



What is the future for DB investment strategy?

Paul Kenny

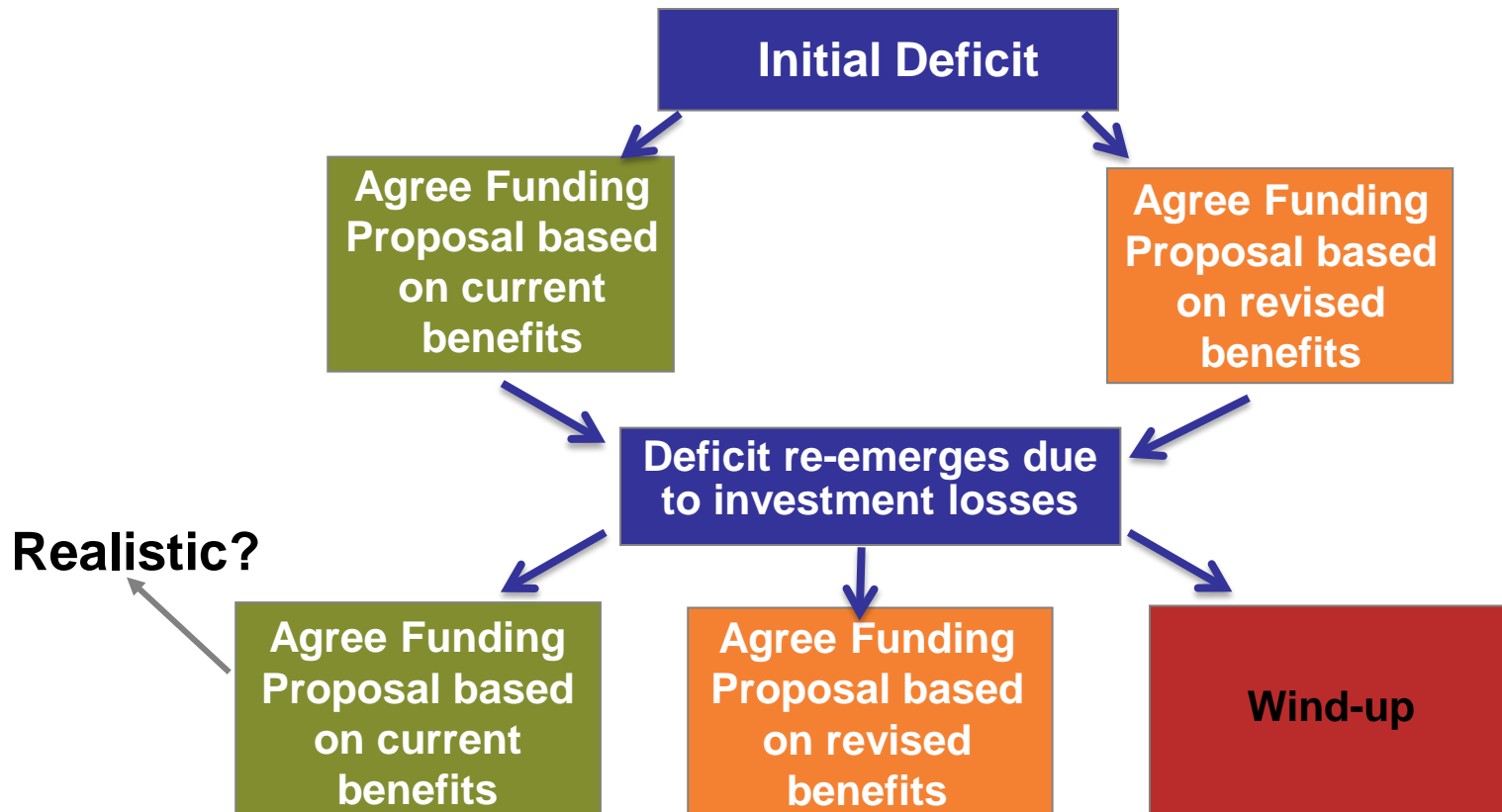


Theme for Today

Risk Management



Importance of Investment Strategy Risk Management



Crucial that investment strategy is managed to help deliver scheme benefits

Majority of DB schemes should target Equity risk reduction

Key drivers of equity risk reduction

Future proofing

