

# **Developing the National Pensions Reserve Fund**

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I am delighted to have been invited to address this august gathering and to share the context of and structures in place for Ireland's €8 billion National Pensions Reserve Fund. Indeed, this month marks the second anniversary of the Fund's establishment and it is opportune to review progress to date.

The Fund is intended to provide for partial pre-funding of social welfare and public servants' pension requirements from 2025. In discussing the NPRF I often recall the familiar words – familiar to those of my own vintage in any case – of the Beatles: Will you still need me, will you still feed me, when I'm 64! For many of today's 30 year olds, this is more of a 'real-time' question than they think.

Over the next 20 minutes or so I will cover the following aspects of the Fund's development.

**[SLIDE ONE]**

- Background to the Fund
- Key Legislative Provisions
- Investment Strategy / Portfolio Construction
- Selection of Managers and Other Service Providers
- Market Entry Strategy
- Performance
- Where we go from here.

[I will be happy to take questions from the floor?]

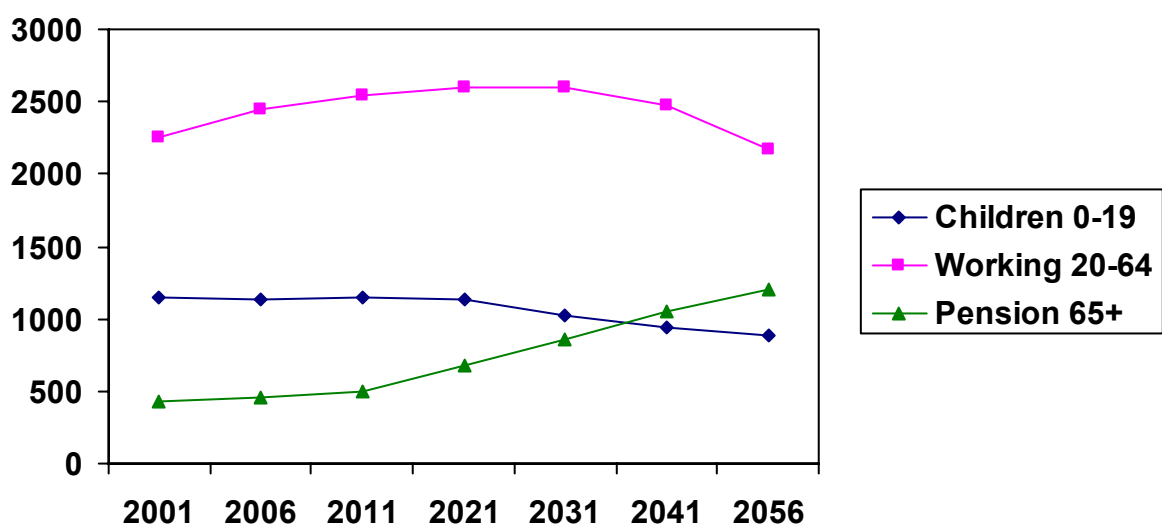
## Background

The National Pensions Reserve Fund provides for partial pre-funding arrangements to meet public service employee and social welfare pension liabilities maturing after 2025.

These now cost the Exchequer around 5% of GNP. To maintain the current level of provision in 2026, the cost is projected to rise to over 8% and by 2056, to around 12.5% of GNP.

In Ireland we are used to thinking of ourselves as a young population. This remains true, relatively speaking but many of the social trends – larger families with more women staying at home combined with emigration - that supported that population structure have changed considerably. A recent study published by the Minister for Social and Family Affairs contained population projections which cogently underline the ageing issue

**[SLIDE TWO]:**



The most striking feature is the large increase in the number of people over pension age – the green line. This is expected to rise steadily to reach 673,000 in 2021 (an increase of 57% over 2001) and then 1,198,000 in 2056 (an increase of 180%). However, in the final years of the projection the rate of increase falls away quickly.

The ratio of people of working age to people over pension age (the pensioner support ratio) falls from 5.3 in 2001 to just 1.8 in 2056. This is dramatic by any standard.

The support ratio is important because, generally benefits for those over pension age need to be financed from contributions from working people, ***unless a significant fund of assets has been built up to help pay for the benefits.***

How countries tackle the problems arising from the ageing of their populations, including the provision of retirement income, is a major issue. A key question is whether or not to fund retirement schemes. The age structure of their population means that for many countries, funding will not be a major part of the solution. They are likely to have to resort to measures such as increasing the retirement age or reducing benefits.

