

Why assets alone won't help to avoid checkmate

Pensions

Cardano says UK funds still need to adapt strategies, finds **Sophia Grene**

Girolamo Cardano was a sixteenth century physician and mathematician who supported himself for some years by playing chess. He was also the first to do a systematic study of probability, inspiring a Dutch pensions consultancy and overlay manager to name itself after him.

"We are very risk-focused, looking at what the aims and objectives of stakeholders are and how you can get a robust solution," explains Theo Kocken, Cardano Group's chief executive. "That was a very difficult message 10 years ago [when the company was set up] but it's a lot easier today."

The concept Cardano was and still is pitching to defined benefit pension funds is that they should focus on their funding ratios rather than purely on growing their assets. While the second half of the last century saw massive accumulation of assets in pension funds, a combination of demographics, a changing pensions landscape and a new awareness of risk means pension funds are now moving towards a decumulation phase.

"You can't steer any more with the contribution rate," says Mr Kocken. "You will be more or less rudderless if you don't focus on the liabilities." In the Netherlands,

this message has got through loud and clear, he says, with pensions taking up significant airtime in the general political debate.

Most radically, Mr Kocken expects the Dutch debate to lead to changing pension contracts to weaken vested rights both for currently contributing scheme members and even those already in retirement. "It's very difficult not to talk about intergenerational transfers of wealth – younger people should be extremely angry about the amount of money they're putting in."

In the UK, where Cardano launched its business three years ago, the debate has lagged behind, according to Kerrin Rosenberg, chief executive of Cardano UK, as has the general level of funding for pensions.

"UK pension funds probably need to take more risk," says Mr Rosenberg, although he goes on to specify that the greater risk should be carefully chosen. "The dominant model in the UK is to take two big risks: a big risk on equities and a big short position on interest rates and inflation." The latter risk is an implicit one, based on the nature of pension fund liabilities that are to a large extent defined by interest rates and inflation.

Although the pension industry has woken up to the need to focus on liabilities, Mr Rosenberg is scornful of the commonest approach to the problem, dynamic de-risking. "It's perfect, provided you get lucky." Dynamic de-risking involves locking in funding improvements as they occur, although their occurrence mostly relies on

gains from asset growth.

Mr Kocken encountered a similar situation 10 years ago in the Netherlands where "people had a vision [of a particular asset allocation] and followed that, ignoring liabilities. I asked 'what if your vision is wrong?'"

At the time, relatively few pension schemes were prepared to consider this risk, he says. "Pensions that were big compared to the companies sponsoring them, or with corporate sponsor issues", ie ones that could not rely on

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the corporate sponsors to bail them out, were the only ones worried about the consequences of misguided investment strategies.

Ten years on and two stock market crashes later, nobody is so confident about their investment strategy, particularly if it assumes strong growth from equities, so Cardano's pitch is getting easier.

The terms of the debate are still different in the UK from in the Netherlands, however. "We had a proposal for a 38-year recovery plan from the Royal Mail pension fund," says Mr Rosenberg. "That's another way of saying 'we'll never get out of this hole.'"

By contrast in the Netherlands, according to Mr Kocken, "with a five-year recovery plan, if it's not on

course after one year, they restructure, including transferring some of the deficit to current pensioners".

He thinks only a large scale failure will really change attitudes to pension deficits in the UK, and even that would be insufficient unless "enough workable solutions are being proposed".

No discussion of pension risk management is complete without mentioning longevity risk, but neither of Cardano's two chief executives is optimistic about the development of a longevity hedging market.

"It's still nascent," says Mr Rosenberg. "Some people extrapolate incorrectly from other derivatives where there is liquidity on both sides. With longevity, there is a structural imbalance, [few market participant stands to gain from increasing longevity], so pricing will always include some payment for taking risk."

This does not mean it will never be sensible for pension funds to buy longevity protection, he says, but it does make it hard to work out if they are getting value for money.

The pensions industry is slowly rising to the challenge of what Mr Kocken describes as "the biggest intergenerational pressure in a couple of centuries", but neither he nor Mr Rosenberg seems enormously optimistic enough is being done to avert some big problems in the next couple of decades. "You need adjustments of contracts now," says Mr Rosenberg. "If not, 20 years from now, pension funds will be empty."