Section 50

Risk reserving

Buy out/in

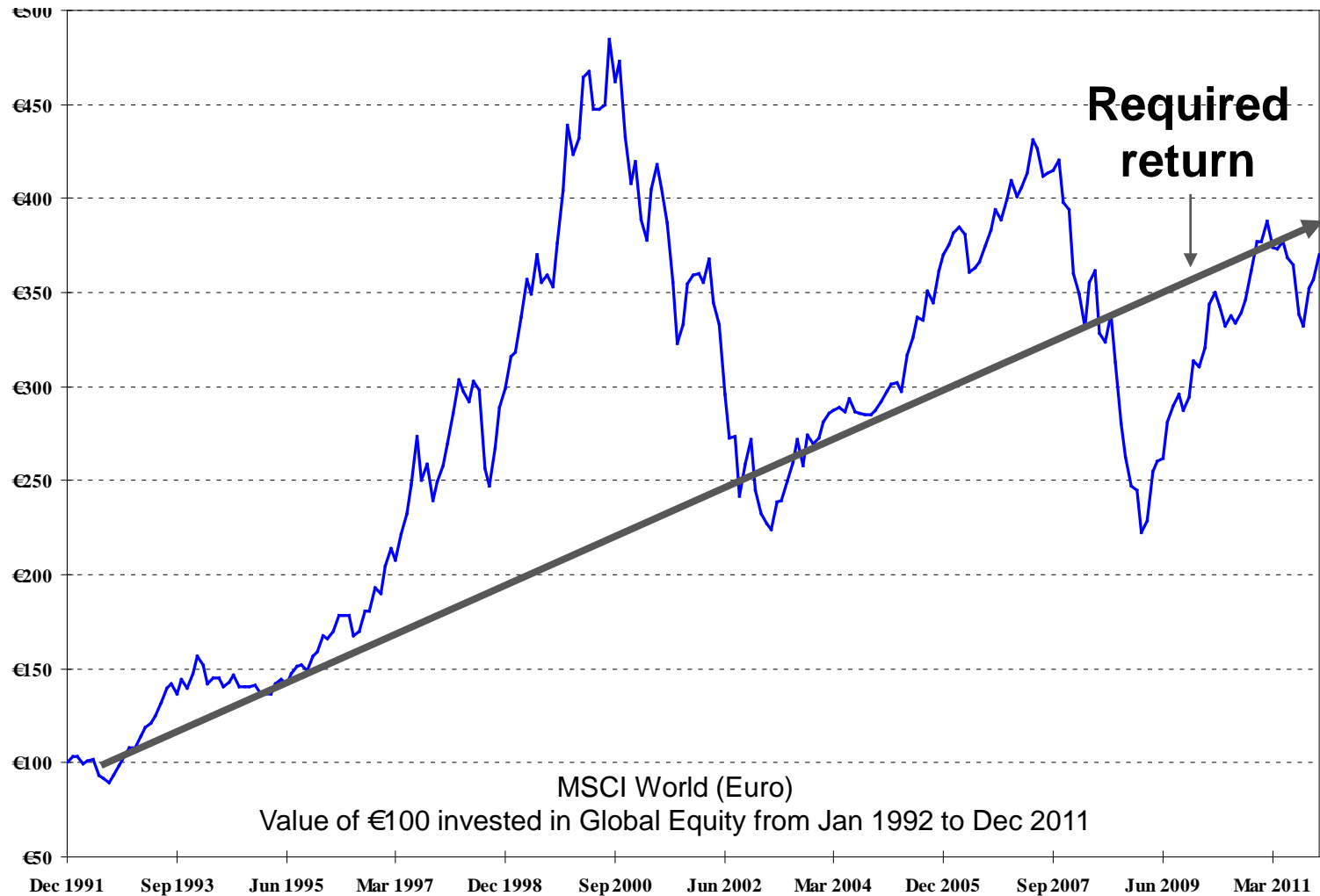
Wind-up

Accounting changes

Short-term hurdles

"Risk On / Risk Off"

How do you manage a scheme in this environment?



Equity Risk Premium Myth or Reality?

Equity Risk Premium

10 Year Equity Risk Premium	-4.8% per annum
Expectation for Future Risk Premium	Typically 3%-4%
Actual Future Risk Premium	?

