Developing Investment Governance and Benchmark Strategies

Heinz P. Rudolph

Lead Financial Economist

The World Bank Group

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1. What's wrong with the traditional open pension fund competition model?

- Pension funds compete on returns and individuals "vote with their feet"

Competition on returns

- Focus on short-term returns and lack of strategic asset allocation
- "Do your best" is a poor measure of performance

Educated demand

- Lusardi and Mitchel (2014) [next page]

Relative return guarantees

- Additional distortion in the asset allocation: PFMCs adopt capital protection strategies

Financial Education (Lusardi and Mitchel (2014))

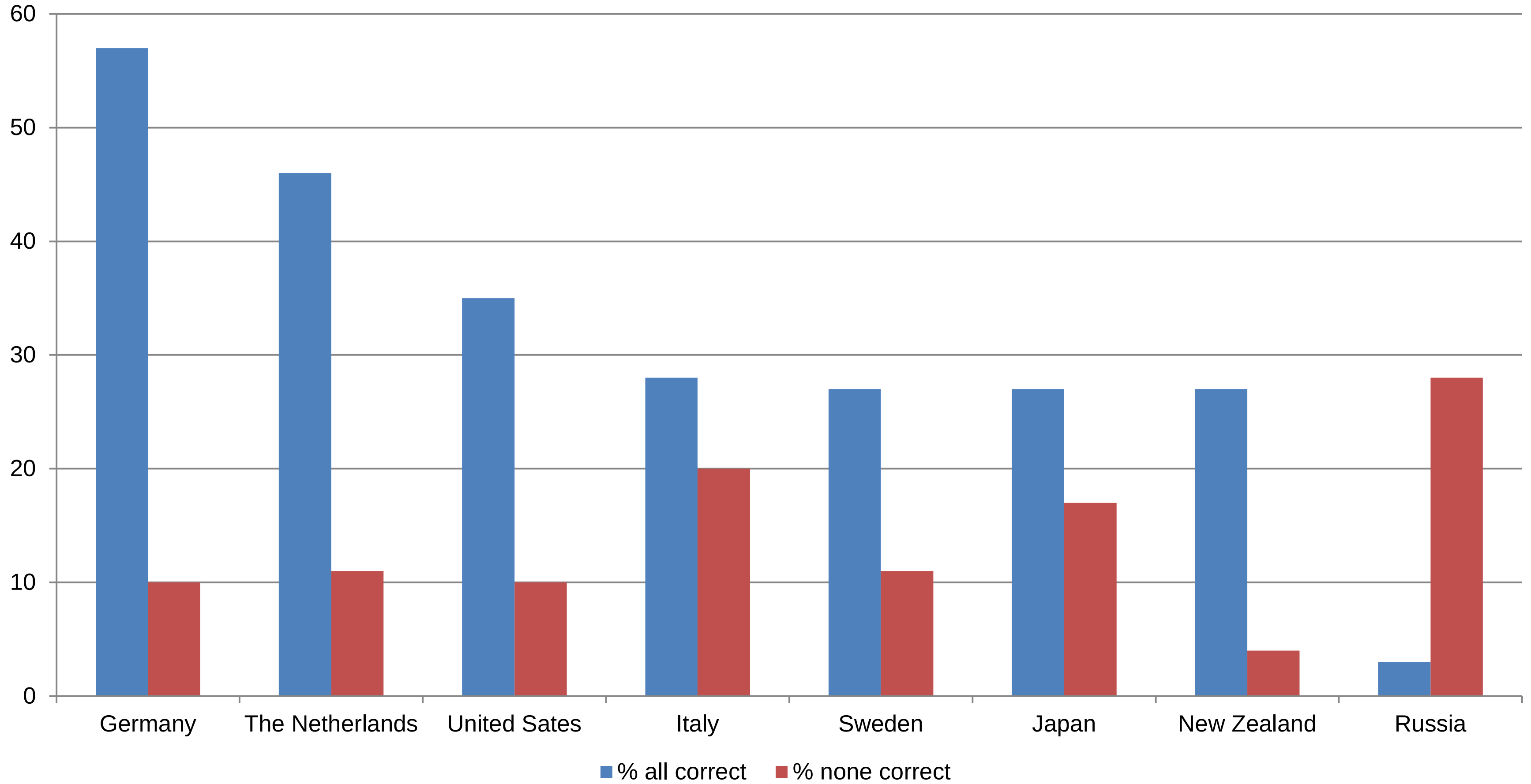
Respondents were asked three financial literacy questions:

