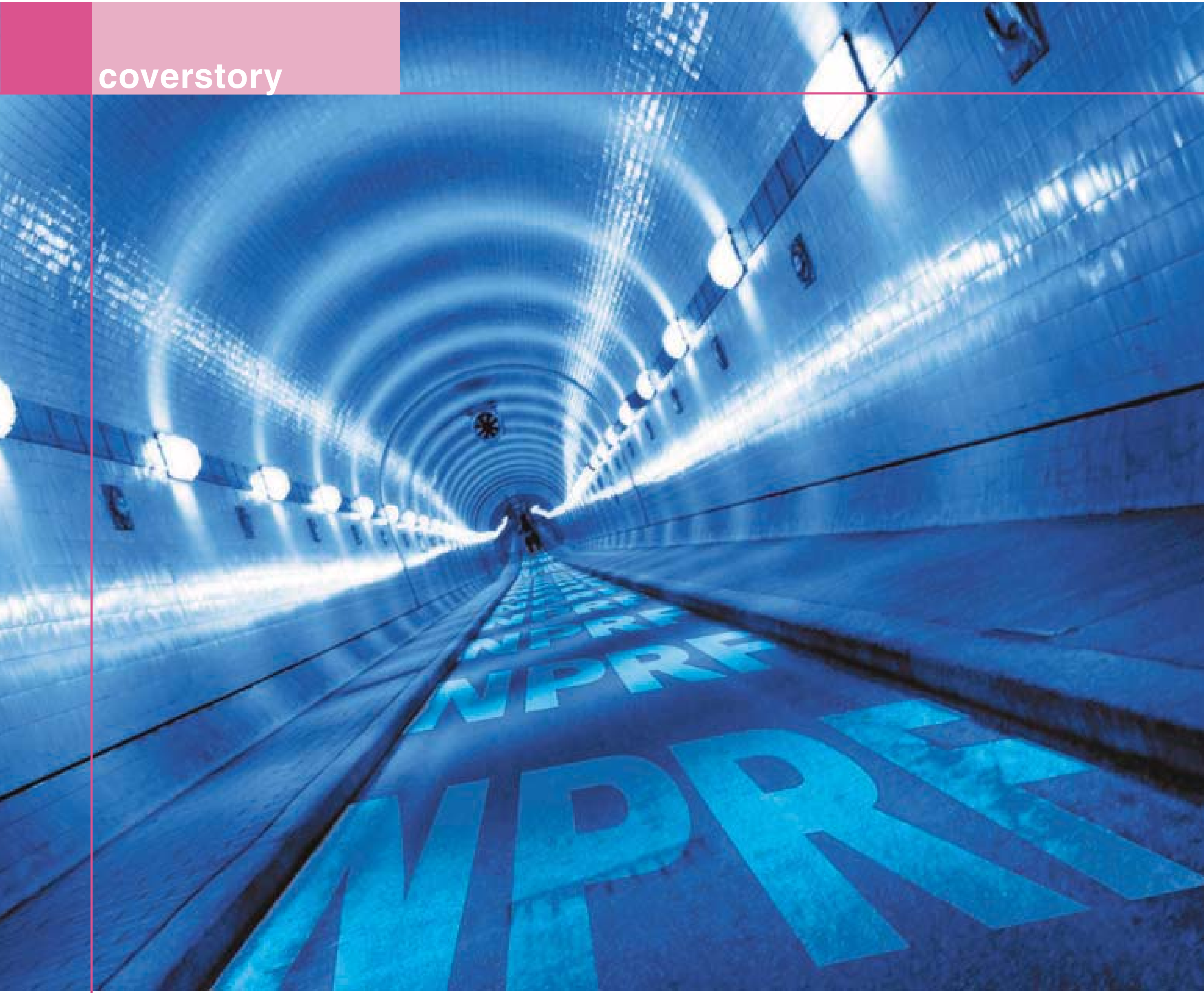

2025

NATIONAL PENSION RESERVE FUND STILL ON TRACK

Convincing people to save for their old age is no small feat, as anyone in the pensions industry – from the PRSA salesman to the Minister for Social Affairs can attest.

Everyone knows they will grow old someday; ask people on the street when they would like to retire and the magic age of 55 is inevitably quoted. But finding that sure-fire formula that links the recognition for the need to save with the actual commitment to divert income into a pension account, is the real challenge.

The Minister for Finance in 2000, Charlie McCreevy, was nothing if not a practical man, and he recognised this shortcoming in human nature. He set up the National Pension Reserve Fund.

The simple fact, said McCreevy, was that from 2000 to 2050 the cost of funding social welfare and state employees pensions would rise from 4.7% to 12.4% of Gross Domestic Product. There simply would not be enough young workers to fund the cost of older ones retiring based on the current pay-as-you-go funding method.

