



**Surviving
Bear Markets :**
Time to change ?



Consulting in Bear Markets : a Swiss consultant perspective.

Dr. Graziano Lusenti

**Swiss Pension Fund Actuary, Advisor to Institutional Investors
Managing Partner, Lusenti Partners, Nyon (CH)**

Consulting in Bear Markets : a Swiss consultant perspective.



**Graziano Lusenti
Lusenti Partners Sàrl**

Graziano Lusenti is the funder, owner and active partner of the company Lusenti Partners Sàrl, in Nyon, Switzerland, since September 2002. This company is a consultant for institutional investors.

Previously, he was managing director of Robeco (Switzerland) SA (formely : Robeco Institutional Asset Management (Swizerland) SA).

Mr. Lusenti has a post-graduate degree and a Ph.d in political science from the Institut Universitaire de Hautes Etudes Internationales of Geneva's University. He also has the Federal Degree of Swiss Pension Fund Actuary.

He has also published numerous books and articles in Swiss and foreign magazines.

CONTENT

- 1. Introduction: Overview of the Swiss Pension Fund Market**
- 2. The Swiss Pension Fund Market: Graphs & Tables**
- 3. The Consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium**
- 4. Action Check-list: Liabilities
(and Assets Liabilities Management)**
- 5. Action Check-list: Assets
(and Changes in Asset Allocation)**

1. Overview of the Swiss pension Fund Market

- **Huge Market:**
Switzerland is Europe's third biggest pension fund market by assets, after the UK and the Netherlands: CHF 490 billion, EUR 335 billion (end of 2000)
- **Pension funds and insurance schemes:**
Out of the total, 20% is managed by insurance companies (insured schemes) and 80% by autonomous and partly autonomous pension funds
- **Pension assets and GDP:**
This asset pool represents 125% of GDP, a higher proportion than in the UK, the Netherlands and the USA
- **Occupational pensions and Social Security:**
Swiss occupational pension fund contributions represent 41% of total Swiss Social Security contributions, their benefits represent 31% of total Social Security benefits

1. Overview of the Swiss pension Fund Market

- **Compulsory coverage:**

Employees with an annual salary exceeding CHF 25'320 (ca. EUR 17'500) are to be covered by a compulsory occupational retirement, survivors and disability pension or insurance scheme

- **Insured people:**

Total number of insured people amounts to 3.225.000 (45% of total population)

- **Few large funds:**

There are 2.600 pension funds entitled to provide occupational pension provisions. But the 100 biggest funds insure 70% of the total number of insured people

- **Concentration in assets:**

There are 72 funds with assets exceeding CHF 1 billion each (EUR 680 million) and 143 funds with assets comprised between CHF 300 million and CHF 1 billion. Those 2 groups represent together 75% of the Swiss pension funds total assets

CONTENT

- 1. Introduction: Overview of the Swiss Pension Fund Market**
- 2. The Swiss Pension Fund Market: Graphs & Tables**
- 3. The Consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium**
- 4. Action Check-list: Liabilities
(and Assets Liabilities Management)**
- 5. Action Check-list: Assets
(and Changes in Asset Allocation)**