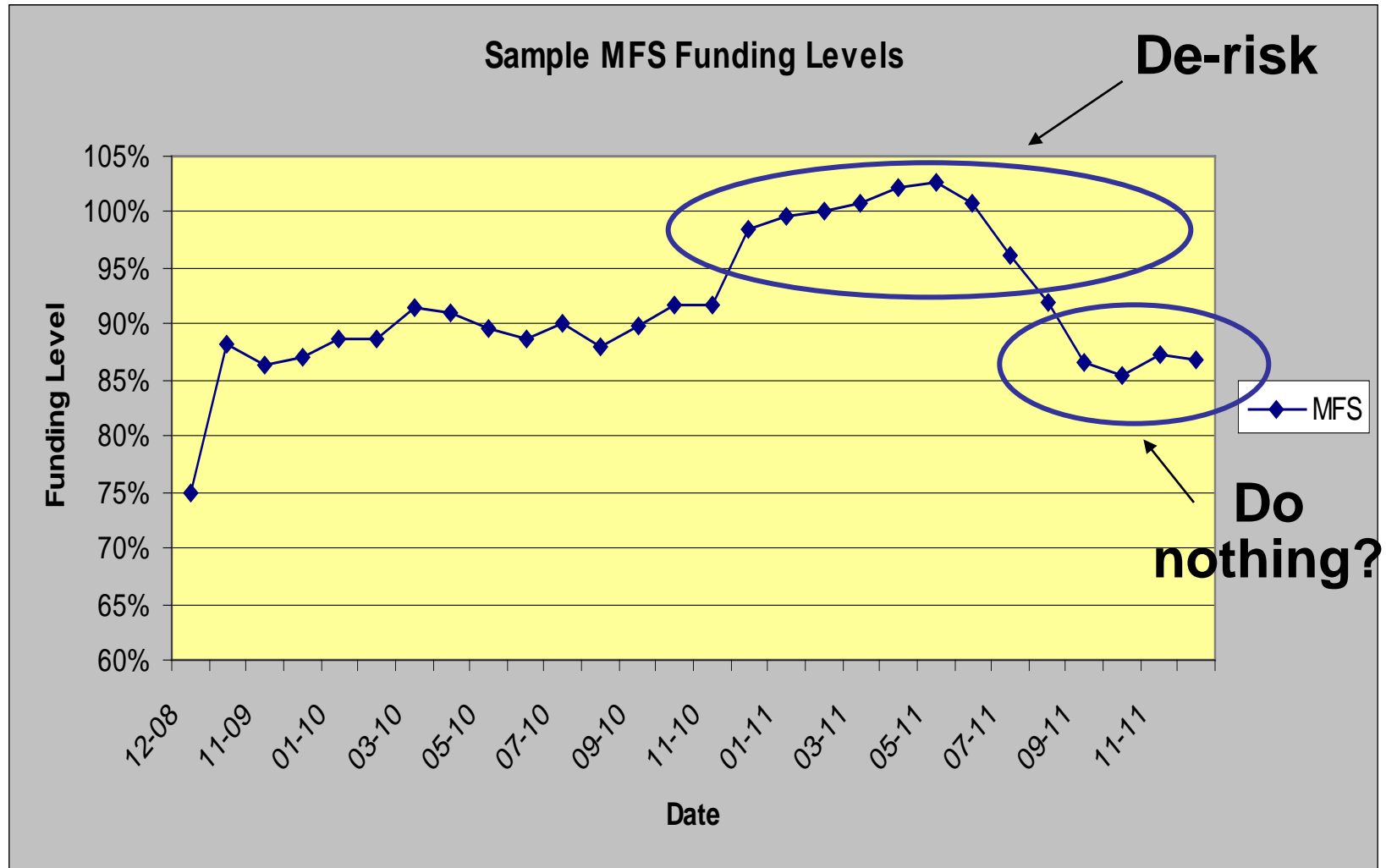
Source: Datastream – ML >10 Year Government Bond Index versus FTSE World (Euro) to 31 December 2011

*Reasonable to assume a positive risk premium -
No guarantees that a premium will actually be
delivered*

So, what can we do?



