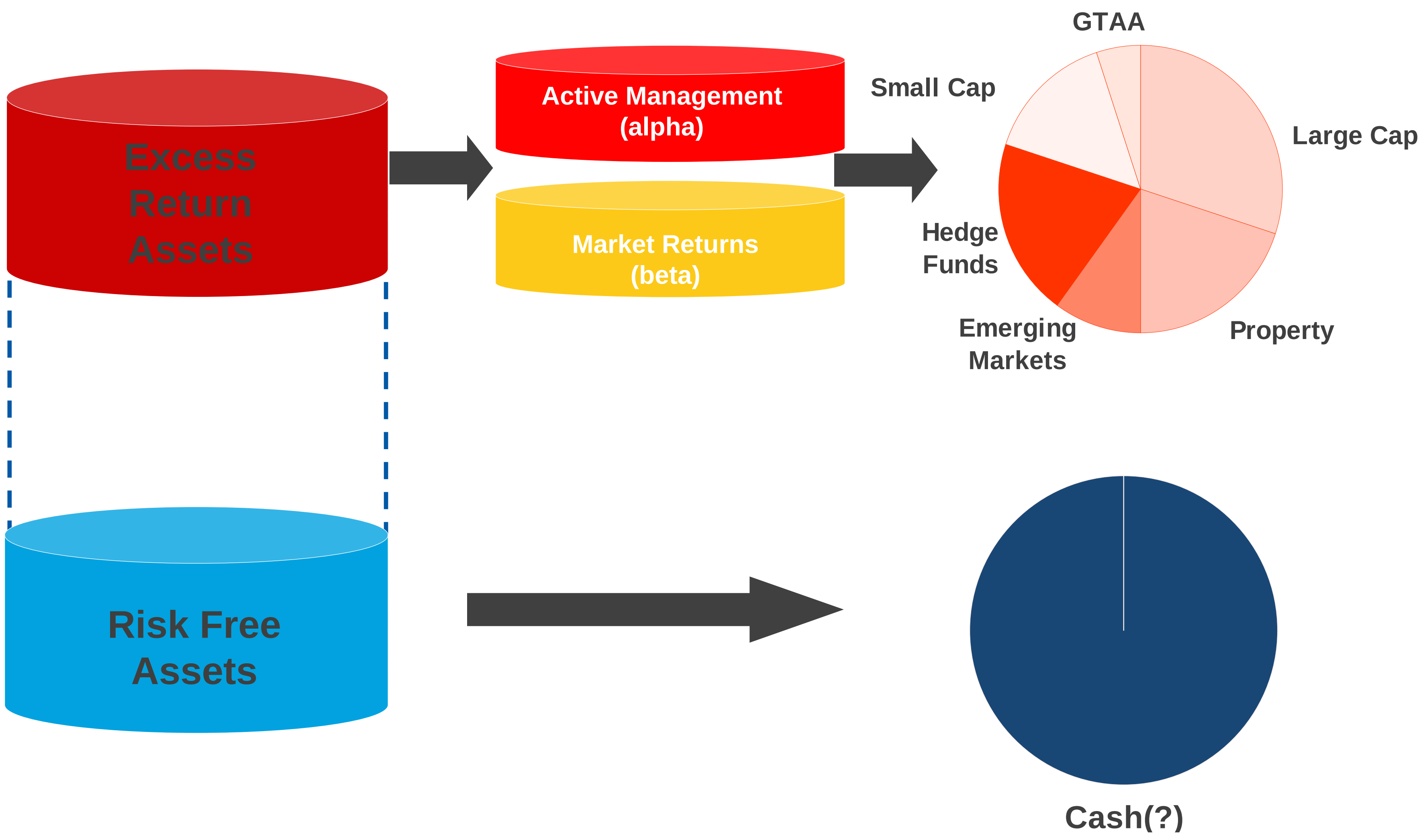
Step 3: identify the strategy that takes that risk in an optimal way



- Objective is to move up and/or left, i.e. higher return and/or lower risk

Cost constraint in Standard PRSAs (1% p.a. plus 5% on entry) will affect the choice of (a) active vs passive and (b) new asset classes