NOT ORIGINAL

It wasn't an original idea – other countries decided to fund their future pension obligations with real money too – but his solution was a bit of lateral thinking, Irish-style.

Not only would the privatisation proceeds of Telecom Eireann kick-start the new Fund, said Minister McCreevy, but he would legislate to pay the equivalent of 1% of GNP into the fund until 2025 and ring-fence it so that future Ministers for Finance couldn't plunder it if economic times ever got a little tight again.

It was either that, said the Minister-cum-accountant, who had a genuine interest in pension provision - it was on his watch that compulsory annuity purchase for the self-employed, company directors, AVC and PRSA holders was dropped and Approved Retirement Funds introduced - or we had to accept that taxes would soar. If the NPRF was in place, he said, there would be money to meet a portion of the nation's funding obligations from 2025.

Six years later and the initial cash injection of c€6.5 billion – the Telecom Eireann proceeds and 1% of GNP – has turned into over €17.61 billion at the end of the third quarter of 2006 with a third quarter return of 6.9%. (It was worth €15.4 billion at the end of 2005). The target for the fund by 2025 is €140 billion.

Quite a lot has changed since the Fund was first launched – not just the state of the country's finances, which have clearly improved - but the size of the population.

Has the funding crisis eased at all, *Irish Pensions* recently asked the NPRF Commission Director John Corrigan and Dr Michael Somers, the Chief Executive of the National Treasury Management Agency and NPRF ex-officio director?

The peak crisis date, "is 2047 we are told, but it could be anytime after 2040," explained Mr Corrigan. 'The dependency ratios of 5:1, of workers to retirees based on retirement by age 65, falls to 2:1 by that date and all the most recent reports broadly agree that that is how the situation will dis-improve."

"No one expected that we would have

Pictured are (l-r) Michael Sommers, Chief Executive National Treasury Management Agency, Paul Carty, Chairman National Pensions Reserve Fund and John Corrigan, Director National Pensions Reserve Fund

400,000 emigrants living here by now," adds Dr Somers, "but who knows whether they will all stay or go home. Or how many children they will have. It is believed however that the dependency ratio would change only very slowly due to population change. If the retirement age was raised that would have a very different outcome."

Demographics is not a prime concern of the NPRF. "Our brief is to be the investment manager, says Mr Corrigan. "We take the figures as we get them and if that profile has changed – well, we work to maximise the value of this fund, regardless of what the liabilities are." Dr Somers: "If the government wants to jack up contributions to meet higher liabilities, that's fine. If they want to lower them, we will work within those specifications. That's a political decision."

As it is, the NPRF will only make about a c25% contribution to the cost of existing old age pensions and towards part of the cost of public sector pensions, "which are unfunded", says Dr Somers.

NO CRYSTAL BALLS

There are no crystal balls on display at the NPRF offices in the Treasury Building on Grand Canal Street with their fine views of the city. It is in this building that the country's national debt is also managed. The directors say their job is to steer the now €17.6 billion plus fund through the most prudent investment waters possible towards achieving that target. It certainly explains why they have only recently begun investing in property and private equity funds and why they have so far avoided the expensive – and higher risk - hedge fund markets.

"We may have a longer horizon with nothing coming out until 2025 compared to other pension funds, but we do produce figures every quarter and we are compared with everyone else. But what is useful is that we don't have to be so concerned about liquidity," says Dr Somers.

John Corrigan: "The key issue is the investment horizon. In personal savings terms this scheme is more like a defined contribution scheme than a defined benefit one in that the objective is wealth maximisation; that is what the Commission has identified as its goal. It also informs the investment strategy".

Critics argue that the Fund's strategy is too conservative. Is it? And would reducing the National Debt with all this money not have yielded even better returns?

"It is untrue that we have not outperformed the market," says Mr Corrigan. "We don't compare ourselves against the average Irish pension fund, but in fact, since our inception in April 2001, the average Irish pension fund has achieved a return of 4.7% and the NPRF has achieved a return of 5.9%."

"If we'd betted on horses perhaps we'd have

> **The idea that equities will generate huge rates of growth, year in year out – and we have a very long horizon - is kind of nuts**

BRIEF WIDENED

The Fund's brief has been widened this past year with €241m in the third quarter committed to five property investment funds and €16m to one private equity investment deal. It now has an 8% allocation target to both property and private equity to be achieve by the end of 2009.

The directors accept that the National Pension Reserve Fund might be a victim of the outperformance syndrome – the idea that ordinary investors and some trustees may have that the huge returns from global property and equity markets should be achieved by this megaw pension fund as well.