Look to Reduce Equity Risk in Times of Funding Level Strength



Ideally De-risk to Government Bonds But not necessarily (at least initially)

Risk Managed Equity

Corporate Bonds

Emerging Market Debt

Infrastructure / Property / Private Equity

Alpha Strategies

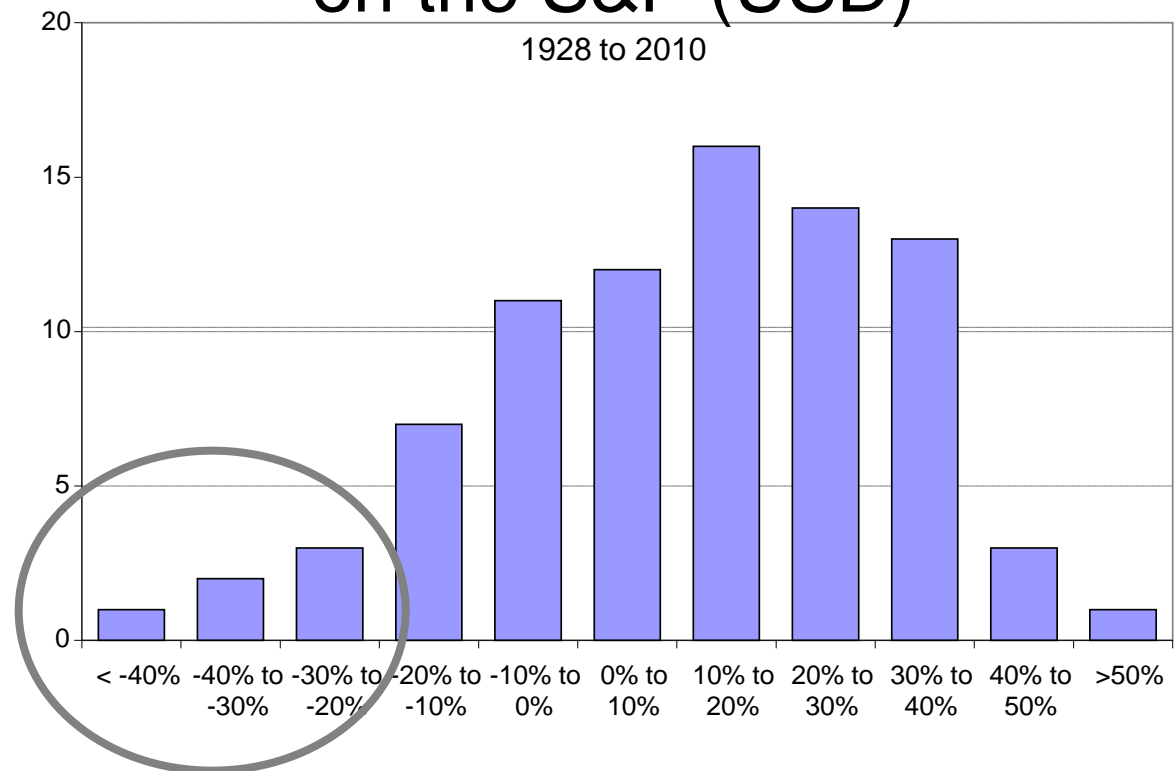
Aim for a blend of risk sources / return drivers

If Retaining Equity Exposure, Look to Manage Tail Risk

Calendar Year Returns Below -20%	
1930	-28%
1931	-47%
1937	-35%
1974	-26%
2002	-22%
2008	-37%