In Ireland the median age is some 10 years lower than the European, meaning we are uniquely positioned to address the funding question through the National Pensions Reserve Fund mechanism.

But even in Ireland's case, given the magnitude of the prospective costs and the many other competing demands on the State's finances, the Government has decided that it would be unrealistic to expect the Exchequer to fully fund the increased costs of ageing in advance. The Department of Finance estimated that about 3.5% of GNP would have to be set aside annually to equalise the Exchequer burden of health and pension costs over the next 50 years. This was deemed by the Government to be simply too much to expect of any generation.

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Accordingly, it was decided to set aside and invest, in addition to the net proceeds of the sale of the state-owned phone company, Telecom Eireann, a sum equivalent to 1% of GNP annually to meet the cost of future pensions. It is estimated that this prefunding arrangement should allow for a cap of around 6.25% of GNP to be placed on net Exchequer outlays on pension over the period from 2025 to 2055 which otherwise, are projected to rise to 12.5% of GNP.

While the establishment of a pensions reserve fund in Ireland is a welcome innovation and has been hailed by the World Bank and the international credit rating agencies, it is not a unique response. There are many similar type funds to be found internationally, for example, the federal and state governments in the US have funding arrangements as have many of the Scandinavian countries. More recently, New Zealand and France announced the establishment of pension reserve funds and I am pleased to say that they have looked to the Irish fund as a model.

## [SLIDE FOUR]

### **Legislation**

The guiding principle behind the NPRF is that it should be managed and operated as closely as possible along private sector, commercial lines, in order to achieve the best return on investment for Ireland's citizens.

In framing the legislation providing for the establishment, management and governance of the Fund, the Minister for Finance directed that it should be modelled as closely as possible on private sector occupational pension fund arrangements – which you will be very familiar with – where a body of independent trustees is responsible for the oversight of the Fund. In that regard there are a number of core principles in the legislation establishing the Fund:

- The Fund is managed by commissioners who are **independent** of Government. They control and manage the Fund with discretionary authority to determine and implement its investment strategy. The legislation specifies that appointees must have acquired substantial experience at senior management level in relevant areas.
- The investment strategy must be based on a **commercial investment mandate** with the objective of securing the optimal return over the long term, subject to prudent risk management. In the parliamentary debate on the legislation, the Minister for Finance expressly acknowledged that, given its large size in comparison to the size of the Irish market, it is inevitable that most of the Fund will be invested abroad.
- There should be no drawings from the Fund prior to **2025**.

- To ensure that the integrity of the Fund cannot be undermined it is expressly **precluded from investing in Irish government bonds**.
- There should be full **transparency and accountability** by requiring the Commission to publish annual accounts and an annual report containing the following information:
  - the investment strategy
  - the investment performance
  - A valuation of the net assets and a detailed list of the assets at the year end
  - the investment management and custodianship arrangements
  - fees, commission and other expenses incurred by the Commission and by the Manager.

In addition, the Chairman of the Commission and the chief executive of the National Treasury Management Agency, - which has been appointed Manager of the Fund for an initial period of 10 years - are required to appear before and give evidence to the Dail Committee of Public Accounts.

In sum, the legislation vests the control and management of the Fund in the National Pensions Reserve Fund Commission. The Commission manages the Fund through the National Treasury Management Agency (NTMA) and may also delegate to the NTMA any of its functions, as it considers appropriate. In that regard, subject to the direction of the Commission, the NTMA itself may manage the assets of the Fund or outsource all or part of the management to external institutional investment managers.

The Commission has decided that, apart from cash and certain fixed interest securities, the management of the assets should be outsourced to specialist investment management institutions.

### **Investment Strategy**

The legislation specifies the following investment policy for the Fund.

#### **[SLIDE FIVE]**

19. (1) ‘Moneys standing to the credit of the Fund shall, from time to time, be held or invested for the benefit of the Fund by the Commission, in or outside the State, so as to secure the optimal total financial return, as to both capital and income, having regard –

- (a) the purpose of the Fund as set out in section 18(1), and
- (b) the payment requirements of the Fund as provided for under section 20, provided the level of risk to the moneys held or invested is acceptable to the Commission.’

The objective of the Fund is to achieve an optimal total financial return, taking due account of the level of both investment risk and the level of risk relative to the liabilities.

