

Global round-up



Legislation focuses on DC in US

In 2009, participant-directed defined contribution (DC) plans are expected to come into the spotlight in the US due to the large number (approximately 70 per cent¹) of private-sector workers who rely on DC plans as their only source of retirement savings. In addition to legislative issues, plan sponsors will need to address a number of other important DC issues relating

to target date funds (TDFs) and stable value options.

In 2008, there were many concerns over whether TDFs would deliver on their investment diversification and financial advice promises. Over 2008, investors in the TDF income funds designated as appropriate for retirees saw their account balances decline between 20 per cent and 37 per cent. These are very

troubling results. In 2009, investors will need to address the deficiencies found in the methodologies used to measure TDF investment results and implement an appropriate framework to develop measurement criteria better aligned with TDF objective functions (that is, achieving retirement financial security).

Many DC plan sponsors have historically offered a stable value option to deliver safety of the principal investment, consistent positive investment returns and liquidity. As a result of dysfunctional fixed income markets, however, lower market-to-book ratios

represented a serious unexpected risk issue. In 2009, we anticipate stricter investment guidelines, less wrapper contract flexibility, fewer wrap industry participants, less capacity, higher fees and increased introspection regarding the appropriate level of risk in stable value funds. The continuing viability of stable value as a DC option will need to be assessed in the context of those developments.

Taking all these issues into account, the only certainty about the year ahead is that there will be new challenges to face as financial stresses feed into the real economy.

¹Center for Retirement Research at Boston College, 'The Financial Crisis and Private Defined Benefits,' November 2008, Number 8-18.

The meltdown of China's stock market

China's stock market dropped approximately 70 per cent from its peak in October 2007 to December 2008; a loss of nearly 24 trillion RMB, or roughly US\$3.5 trillion, in market value. The average forward Price to Earnings ratio has fallen from 49 in October 2007 to 14 in the same period.

The meltdown of China's stock market can be attributed to both the macro economy and the unique local market structure.

The People's Bank of China tightened monetary policy by raising the interest rate five times and the reserve rate nine times in 2007, which posed tremendous challenges to the real economy – especially small enterprises. The more recent global financial crises and domestic catastrophes, including the Sichuan earthquake, made the situation worse.

On the market side, unlimited financing requests from listed and pre-IPO companies dried up the capital supply on the market. State share reform also allows major holders of non-tradeable shares to float their stocks on the secondary markets. Due to the low cost base of these non-tradeable shares, the market was shaken by the huge flood of stock supply, which obviously changed the supply-demand relationship. Last but not least, the overly high valuation in China's domestic market was due for a correction.

We are yet to see the recovery of the market from both a psychological and capital supply perspective.

Ireland: funding pressures to the fore in 2009

With most defined benefit (DB) pension schemes maintaining a pronounced exposure to growth assets in general and equities in particular, the decline in equity markets over the last 12 months has left the large majority of schemes facing substantial deficits under the statutory Funding Standard. The local regulatory authority, the Pensions Board, will have a heavy workload reaching agreement on funding plans required under the regulations. Trustees will need to take a fresh look at their total risk appetite and scheme sponsors will be called upon in many instances to make fresh capital injections or increase ongoing contributions by a substantial amount. This will make for difficult decisions all round.

While dealing with these issues, trustees will need to be more cognisant of good governance in managing their investment arrangements. The Irish Association of Pension Funds (IAPF) released their new Investment Guidelines for DB and DC pension schemes in April. These guidelines set a more explicit framework for measuring and managing investment risk and will, in some instances, require a significant change in behaviour.

Review of Canadian pension system under way

Expert commissions were established in Nova Scotia, Ontario, Alberta and British Columbia to provide a comprehensive review of the pension system in those provinces. Key objectives were to increase pension coverage of employees and self-employed workers and to preserve the use of DB plans where possible. In addition, consideration of ways to deliver an improved benefit for DC members was reviewed, particularly in Alberta and British Columbia. A key recommendation of the Ontario report is the creation of industry plans that would enable small to medium-sized companies to offer a DB plan to their employees in a cost-effective manner and to enable the level of investment diversity often only seen in the largest plans. British Columbia made a similar recommendation targeted at the DC plan sponsor. Other recommendations made by Ontario include changes to the way discount rates are set for valuations, improved governance arrangements, funding arrangements targeted to the type of plan sponsor (that is, single versus multi-employer) and a review of the tax code as it relates to pensions.



DC developments in Hong Kong

DC schemes represent 80 per cent of the total assets of both Mandatory Provident Fund schemes and voluntary Occupational Retirement Schemes Ordinance (ORSO) plans. Both schemes cover around 80 per cent of Hong Kong's workforce of 3.5 million. In other words, about two-thirds of the employed population are participating in DC investments.

However, members in Hong Kong generally pay little attention to their DC investments or do not have a clear understanding of their DC investments. Therefore, in the near term, this calls for a DC model that addresses the lifecycle of members and helps those members who lack investment knowledge.

Recently, a few service providers have launched target-date retirement funds that dynamically (and automatically) reallocate a member's assets over time according to the member's age. The trend towards the development and education of lifecycle products will prevail over the next few years.

Hedge fund update

Hedge funds have faced particular scrutiny this year. Poor performance matched with high fees and little transparency, regulatory changes, the fall of Lehman Brothers and the Bernard Madoff scandal have led to redemptions across the hedge fund industry. In addition, the cost of borrowing has risen significantly for some strategies and the availability of borrowing has fallen. Lack of liquidity became a serious problem, making the deleveraging and redemption process even more difficult and painful for many hedge fund participants. A significant number of redemption requests were placed at a difficult time to liquidate, inevitably continuing to put further technical pressure on pricing.

Watson Wyatt's hedge fund research team believes that the hedge fund universe is set to shrink, either from necessity or from the desire to reset the high water mark. The team still believes in the ability of highly talented investors to adapt to a changing environment, in particular multi-strategy managers. Fee structures will be better aligned to investors' interests and hedge funds should be helped by the increased opportunities in the market, created as a result of recent market dislocations.

Impact of the global financial crisis on Australian funds

The global financial crisis gave rise to various responses from regulators, for example the restrictions on short selling.

In October, in order to promote stability in the financial system and to enable the continued flow of credit, the government introduced a guarantee on all deposits of Australian banks, building societies and credit unions for a period of three years (with the guarantee on deposits subsequently capped at A\$1 million). The government also announced that it would guarantee any unsecured debt instruments issued by the banks, in exchange for a fee.

However, the introduction of the deposit guarantee precipitated a flow out of money market funds into deposit accounts, exacerbating market illiquidity.

The rating agencies have come under greater scrutiny and are now required to hold an Australian Financial Services Licence (AFSL), issued by the securities market regulator, ASIC. (They were previously exempt from this.) They will also be required to issue an annual compliance report which is intended to cover the quality and integrity of their ratings processes, their management of any conflicts of interest and their responsibilities

to the investing public and issuers.

There is now the very real prospect of a second consecutive year of negative returns for superannuation funds. There has been a trend within some DC funds for members to move into a cash option. Given the extreme levels of market volatility and an increase in queries from members, the financial regulator has opened the door for super funds to offer financial guidance to members. Such relief is, however, only intended to be a temporary measure.