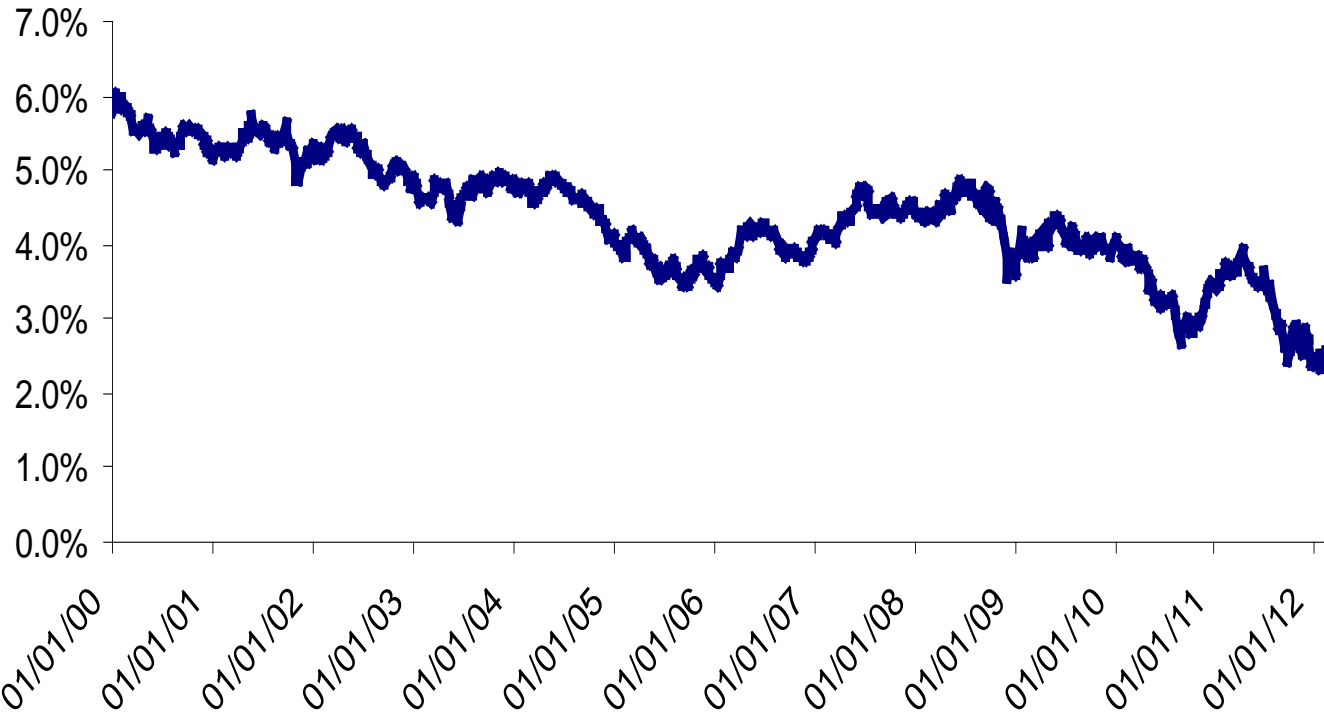
Source: Datastream, indices used S&P

Frequency of Calendar Year Returns on the S&P (USD)



Liability Risk

Over 10 Year German Government Bond Yields



Source: Bloomberg

The
Hope
The
Reality?
The
Fear

What options are available to try and deal with the low bond yield environment?

Option 1 - Sovereign Annuities / Sovereign Bonds?



