



# Defining the pension and investment industry of **the future**



The pace of change in the investment industry is more rapid than ever before, creating enormous challenges for institutional investors, investment managers and intermediaries such as consultants.

In this more complex investment world, not all organisations will be agile enough to exploit the new opportunities on offer. Those that make the attempt will need to match the strategies they follow with the skills they possess.

In its 'Defining moments' research, the Thinking Ahead Group explored what the future investment landscape might look like, based on interviews with a number of industry leaders.

This expert opinion survey focused on three areas: what will happen, what should happen and what do people fear most. The main findings are shown in **Figure 1**.

### The big picture

If there is one word that captures the expected flavour of the next few years in the financial industry, it is complexity. We believe we are seeing a different form of evolution as a result. Our ordered sequential way of anticipating change is challenged because of the more

complex world. Our future is being buffeted by unknowable extreme events – 'black swans' – and we are moving in jumps, not smooth transitions from one state of the landscape to another.

With such a change, it is critical to stay with this clear big picture: that the pensions and investment industry has a core purpose, turning today's workplace savings into tomorrow's retirement income, in which success is critical.

### Things to be worried about

There are a number of significant issues facing institutional funds:

- there are fault lines with the investment management value proposition, in that the vast majority of investment products

carry too much cost for the value they deliver

- there is little long-term in thinking about investments
- the industry is prone to crises because of poorly structured incentives and other excesses.

The main problem resides in excessive competition, complexity and compensation. We suggest that the rewards and sanctions facing industry participants are not always appropriate, resulting in participants being incentivised to act in ways that will ensure the system remains prone to periodic crises.

**Figure 1 | Expert opinion survey**

	What will happen?	What should happen?	What do people fear most?
1	Alpha appetite to grow	Increased long-termism	DC under-delivers
2	Talent shortages to stay	Stronger governance	Undue short-termism
3	Value of independent advice to rise	More independence in advice	Growth of regulation
4	Marketplace change will be substantial	Rise in ethical standards	Over-complexity in investment products
5	Growth of absolute return	Separate going rates for alpha and beta	Over-complexity in derivatives



**The current forces for change**

There are several areas where important changes have occurred (or will occur) in the thinking and the approach of market players. Each of these is a catalyst for further change in the system:

- the preference for absolute return products – created by the end of the last bear market in 2003
- fresh governance model thinking – captured by the Philips Pension Fund’s move to fiduciary management in 2005
- new framing of risk – the financial crisis has precipitated major changes in the modelling and viewing of risk
- new regulation – a future phase of significant regulation which will impact the financial industry on a scale similar to the Sarbanes-Oxley Act effect on US corporations.

We see these events as ‘defining moments’ which send development down one path rather than another.

**Near-term trends**

We have identified six major trends acting on the institutional investment industry in the near term, see **Figure 2**.

**Pension fund investment governance**

To cope with the changes, pension fund governance may need to adapt to complex circumstances in order to secure any competitive advantage. This could include, for example, a step change in organisational design, with more use of non-executive boards, delegated executives and fiduciary management.

**Pensions design**

A considerable shift from the provision of DB to DC is being driven largely by demographics, the regulatory environment and a shift in social structures from paternalism towards individualism.

**Extra-financial factors: sustainability**

The pressure for institutional funds to apply responsible investing principles has increased in recent times. Sustainability is moving up the agenda, with climate change the strongest element.

**The talent bubble**

The demand for talent has grown, with particular competition for leadership talent. Compensation will be a big driver of talent

**Figure 2 | Near-term macro-trends**

<b>Pressure for talent</b>	Talent needs to stretch more in both breadth and depth with talent shortage normal; return on talent likely to increase
<b>Improvements in governance</b>	Improved recognition of return on governance feeds through in increased attention and new models; more talent attracted to Chief Investment Officer role at funds
<b>Product proliferation</b>	Product specialisation leads to major proliferation, with risk, style and scope of mandates all getting broader; particular growth in absolute return and alternative assets
<b>Extra-financial factors</b>	Environmental, social and governance considerations grow in impact both as indirect sustainable performance influences and as desirable end attributes in their own right
<b>Pensions design, towards a DC model</b>	DC becomes the dominant global model with its attendant ‘individualisation’ with risk transfer and new ownership versus control tension
<b>Organisational change</b>	Organisations address change in terms of scaling, specialisation and HR with expansion globally and in adjacent spaces putting leadership and survival on the line



**Figure 3 | Longer-term macro-trends**

<b>Better multi-period investment design</b>	A new success measure for funds will be employed looking more at the key steps in the journey; measurement fully adjusts for risk
<b>Better DC</b>	The improved member value proposition needs platform strength, better investment design, glide-path design and a technology supported engagement model
<b>New food chain</b>	The big moves are away from reliance on fiduciaries/board/committee towards a Chief Investment Officer type role, which manages costs more aggressively than previously
<b>New investment content</b>	There is a growing list of innovations: porting alpha and beta, beta creep, structured products, solutions
<b>Continued crisis contagion</b>	Given the systemic flaws, excessive complexity and compensation in particular, continued prolonged significant distress events are likely
<b>New players and new organisational order</b>	Under more performance pressure, organisations will need to develop new competencies

mobility, but there is an increasing emphasis on non-compensation drivers such as culture and associate development.

#### Product proliferation

We see product proliferation as being driven primarily by players seeking to secure an advantage in the marketplace. Particular growth areas are likely to be in diversity of asset classes and derivatives based strategies.