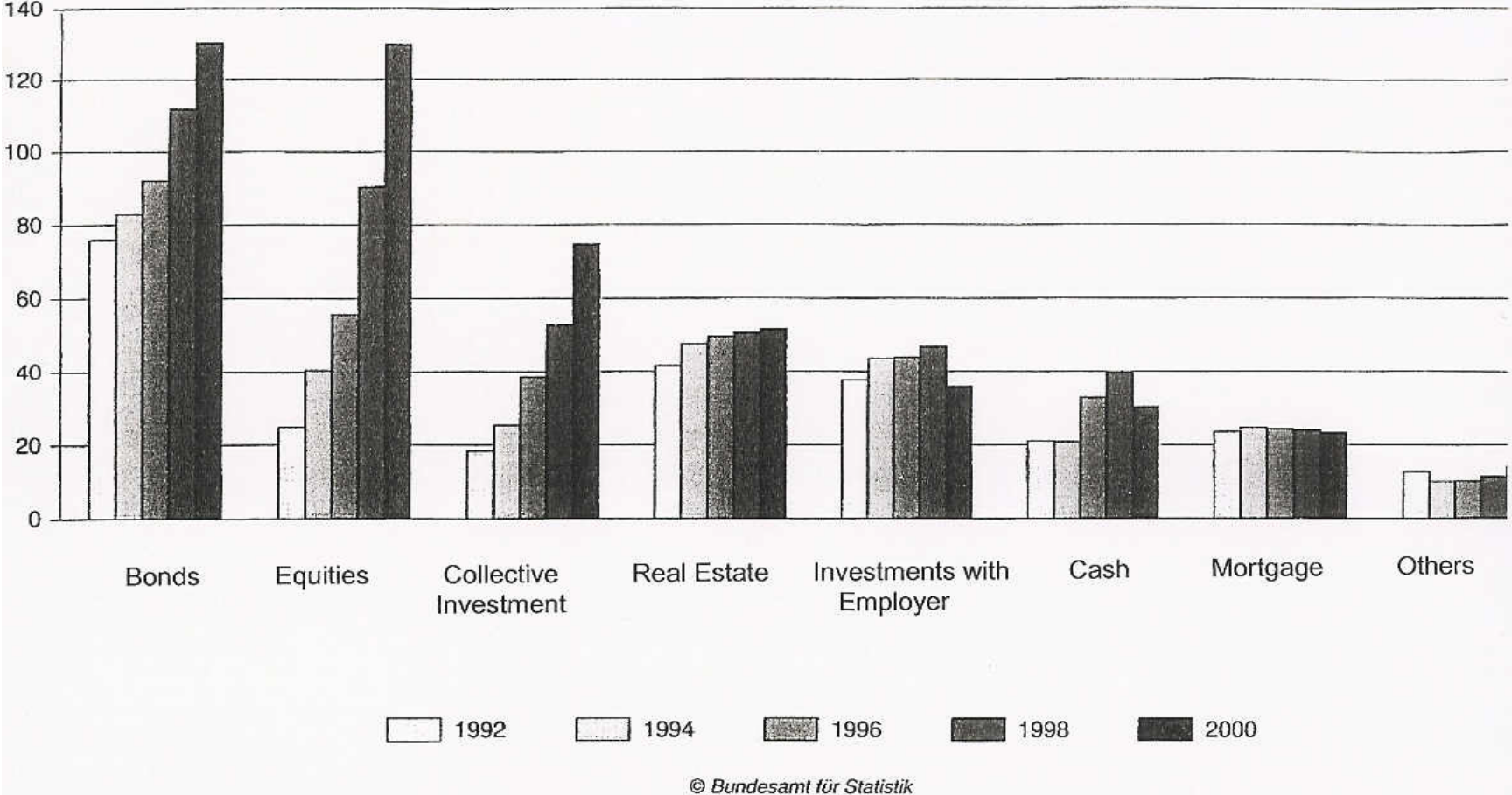
The Swiss Pension Fund Market: Graphs & Tables

Private and Public Sector Pension Funds Asset Allocation, in percentage, 31.12.2000

Asset Class	Private Sector, in %	Public Sector, in %
Direct investments	81,8	91,6
Assets with employer	2,8	14,2
Bonds	28,5	21,8
Equities	25,2	29,6
Real Estate	10,4	10,8
Mortgages	3,5	7,9
Cash	8,1	5,5
Others	3,3	1,8
Collective investments	18,2	8,4