Dr Somers: "I don't know where people actually think wealth comes from. The world is not generating the kind of wealth that some have come to expect. This notion perhaps comes from the success of the Irish property market and the strength of the ISEQ.

exceed these returns," says Dr Somers with a laugh. "Or, imagine the headlines there would be if we were wildly speculating on property. I think we've done the right thing by not buying into hedge funds, despite the efforts to try and get us to do so.

"The first point that needs to be made is that no other government expenditure has been curtailed by the investment that has gone into this fund. This money does not count as expenditure under the Maastricht Treaty. The only way it would is if we went out and bought an actual office block. Otherwise it is not counted at all.

"The alternative use for the contribution would be to reduce the size of the national debt. The National Reserve Pension Fund, since it was set up, has produced profits of marginally €5 billion. The pure profit of the fund is €2.7 billion – pure, clean profit that otherwise would not be there if the contributions had been used to pay down the national debt."

As for whether the Fund has performed as well as it should, John Corrigan replies: "You can always find an index that will outperform you, but we have our own benchmark that is designed to deliver this measure of wealth maximisation. It essentially is a mixture of equity and bond indices weighted for the strategic asset allocation set out in the annual report. And that would have roughly been 80% equities, 20% bonds. We are moving towards 87% equities and 13% bonds by the year 2009 more linked to real returns rather than bond returns.

"If we had been 100% invested in Irish equities we would certainly have performed better, but it would also have resulted in the re-nationalisation of several companies and the stock specific risk would have been huge."

WHO MAKES UP THE NPRF?

The National Pension Reserve Fund is controlled and managed by the National Pensions Reserve Fund Commission. The Commission's functions include the determination of the Fund's investment strategy in accordance with the Fund's statutory investment mandate. This mandate requires that the Fund operates on a commercial basis so as to secure the best possible financial return subject to prudent risk management.

The National Treasury Management Agency (NTMA) has been appointed Manager of the Fund for an initial period of 10 years and the Commission performs its functions through the NTMA whose Chief Executive is Dr Michael Somers. The Commission, which is made up of six members, including its Chairman, Mr Paul Carty and Dr Somers (as ex-officio member) formally meets four or five times a year. Investment subcommittees with responsibility for separate asset classes – such as equities and bonds, property or private equity will meet more regularly to discuss and review their sectors. It is upon the recommendation of these committees that fund manager mandates may be changed.

The €17.6 billion is currently invested with the following investment managers:

- Acadian Asset Management Inc.
- AXA Rosenberg Investment Management Limited*
- Barclays Global Investors Limited
- Bank of Ireland Asset Management Limited / State Street Global Advisors (UK) Limited
- Capital International Limited
- Daiwa SB Investments (UK) Limited
- Deutsche Asset Management International GmbH**
- Goldman Sachs Asset Management International
- Invesco Institutional (N.A.) Inc.
- Irish Life Investment Managers Limited
- JPMorgan Asset Management (UK) Limited
- Lord, Abbett & Co
- Oechsle International Advisors LLC
- Putnam Investments Limited
- RCM (UK) Limited
- Schroder Investment Management (Singapore) Limited
- UBS A.G.

"The idea that equities will generate huge rates of growth, year in year out – and we have a very long horizon - is kind of nuts. Last year we almost made 20% from the fund, this year perhaps it will be 9%. (This generates a guffaw from John Corrigan, who says he doesn't "necessarily share the very optimistic view of some of my colleagues").

"The one thing you can expect from forecasting returns is that you will probably be wrong," admits Dr Somers. "It doesn't take much to turn the tables – even something like the comments of the US Federal Reserve Chairman can affect returns."

"Clearly the old age pension, which only pays about 30% of the national industrial wage is not sufficient for people to live on in any great comfort."

At the NPRF, calling someone 'prudent' or 'conservative' is not deemed as an insult. The goal is nominal c8% returns from equities, "and realistically, 4%-5% from bonds which translates into an equity risk premium of 3%," says Mr Corrigan.

"The main determinant of your investment return is your strategic asset allocation and if you get that wrong you're goosed. You can have the greatest asset managers in the world that can add 20% to your fund in any given year, but you better not have the wrong asset mix in the long term. That 3% conservative risk premium is what drives this fund's asset allocation."

Dr. Somers: "You can fool yourself into thinking you are going to get these mega-returns, but it doesn't work that way. We have trawled the world looking to get the best fund managers that there are. They are, for the most part, very good, but not everyone can outperform all the time."

The Commission keeps a close eye on emerging markets and investment opportunities in places like the Far East, in whose favour the global economic tide is turning. The Fund's exposure is still quite small, says Mr Corrigan. China may be the emerging giant, he says, but for the moment, a great deal of its continuing success depends on the spending power of the United States consumer, who is feeling the credit pinch.

A delegation of Chinese department of finance officials has even been to visit the NPRF. "They were particularly interested in our scheme", says Dr Somers, as they too are coming to grips with the long term retirement needs of their massive population.