The Commission retained a firm of international investment consultants to advise it on the formulation of an appropriate long term strategic benchmark.

Using efficient frontier modelling, the consultants’ advice took as their starting point a least risk portfolio. Having established the least risk

strategy they then considered ways to enhance the return. By definition this involves moving away from the least risk position.

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The Commissioners considered the advice of the consultants at a two day off-site meeting in June 2001 where we were presented with a menu of many different possible efficient portfolios with different risk / reward trade-offs ranging from 70% equities to 100% equities and with various Euro / Non Euro mixes.

The most attractive long-term portfolio in terms of risk / reward tradeoffs was deemed to be the portfolio with an 80/20 equity bond split with a 50/50 split between Euro and Non Euro equities.

In addition, the chosen portfolio has 50% of its non-Euro exposure hedged. This forms the basis for the subsequent decisions regarding portfolio construction.

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With the exception of an overweight position in the Eurozone equity market, the decision was taken to allow market weights to drive the allocation between countries.

We further refined the mandate profiles as follows

**[SLIDE]:**

Asset Class	Investment Style	Alpha %	Tracking Error %
Eurozone Equity X2	Passive	0	<b>0.10</b>
Pan-European Equity X3	Active – Core	0.75	<b>5.00</b>
US Equity	Passive	0	<b>0.10</b>
US Equity	Enhanced	0.25	<b>1.50</b>
US Equity X2 (Value & Growth)	Active	0.90	<b>6.00</b>
Japanese Equity X2	Active	1.00	<b>6.00</b>
Pacific Basin Equity	Active	1.00	<b>6.00</b>
Global Equity X2	Active – Core	0.90	<b>6.00</b>
Long Euro Bonds	Passive	0	<b>0.05</b>
<b>Long Euro Bonds</b>	<b>Active</b>	<b>0.30</b>	<b>2.00</b>

There has been a lot of debate around the Fund’s apparently heavy weighting in equities, no doubt driven by the markets’ poor performance over the last three years or so. The following points are important:

- To date, the Fund has received only about 10% of its projected total income to 2024
- The Commission has pursued an averaging in market entry strategy with the result that the Fund so far is well below its 80% target weighting in equities thus avoiding the worst impact of the bear market. I will return to this point. And
- A simulation exercise completed by the NTMA estimates that equities being purchased now by the Fund will not have to be liquidated until around 2035. For equities to underperform bonds on a 30 year view, it would be necessary to hypothesise a scenario where, over that time period, the return on invested equity capital

did not exceed its cost. Should such a scenario come to pass, it is highly likely that the fundamental capitalist model would have failed. While this may be regarded as remotely possible, the Commission does not believe that it would be sensible to plan for it – we hope that future generations will not judge us too harshly if we failed to predict the death of capitalism!

**[SLIDE]**

**Now let me turn to the question of Manager / Other Service Provider Selection**

A global search for managers to run the mandates decided by the Commission was carried out on its behalf by the NTMA. This was conducted under the restricted tendering procedures provided for in EU public procurement rules. This is a two stage process in which a notice inviting providers to submit requests to participate is published; then a limited number of those applicants are invited to proceed to tender.

The relevant EU Directive is unbelievably detailed and dictates exactly how the competition should be conducted. While it might seem unduly onerous, it results in a process that is transparent, fair and above reproach.

We realised early on that, as we were inviting expressions of interest from literally the whole world, we were likely to get an unprecedented number of responses. Therefore, we felt strongly that it would be necessary to utilise technology – and more specifically a web based platform - through which managers could express interest and simultaneously provide quantitative information with which to objectively and mechanistically evaluate them.

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This evaluation resulted in a much smaller number - between five and 20 managers per mandate - being invited to go on to Stage 2. The

mechanistic evaluation was based on a pre-agreed scoresheet that was signed off on before any expressions of interest were evaluated.

The Commission was looking for managers with an externally verified high Information Ratio, (compliant with the Global Investment Performance Standards) indicating that they are able to generate more value-added (alpha) for each unit of active risk or tracking error. We were looking for managers with a clearly articulated investment process which can be expected consistently to deliver alpha within clearly defined performance targets and risk parameters. They were also required to have stable and properly incentivised investment teams, sound IT systems and databases and a clear sense of corporate governance.

An active investment manager's demonstrated ability to operate within prescribed risk parameters was essential if there were to be effective management and control of the Fund's active risk across the different asset classes and at the total Fund level through the formalised risk budgeting process. 574 expressions of interest were received under Stage 1 in relation to the manager mandates.