Setting a default investment strategy
Summary of risk budgeting approach



Maximise quality of communication

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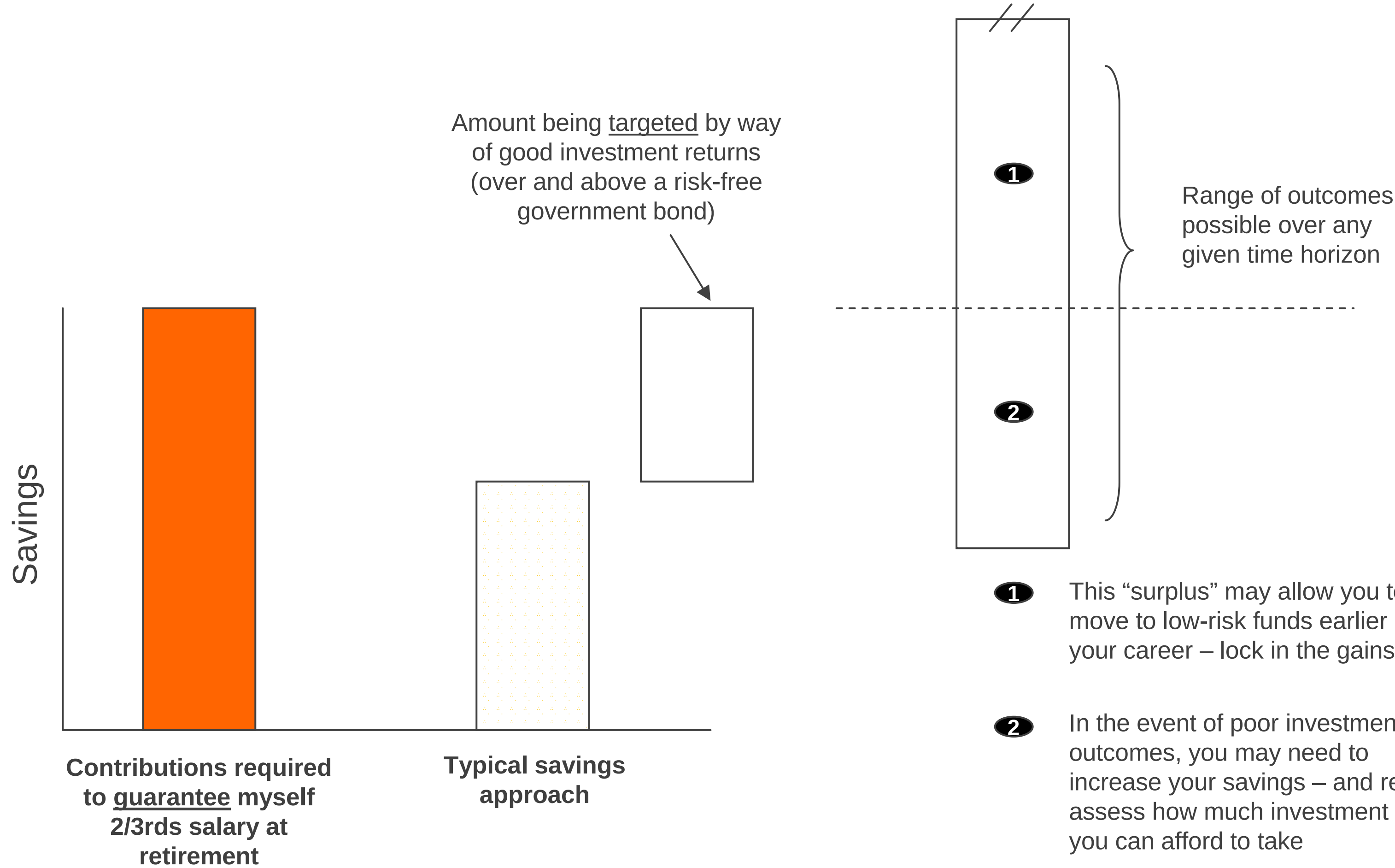
Explaining investment risk and why it needs to be taken

- Funding discussion: how much investment outperformance to anticipate when I'm figuring out how much to contribute?
- Investment policy discussion: how much investment risk to actually take?



1 This "surplus" may allow you to move to low-risk funds earlier in your career – lock in the gains!

2 In the event of poor investment outcomes, you may need to increase your savings – and re-assess how much investment risk you can afford to take

Maximise quality of communication
Various ways of skinning the cat

- Communicating extent of investment risk
  - Worst three-month period of returns from each fund/default strategy
  - Compare standard deviations of each fund and explain
  - Show actual returns over short and long-term time periods
  - Explain the “target” risk on the fund and what that will mean by way of volatility (e.g. returns outside range of –x% to +y% in one year out of three)
  - Explain risk in real terms not nominal

- Communicating impact of investment risk
  - Pension income expected to accrue given x% investment growth vs y% investment growth
  - Contributions required to target % of salary at retirement, under different return assumptions
  - Methods for assessing progress versus goals, getting across to investors that their contributions will have to vary depending on long-term investment returns

Summary/conclusions

Summary/conclusions

- PRSA Actuary has (arguably) a trustee-type role
  - IAPF Investment Guidelines for defined contribution trustees provide a neat summary of the PRSA Actuary's wider role
- The Actuary's role has to be judged in the context of the prevailing pensions environment, and will therefore become more testing as this environment evolves:
  - Compliance
    - "fair, clear, not misleading" – accepted definition is evolving?
  - Maximising quality of product
    - Risk budgeting techniques now widespread, remove unrewarded risks, maximise asset class diversification etc
  - Maximising quality of communications
    - Communication of investment risk is <u>the</u> pensions theme of the 21st century – does it now need to stretch to PRSA communications?
    - Or alternatively we accept that communication cannot work and be very <u>directive</u>, e.g. "people under 40 should avoid bonds and cash", "unless you are a very confident investor stick with the default option"