"They were particularly interested in the fact that many other funds that have been set up by other countries have very short term horizons," says Mr Corrigan. "Other schemes are also more open to political interference about how they allocated their assets than ours. The French fund, which followed ours, does not guarantee the annual contribution. The New Zealanders set one up that is quite similar to ours and the Canadian one is funded directly by the citizen, and not for them by the state. We've been a great nation of knockers about not getting things right, but I think we've got this one reasonably right so far."

With the NPRF now firmly in place – and compulsory contributions in the form of the 1% GNP injected into the wide selection of investment funds for the long term good of the people of Ireland – do the Commission directors think that mandatory private pension contributions should also be introduced?

"That is a political decision," says Dr Somers. "But clearly the old age pension, which only pays about 30% of the national industrial wage is not sufficient for people to live on in any great comfort. This Fund is in place to help maintain at least that level of payment by 2025 and thereafter.

"As for our involvement, the idea has been raised that we would manage any fund if they did decide to do so and that we would tack it onto the present pension fund. As for collecting the contributions, I think we would run a mile from that. We're not retailers. There are all sorts of ways that it could be collected – including, via the social insurance payment route."

Mr Corrigan adds: "As fund managers, the question is, could we deliver a cost effective solution? The fully weighted cost, all overheads, on managing this fund is about 22 basis points. Now that is a very cost effective arrangement. But it would have to be loaded up with distribution costs so that could be delivered to the consumer, but it's a very good starting point."

NPRF's RECENT PERFORMANCE

The Fund grew by €3.7 billion from €11.7 billion at end 2004 to €15.4 billion at end 2005. It earned a return of €2,410 million or 19.6 % in 2005 reflecting its heavy concentration in equities and the strong growth in world equity markets.

The Fund currently holds shares in about 1,800 quoted companies worldwide.

The Fund's end-year value was equivalent to 11.4 % of GNP. In February 2005, the Fund announced a significant diversification of its strategic asset allocation, primarily through an 18 % allocation to alternative asset classes - property, private equity and commodities - to be achieved on a phased basis by end 2009. By the end of 2005 €629 million was invested in global equity markets. Of this, €188 million was invested in small cap equities and €291 million in emerging markets equities and €170 million was invested in commodities.

By the end of 2005, a total of €404 million had been committed to international property funds and €181 million to international private equity funds. Moneys committed to these funds will be drawn down as suitable investment opportunities arise.

TABLE: EUROPEAN PENSION EXPENDITURE PROJECTIONS - % GDP

	2000	2030	2050
IRELAND	4.6	7.6	9
ENGLAND	5.1	4.7	3.9
FRANCE	12.1	16	15.8
ITALY	14.2	15.9	13.9
GERMANY	10.3	13.2	14.6
SPAIN	9.4	12.9	17.7
PORTUGAL	9.8	16	14.2

Source: European Commission

HAS THE NPRF BEEN 'ETHICAL' ENOUGH?

Has the National Pension Reserve Fund taken an ethical enough investment position? Not according to the Green Party, or other Dail representatives who have grilled the Commission's Dr Somers during Oireachtas hearings into the performance of the Fund.

In a statement last Autumn the Green Party spokesman on Finance, Social & Family Affairs, Community, Rural Development, The Islands Dan Boyle TD said that they are "seeking cross party support to bring an end to unethical investments by the National Pensions Reserve Fund (NPRF). In June it published a Bill that would see an end to Irish money being invested in unethical industries including weapons, tobacco manufacturers and companies profiting from the conflict in Sudan."

He said that as much as €30 million is invested in Sudan by the Fund. "It is a tragic farce that the Government supports overseas aid projects while at the same time invests millions of euros in businesses profiting from the conflicts that bring about the need for aid in the first place."

This is sensitive subject for the NPRF directors who remind *Irish Pensions* of their statutory responsibility to maximize profits and to operate strictly to commercial criteria.

"We get beaten up about this every time we meet the Dail Committee," says Dr Somers wearily. "We do not choose the individual companies the fund invests in, the Fund managers do that. We do not go out of our way to invest in tobacco or armaments. Often the tobacco manufacturer is just an arm of a larger conglomerate. It should be said too that this State is happy to collect vast amount of tax from tobacco sales – well over a billion euro last time I checked."

As for investing in the armaments industry, Dr Somers recounts how the Norwegians "don't invest in Boeing because they manufacture fighter jets, but Boeing also make very fine aircraft that one of the biggest companies in this state – Ryanair – buys. I might add that we do have an army in this country, and we do buy armaments including– guns and bullets."

If the Irish legislature passes a law banning any such investments, the NPRF will see it is enforced with their fund managers, he says.

- Jill Kerby