	Stage 1	Stage 2
<b>Active</b>		
Pacific Basin (ex Japan)	50	20
Japan	59	20
US Core	28	0
US Value	62	20
US Growth	79	20
Pan European	90	20
Global Equity	85	20
<b>Passive</b>		
US	15	13
US Enhanced	37	20
Eurozone	12	5
<b>Bonds</b>	57	20
<i>Total</i>	574	178

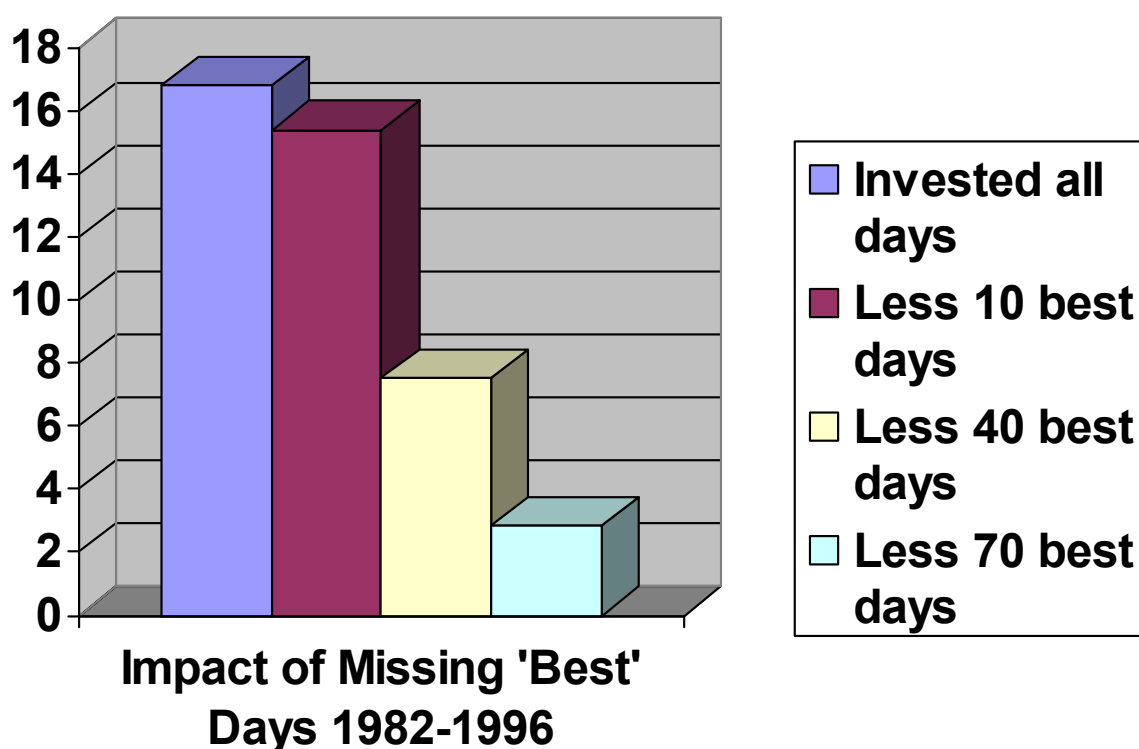
The expressions of interest were opened on 13 August 2001. Work on checking and clearing the data was completed with advisors, the Frank Russell Company, and we were able to notify unsuccessful and successful companies within a month. RFPs from the 178 successful companies were to be completed and returned to the NTMA by 22<sup>nd</sup> October 2001. Subsequently, some 50 managers were interviewed in detail and 14 successful candidates were appointed on a phased basis over the period

December 2001 to early March 2002. In addition to the managers the Commission also appointed a global custodian and a transition manager.

### **The next issue we had to deal with was the Market Entry Strategy**

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As this chart shows, market timing can be problematic :



*Source: Goldman Sachs – being redrawn.*

The conclusion to be drawn is that in trying to avoid the ‘worst’ days to invest, you may indeed miss the ‘best’ days, which could reduce the portfolio’s return!

Having decided on the long term strategic asset allocation at its two day meeting in June 2001 the Commission considered at some length whether

it should then immediately access the markets using financial futures or wait until the managers were appointed. At that time markets – as represented by the Standard & Poor’s 500 Index – had already fallen by some 17% from their high 15 months earlier. Indeed the whole question of the Fund’s market entry strategy had been the subject of a robust debate as represented by two articles containing opposing views published in the Spring 2001 edition of the Irish Banking Review.

