

# Consequences of Excessive Prudence on Investment Strategies

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## Who is this most relevant to

	Very Relevant	Somewhat Relevant	Not Very Relevant
Large DB Schemes	x		
Small DB Schemes	x		
Large DC Schemes		x	
Small DC schemes		x	

## Background

The Pensions Authority is a statutory body set up under the Pensions Act, 1990. The Pensions Authority's mission is to support a sustainable pensions system that will provide adequate and reliable pensions and that achieves wide coverage.

But does the Authority's current guidelines support a sustainable pensions system or are they resulting in unintended investment risks and the premature windup of otherwise viable pension schemes?

While accepting that Irish schemes have had a historical mismatch between their assets and liabilities, is now the right time to close this gap and are the Pensions Authority the right people to make this decision?

## Issues to consider

### “Reckless Prudence”

The current guidelines forces pension schemes to buy assets (i.e. bonds) at record high prices. This simplistic approach fails to take in to account the risk of absolute negative returns generated by bonds or issuer risk or inflation risk.

## What about the power of diversification

Currently risk reserve only takes into bond type Investments. This may discourage trustees from looking at other alternative assets which might be higher yielding, offer more capital protection and protect against inflation. Should trustee's investment decision be reduced to a binary decision between bonds and equities? By investing in nominal bonds, it reduces the chances of being able to provide pension increases going forward, if inflation increases by 2% a year over the next 20 years this would result in a 50% cut to real pension income!

## What will the future hold? & who will be left holding the baby?

This narrowed investment focus could lead to more schemes closing down while others may make significant cuts to their benefits?

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In some cases, where schemes are in a Funding Plan, they may have to target a higher return to keep it on track which may require it to adopt a more risky strategy than is otherwise would.

If more schemes are forced to close prematurely who will pick up these unfunded pensioners in the future, the government and worker of the day, is this feasible? Is this a sustainable pension system?

## The efficient use of capital

Are conventional annuities backed by German and French bonds the most efficient use of Irish capital. Irish regulation forces Irish pension funds to invest in very expensive German/French bonds to help them build roads, schools, hospitals etc. Should this capital not be used to support Irish infrastructure and jobs?

## “past performance is no guarantee of future security”

This investment strategy of increasing the allocation to highly rated government bonds may have been the solution to the last crisis but the role of the Pensions Authority and the industry should be to future proof Irish scheme from the next financial shock, not create it.

## Summary

The industry at larger are in agreement that sustainable pensions is a goal we all aspire towards. However, there is a belief amount many trustees that pension’s authority takes too simplistic an approach. At a recent IAPF conference the pension’s authority suggested that trustees should to invest in accordance with the “prudent person” rule. This was quoted as being “the assets shall be invested in the best interests of members and beneficiaries” however this interpretation ignores “assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole” or “the assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset”.

Most trustees are aware of their responsibilities and are managing the fine line between derisking their portfolios in the interests of their members and maintaining the viability of their schemes into the future.

## For Further Information

IAPF Investment Conference 2014  
<http://www.iapf.ie/Events/event/?id=247>

IAPF Pension Scheme Governance – The Role of the Trustee  
<http://www.iapf.ie/informationlibrary/publications/iapfpublications/default.aspx?iid=421>

Understanding Pensions - The Friendly Guide to Pensions  
<http://www.iapf.ie/informationlibrary/publications/iapfpublications/default.aspx?iid=302>

The Pensions Authority  
[www.pensionsauthority.ie](http://www.pensionsauthority.ie)