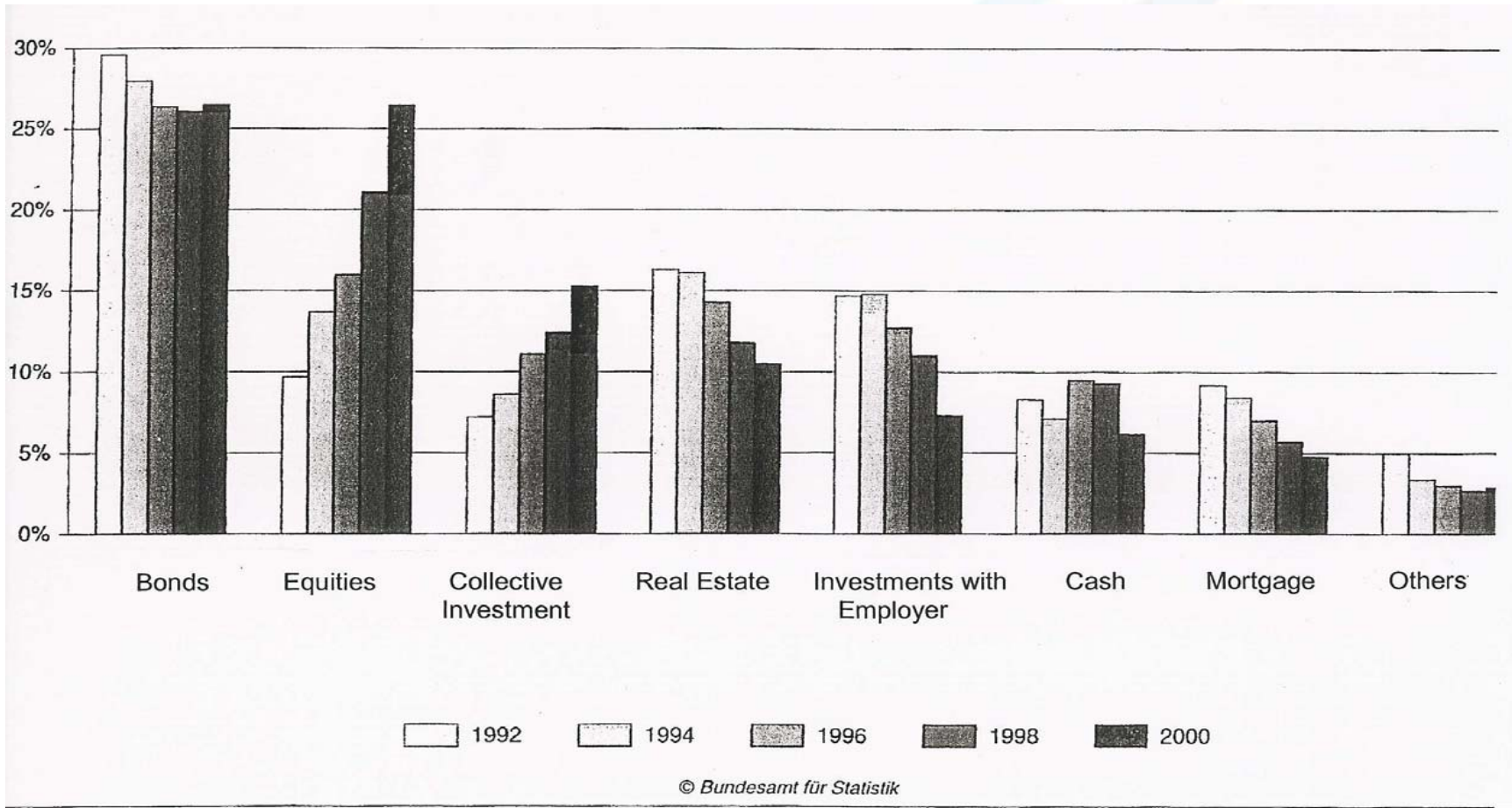
The Swiss Pension Fund Market: Graphs & Tables

The evolution of Swiss pension funds asset allocation, in billion CHF, 1992-2000



The Swiss Pension Fund Market: Graphs & Tables

The evolution of Swiss pension funds asset allocation, in percentage, 1992-2000



CONTENT

- 1. Introduction: Overview of the Swiss Pension Fund Market**
- 2. The Swiss Pension Fund Market: Graphs & Tables**
- 3. The Consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium**
- 4. Action Check-list: Liabilities
(and Assets Liabilities Management)**
- 5. Action Check-list: Assets
(and Changes in Asset Allocation)**

The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

**Reserves for securities fluctuations with the largest Swiss pension funds,
in percentage of balance sheet, 31.12.2000**

Reserves for securities fluctuations	Number of pension funds' active members	Number of pension funds
0	239'000	31
0,01 – 4,99 %	187'000	73
5,00 – 9,99 %	206'000	96
10,00 – 14,99 %	491'000	159
15,00 – 19,99 %	344'000	125
20 and more %	265'000	125