(i) If $100 earns 2% per year for 5 years, how much you will have in the account? (more than $102, exactly $102, less then $102), *[compound interest rate]*

(ii) If the interest rate in your savings account is 1% per year, and inflation is 2 percent, in a year, cay you buy more, the same or less in a year? *[inflation]*

(iii) Buying a single company stock usually provide a safer return than the stock of a mutual fund. True or False? *[portfolio diversification]*

Financial Literacy Scores in Selected Countries (Lusardi and Mitchel 2014)



Source: Lusardi and Mitchel (2014)

2. Need to improve incentives' structure of open pension funds…

- Competition among pension fund managers will not result into optimal asset allocation (Basak and Makarov, 2009; Castaneda and Rudolph, 2010)
- It may take decades before financial education achieve minimum standards for the average citizen to take informed decisions
- In the presence of risk aversion, there are better ways of structuring guarantees (5th Contractual Savings Conference)

3. The role of portfolio benchmarks

Performance should be measured in terms of the probability of achieving a certain objective (pension risk), not the short-term returns

- Asset allocation Brazil (DB/DC) [next page]

Benchmark portfolios should serve as a default option for those who feel do not have the capacity to take informed decisions

Benchmark portfolios should be designed to achieve a certain pension objective, given a contribution rate and a level of risk.

- Defining broad asset classes (in multiportfolios) is insufficient
  - » Competition is still on short term
  - » Duration of the fixed income portfolio still focused in the short end od the yield curve

Pension funds are likely to outgrow the market

- Price bubbles
- Duration of the fixed income portfolio & coordination with the government debt management office

Regular performance needs to be measured against the benchmark portfolio

Tracking error or traffic light system

Brazil: Asset Allocation of Pension Funds, 2011

Type of plan	Equities	Bills and Bonds	Cash and Deposits	Other (1)	Memo: Foreign Assets
Brazil:					
Closed Pension Funds	30.7	48.6	9.1	11.5	0.0
Defined benefit	36.4	45.1	6.2	12.2	0.1
Defined contribution	10.7	59.3	22.8	6.7	0.0
Variable contribution	14.5	59.3	15.5	10.5	0.0
Open Pension Funds	3.6	88.9	7.1	0.4	0.0

Source: World Bank

4. Who should decide on portfolios benchmarks?

Pension fund management companies?

- Comparisons among funds become difficult for clients
- Performance measurement turns difficult and only measured at retirement (i.e. Lithuania)

The supervisory agency?

- The supervisor would face a conflict of interest if it defines the pension target and the benchmark

The regulator/government?

- The benchmark should represent the views of an informed demand from contributors
- A high level commission of wise persons can advise the government on the benchmark portfolio
- The definition od the benchmark can be revised periodically

5. Traditional arguments against portfolio benchmarks

a. **Cristal ball fallacy**
   i. While designing benchmarks is not an easy task, it is not impossible either.
   ii. International experience.
   iii. Not deciding on benchmark portfolio will imply lower pensions for individuals
b. **Governments do not want to be responsible for the pensions of individuals in a DC system**
   i. Performance of the pension system will be measured in terms of the capacity to provide adequate pensions (Randle and Rudolph, 2014)
c. **Government become responsible every time there are negative returns or correction in the asset prices**
   i. Proper governance for designing the benchmark is essential for the resilience of the benchmark in episodes of volatility
   ii. The creation of a commission of wise persons with representatives of the educated demand of the country is an important risk mitigation factor.
d. **Since the problem is the herding, it is necessary to expand the investment alternatives**
   i. The problem is not the herding, but the trend
   ii. The use of success fees, incentivize trading, which is expensive and dubiously a way of optimizing long term performance

Thanks!

Heinz P. Rudolph

hrudolph@worldbank.org

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