*Back
Traditional
Annuities*



*Back a
"Basket"
Sovereign
Annuity*



*Back an
Irish
Sovereign
Annuity*

*Careful consideration of risk/return for all
stakeholders is critical*

Option 2 - Trigger Based Hedging

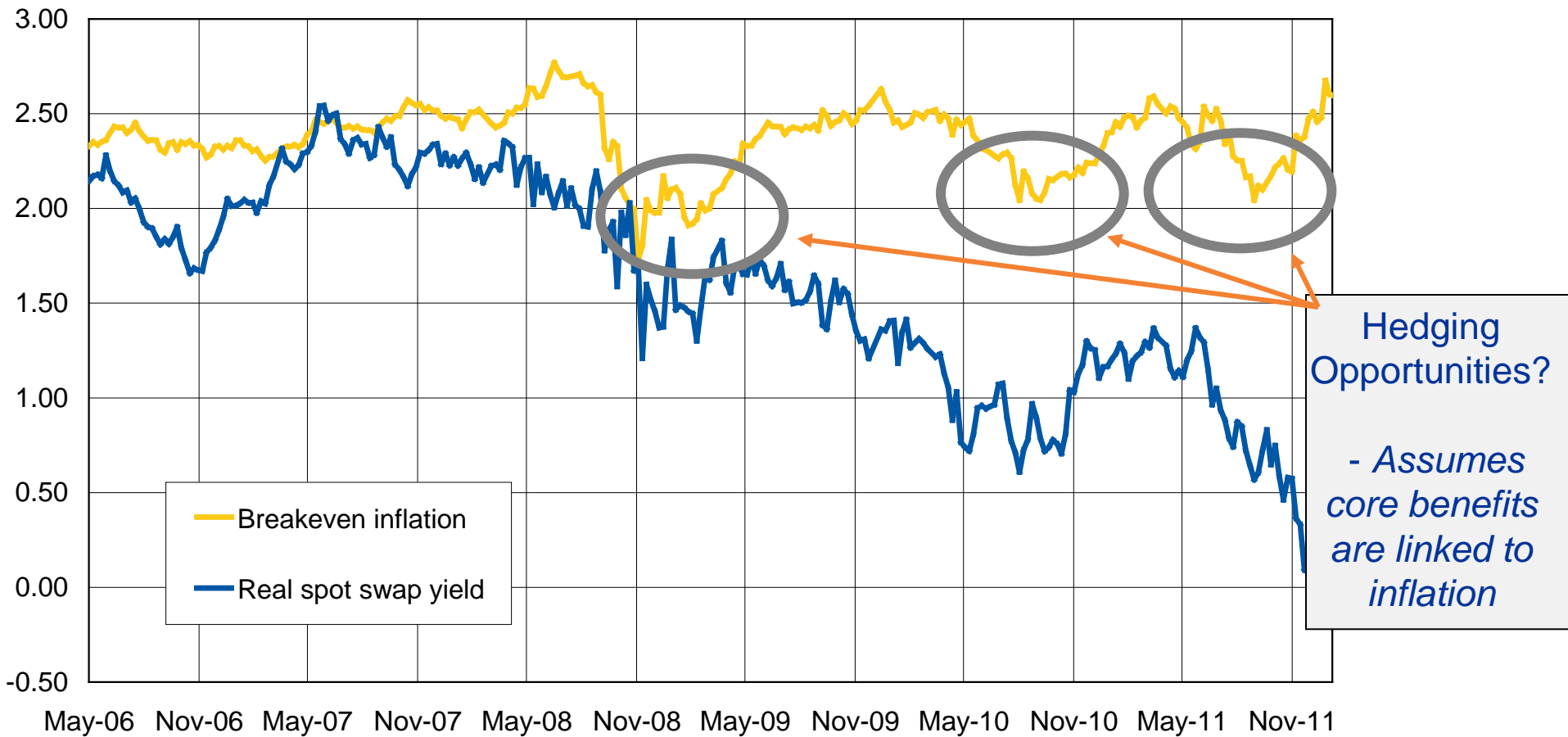
Aim to try and hedge at opportune times

Sample Trigger Framework

Triggers	Real Rates	Target Hedge Ratio
1	2.0%	50%
2	2.5%	75%
3	3.0%	100%

Option 3 – Segregate Inflation Risk from Interest Rate Risk

Historical Eurozone 30 year real spot yields and breakeven rates



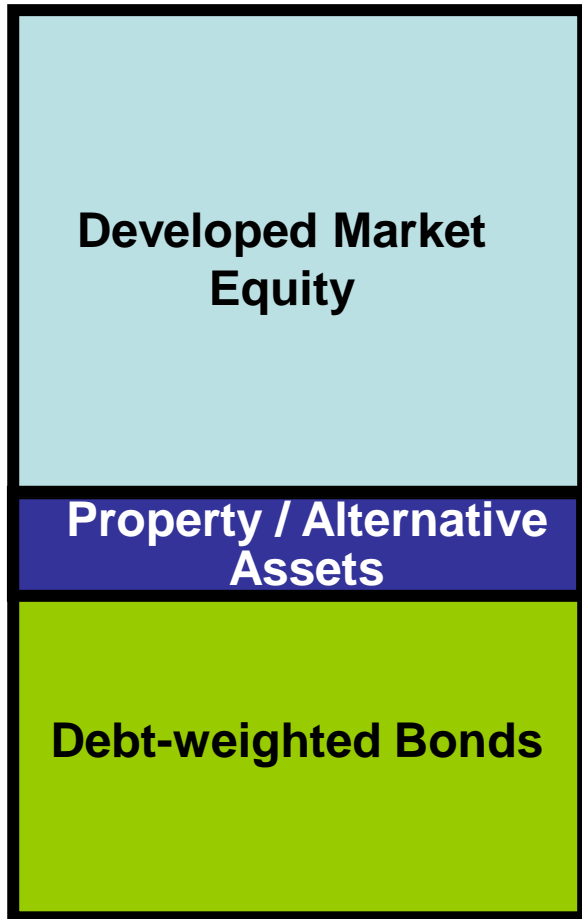
Hedging Opportunities?

