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European Pension Solutions

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The five most common misperceptions:

1. DC schemes generate lower pensions than DB schemes
2. Individuals in DC schemes take poor investment decisions
3. Management fees in DC schemes are too high
4. Collectivity is lost in DC schemes
5. Participants in DC schemes run large interest rate risks

My goal today is to clear up these five misperceptions

Myth 1: DC schemes generate low pensions

How do people get this idea?

In countries with DC schemes:

- Pension coverage is lower
- Contribution levels are about half as high
- Particpants can take their money out before retirement

Solution: Auto-enrolment with sufficiently high contribution levels

Investment returns have been low over the past 10 years

- Lower returns immediately seen on DC accounts
- DB schemes have their solvency problems after a decade of low returns

Conclusion: All capital funded systems have suffered from low returns

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average
Equity	-31.7	11.3	6.9	26.8	7.9	-1.2	-37.2	26.7	20.1	-1.8	2.8
Bonds	9.9	4.0	7.7	5.3	-0.3	1.8	9.4	4.3	1.2	1.8	4.5

Source: Robeco; Poiesz and Swinkels (2012)

Myth 2: Individuals take poor investment decisions

- Participants are financially illiterate and make poor decisions (and are aware!)
  - Too little or naive diversification
  - Fully invested in cash; scared of investing in risky assets

Solution: With smart life cycle default options these problems mitigated

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Av
< 25 years	-16.4	12.9	11.2	29.2	13.7	5.0	-37.7	34.2	15.7	-6.0	
25-34 yrs	-14.5	13.0	11.1	28.1	13.3	5.2	-36.0	32.6	15.1	-5.4	
35-44 yrs	-10.7	12.9	10.9	25.9	12.4	5.6	-32.5	29.4	13.7	-4.3	
45-49 yrs	-7.7	11.3	10.2	22.2	11.0	4.6	-28.1	24.1	12.3	-2.7	
50-54 yrs	-4.7	9.7	9.5	18.6	9.6	3.6	-23.5	19.0	10.8	-1.0	
55-56 yrs	-2.7	7.7	7.9	15.8	7.0	4.2	-16.1	12.3	8.2	0.6	
57-58 yrs	-1.5	5.2	6.2	12.2	4.4	2.9	-11.7	9.3	7.8	2.0	
59-60 yrs	-0.1	4.2	5.6	10.0	3.2	2.4	-5.8	4.6	5.7	3.0	
61-62 yrs	0.3	3.5	4.5	8.3	2.0	2.3	-3.9	5.0	5.6	3.1	
63-64 yrs	2.5	3.6	4.4	6.8	1.8	2.5	-1.1	3.5	4.5	3.4	

Source: Robeco; Poiesz and Swinkels (2012)

- Invest only in equity of employer company

Solution: Forbid by law (otherwise employers may force them in)

Myth 3: Management fees are too high for DC

Historically, DC pension providers have delivered “free” bundled services for small pension contracts, which were paid for by asset management fees.

- Consultant survey* shows asset management fees of DC in the Netherlands PPI are 0.4%, while two largest DB pension schemes (EUR 100+ bn) report 0.5%.

What determines fee levels for asset managers?

- Product complexity
- Size of the mandate
- Added value of portfolio management

So: For the pricing of asset management services it is irrelevant which pension institution or which type of pension scheme!!!

* Source: Lane, Clark, Peacock Netherlands: “Terzake(n) 2011”

Myth 4: Collectivity is lost in DC schemes

- Individuals have little bargaining power with large financial institutions and hence individual schemes will be more costly

Solution: Consumers unite through employer (or "Groupon" effects)

- No disability or widow-pension insurance possible in DC schemes

Solution: Pension providers can include this through insurance comps

What is **not a myth** and in my view the only reason DB schemes exist is that intergenerational risk sharing is lost in individual DC schemes

- Pro: On average higher expected investment return because more risk can be taken
- Con: Endless discussions about property rights of collective savings

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Myth 5: Participants run large interest rate risks

- Participants in some countries are expected or obliged to purchase annuities. Annuities are expensive in a low interest rates environment

Solution: The safe asset is 15-year government bonds and not cash

Without interest rate hedge	< 25 years	25-34 yrs	35-44 yrs	45-49 yrs	50-54 yrs	55-56 yrs	57-58 yrs	59-60 yrs	61-62 yrs	63-64 yrs
Average return (% p.a.)	4.0	4.2	4.7	4.6	4.4	4.1	3.5	3.2	3.0	3.2
Volatility (% p.a.)	13.1	12.3	10.8	9.1	7.4	5.4	4.3	3.2	2.8	2.3
Lower bound (2.5%)	-34.8	-33.4	-30.5	-26.5	-22.4	-16.2	-12.3	-7.3	-5.4	-3.0
Upper bounds (97.5%)	35.0	33.4	30.1	25.3	20.5	16.5	13.4	10.4	10.0	8.0
With interest rate hedge	**< 25 years**	**25-34 yrs**	**35-44 yrs**	**45-49 yrs**	**50-54 yrs**	**55-56 yrs**	**57-58 yrs**	**59-60 yrs**	**61-62 yrs**	**63-64 yrs**
Average return (% p.a.)	4.0	4.2	4.7	6.3	7.8	9.0	9.9	8.8	7.8	7.2
Volatility (% p.a.)	13.1	12.3	10.8	8.6	7.4	7.7	9.5	8.7	7.6	6.6
Lower bound (2.5%)	-34.8	-33.4	-30.5	-23.5	-15.0	-4.6	-4.8	-4.5	-4.1	-3.0
Upper bounds (97.5%)	35.0	33.4	30.1	27.2	27.3	28.7	30.6	25.8	22.2	18.8

Source: Robeco; Poiesz and Swinkels (2012)

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