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On the one hand, the NTMA wrote **“Fully investing the Fund on its establishment would intuitively expose it to unacceptable market risk. An averaging-in approach clearly reduces the Fund’s market risk by spreading risk over time.”**

The contrary view was expressed by a consultant in paper commissioned by the Irish Association of Pension Funds:

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**“An immediate question facing the Commission concerns the entry strategy for the Fund into the market.... Should the Commission invest immediately in the markets, average the money in over a period of a year or so, or use some other method to keep the rewards but mitigate the risk? The problem is capable of mathematical formulation and resolution. There is only one correct answer: close your eyes and take the plunge.”**

A survey of Wall Street strategists' views on the stock market's prospects for 2002 published by Barron's, the respected financial journal, towards the end of 2001 indicated that on average they expected the market to rise by 13%. Of the 11 strategists interviewed only one forecast a decline!

Happily, the Commission decided to delay the Fund's market entry until the managers were appointed and then to accept the NTMA's advice to average in over time. The Fund commenced its averaging-in programme in mid-January 2002; over the course of the year it held an average cash balance of around one-third of the Fund's value, ending the year with almost 25% in cash, mitigating – as I said earlier – the worst effects of the bear market on the Fund.

**[SLIDE]**

I think in retrospect we can say we followed the rules for an encounter with a real live bear: ‘Do not run or cry out. Stay calm, retreat slowly and avoid eye contact’.

**Now I would like to move on to deal with the Performance of the fund.**

Since its launch in April 2001 the Fund has performed relatively well- compared with the average Irish managed pension fund and the Fund’s own long-term strategic benchmark, reflecting the benefits of the averaging in strategy.

**[SLIDE]**

	NPRF	Average Irish Managed Pension Fund	NPRF’s long term strategic benchmark
April – December 2001	3.27%	-0.6%	<b>-3.52%</b>
Year to 31 December 2002 <i>(estimated)</i>	-15.95%	-18.9%	<b>-21.6%</b>
<b>Inception to 31 December 2002 <i>(estimates)</i></b>	<b>-13.2%</b>	<b>-19.3%</b>	<b>-24.4%</b>

This performance was turned in against a virtually unprecedented three successive year decline in global equity markets. The compound return in the FTSE All World Developed Index over the last three years has been -42.5% which according to the Financial Times was the worst three year performance since 1929-31.

Year	Return
2000	<b>-5.34%</b>
2001	<b>-11.49%</b>
<b>2002</b>	<b>-31.49%</b>

Year-to-date the Index is showing a return of minus 2%, having hit a low point of minus 14.3% on 12 March 2003. The long-term nature of the Fund positions it well to cope with the bouts of equity market weakness which it will undoubtedly experience over its lifetime. The Commission is confident that over that period the long-term strategic weighting of 80% in equities will deliver the optimal return. As I said earlier, over the type of long-term horizon which the Fund is operating to, equities must outperform bonds because investors must be rewarded for buying riskier assets. If they are not rewarded the system collapses, because there is no adequate reward for risk-taking.

**[SLIDE]**

### **Where we go from here**

This month represents the second anniversary of the launch of the Fund. To date, the Commission and its Manager, the NTMA, have concentrated on putting in place the mainstream investment mandates, risk and performance measurement systems and other ancillary supports as well as coping with the extremely problematic issue of market entry timing.

More recently, we have been looking at the question of additional asset classes and have decided in principle to invest in small cap equities, corporate bonds, public private partnerships and property. Work is currently underway on devising appropriate business entry strategies for the asset classes. Other categories of investment which we would regard as part of the Fund's investment universe include absolute return funds and I expect we will start looking shortly at how the Fund might access these.

In planning for the Fund it is essential that it should be looked at from a long term perspective. Short termism which focuses excessively on performance or on flavour-of-the-month asset classes will undermine the successful management of the Fund. I am confident that the long term strategic perspective adopted by the Commission with its emphasis on investing in equities, combined with proper risk management systems, clear strategic asset allocation and manager selection processes, as well as sensible monitoring and review arrangements will ensure that the Fund will meet its important investment policy objective – and its ultimate goal in easing the burden of and helping to enable proper provision for the 1.2 million pensioners-in-waiting who will benefit from the Fund up to 2056.

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