- Assumes core benefits are linked to inflation

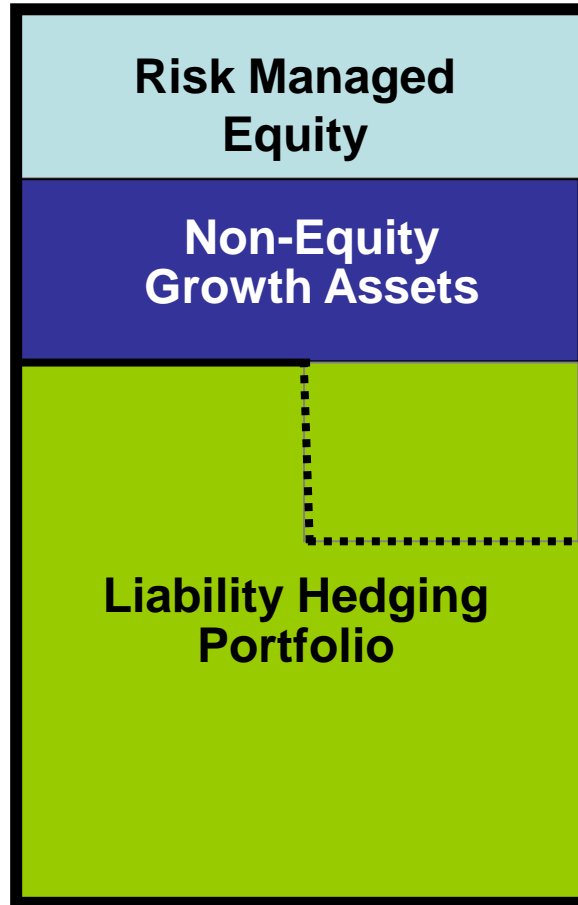
Source: Bloomberg

The Potential Evolution of Investment Strategy

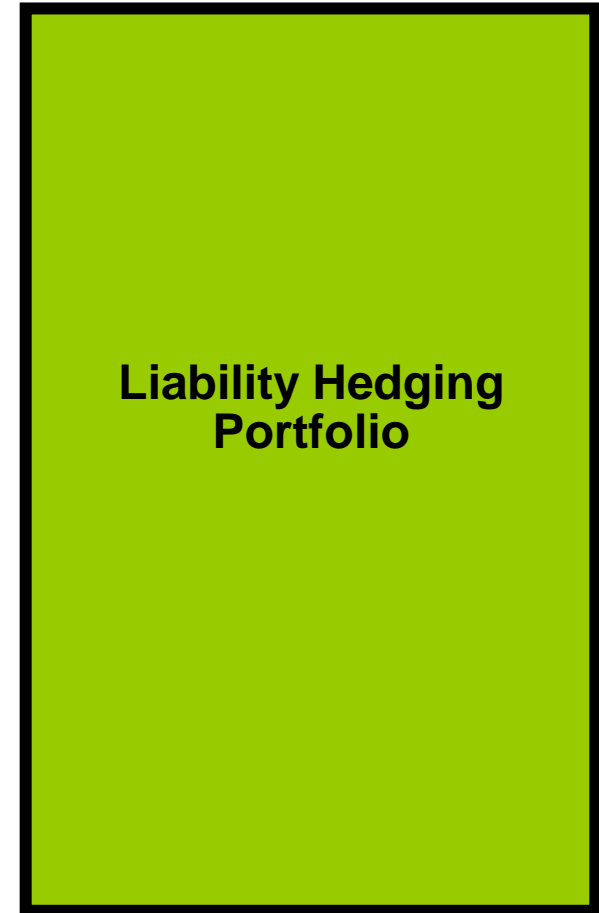
Today



Tomorrow?



End Point?





THANK YOU

Paul Kenny
Principal - Mercer