#### Organisational change

Within all this change, the current trends that we identify are:

- convergence between mainstream firms and alternatives firms as their competitive fields overlap
- categorisation of active products into two types – relative return mandates and

absolute return mandates, with growth particularly in the latter

- increased specialisation, whether by asset class, risk level or investment style
- consolidation of firms, whether to fill product holes, add capability, address geographical diversification or to augment manufacturing and distribution capabilities.

#### The longer-term trends

The significance of the defining moments is more evident in what we see as the longer-term macro-trends (see **Figure 3**).

#### A better journey design

Pension fund investment is a journey rather than a destination, but interim assessments, such as annual measurement, are necessary.

While this provides scope to adjust strategies, annual scorekeeping can introduce shorter-term thinking and behaviours. The better-governed funds of the future will reconcile the tension between shorter-term scorekeeping and journey planning, but there will be no mechanistic formula to follow.

#### Improved DC

There is significant opportunity for improving the value proposition to DC members. There is scope to improve investment efficiency, through strategies with greater exposure to alternative assets and better cost structures. We also expect DC schemes to become pioneers in risk protection strategies. Furthermore, developments in technology will make it easier to enhance glide-path design that turns a member's age and other life circumstances into an optimal investment strategy.

#### New food chain

We anticipate that funds will create a more effective 'food chain', with cost control attracting major attention. The key change will be the introduction of full-time executive investment expertise, which may be out sourced. This approach allows the governing board to concentrate its efforts on issues of strategic importance, while the investment executive translates the strategy into actions.



**New investment content**

Part of the shift in the food chain will be supported by the emergence of new investment content offering higher efficiency. 'Beta creep' and exotic betas will enable investors to secure cheap market returns.

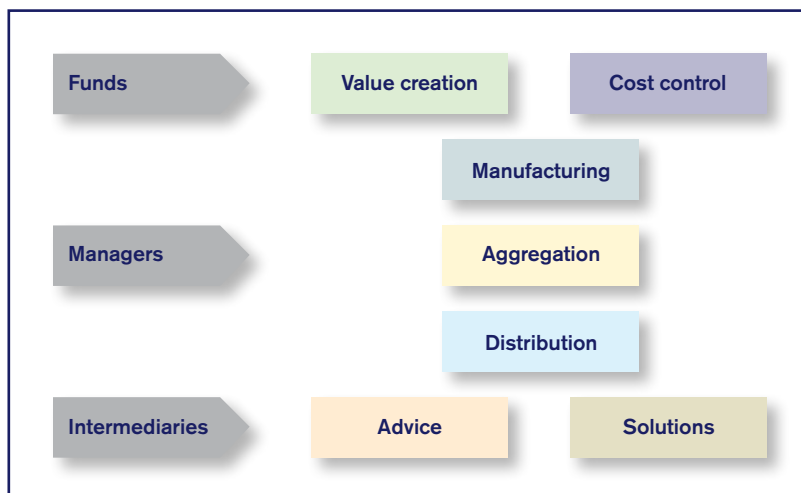
Some trends are already established, with increased use of short selling, derivatives and leverage. The subsequent phase of transition will be the growth of solutions and outcome-specified mandates, which we divide between part-fund and whole-fund solutions. Part-fund solutions are more sophisticated products, such as downside protection funds and multi-asset portfolios, meeting relevant absolute return targets. Success with whole-fund, whole-journey solutions involves the deployment of effective LDI (liability hedging), reliable alpha and cheap, dynamic, efficient beta.

For a DB pension fund, the LDI process of using swaps to match anticipated future cash flow needs simplifies the objective to a return achieving or exceeding LIBOR.

**Continuing crisis contagion**

We expect that the issue of excess competition, complexity and compensation will continue to hover over the industry. We are already seeing attempts by regulators to address some of these difficulties, particularly incentive structures.

**Figure 4 | Future competencies**



### **Organisational change – new managers, new intermediaries, new competencies**

The final future trend relates to how the players react and adapt to the forces we have discussed. The generic competencies that will be required are shown in **Figure 4**.

Players can choose whether to concentrate on mastering a single competency or whether to target a mix.

### **What this means for funds**

By understanding how the investment industry may evolve, funds may be able to adapt to take advantage of these changes.

### **Dealing with risk in a more hazardous and unpredictable financial environment**

Successful funds will recognise that their mission is a journey in which ideal risk exposure adapts to changing circumstances. The fund of the future will be a more dynamic institution when it comes to strategy and risk taking. There will be more attention on the clarity of mission and greater awareness concerning the factors that support risk taking: sponsor covenant, relative wealth and investment opportunity. Furthermore, there is demand for a more sophisticated performance measurement framework which better accounts for risk.

### **Improving the weak value proposition of many investment products**

As fund governance improves, we believe that there will be a greater awareness of costs relative to the value proposition. Funds will also be more aware of the misalignment of interests within current fee structures. The fund of the future will assume more influence over costs through negotiation and will seek a clearer value proposition from investment managers. Funds will make greater use of cheaper beta-based strategies and pay performance fees for true skill.

### **Overcoming short-termism**

Short-termism is a major hurdle for funds, which should look to adopt longer-term strategies. These will involve better ways of operating, as well as more use of long-term mandates.

### **Conclusion**

We write at a time of increased concern and anxiety about the effectiveness of our financial infrastructure. The industry faces certain defining moments in framing these responses. But this is a world of opportunity for those fit enough to change, where fitness is increasingly defined by the ability to be adaptable and apply new thinking.