The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

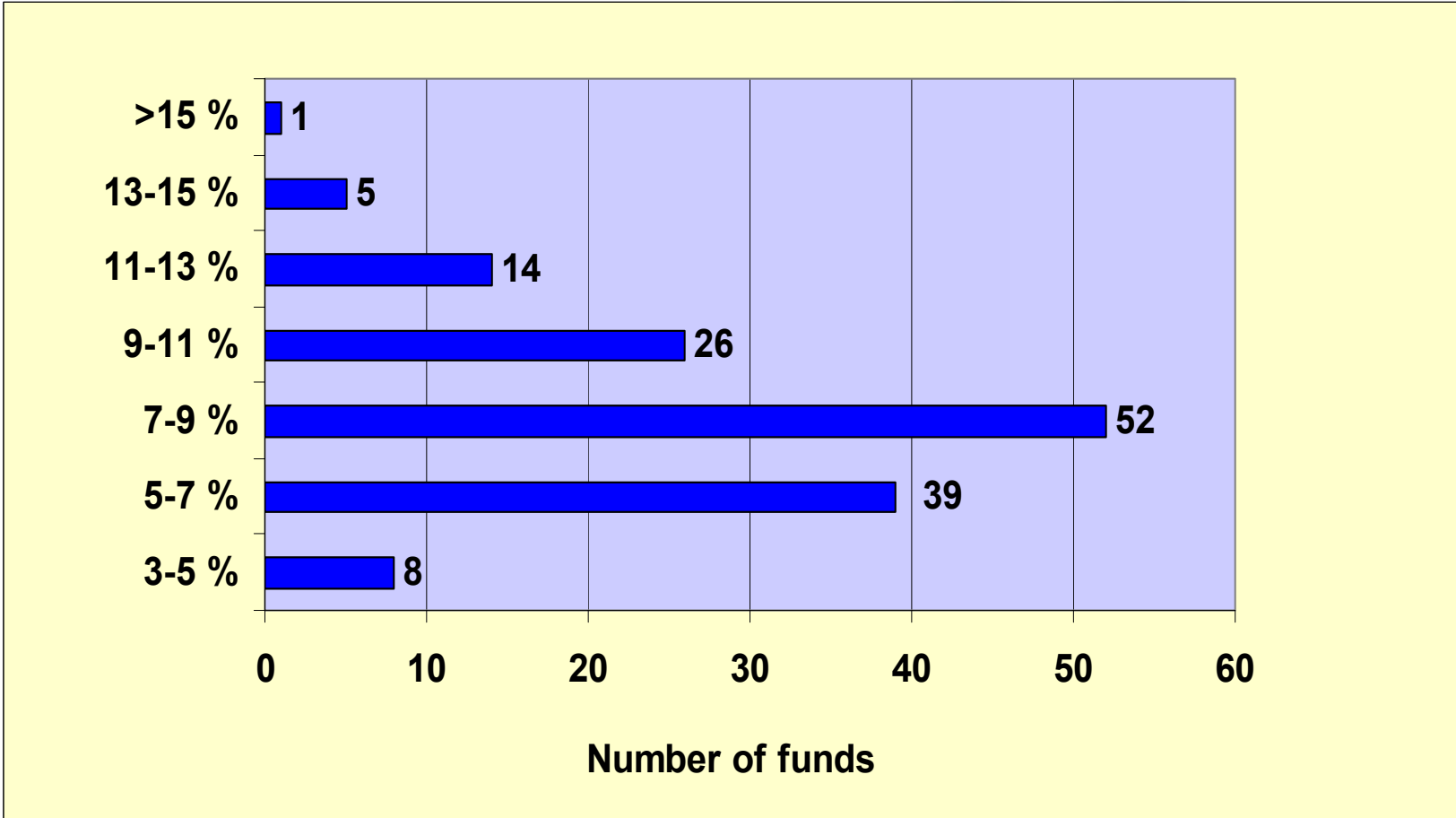
- **Underfunding:**
it is not equivalent to bankruptcy! It is only a signal of disruption between assets and liabilities, an alarm bell indicating something must be done
- **Underfunding is not dramatic as long as.....**
 - the fund must not be shut down
 - the cash-flow is enough to pay out running pensions and other benefits (like vested and transferable benefits)
 - measures on the financing and/or the liabilities side are taken to restore the equilibrium in the medium term (5 years)
- **Differences between public and private sector pension funds and insurance schemes:**
In Switzerland, private sector funds must in principle be in equilibrium at any time, while a technical deficit (usually in the range between 60% and 80%) is allowed for public sector funds (reasoning: they benefit from the permanence of the State...)

The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

- **Technical interest rate on accrued savings:**
Until the end of 2002, the rate was set at 4% (unchanged since 1985). Starting January 1st 2003, it was reduced to 3,25%, to take into account the adverse investment environment.
- **The effects of the bear market are compounded by the impact of the on-going increase in life expectancies:**
In most Swiss funds, retirement pensions are calculated using conversion rates which do not strictly reflect actuarial realities. This implies most funds lost money according to actuarial rules (i.e. paid out benefits were higher than the actuarial present value of the pensions). For most of the 90's, the funds covered the actuarial losses by achieving investment returns significantly higher than the technical interest rate.

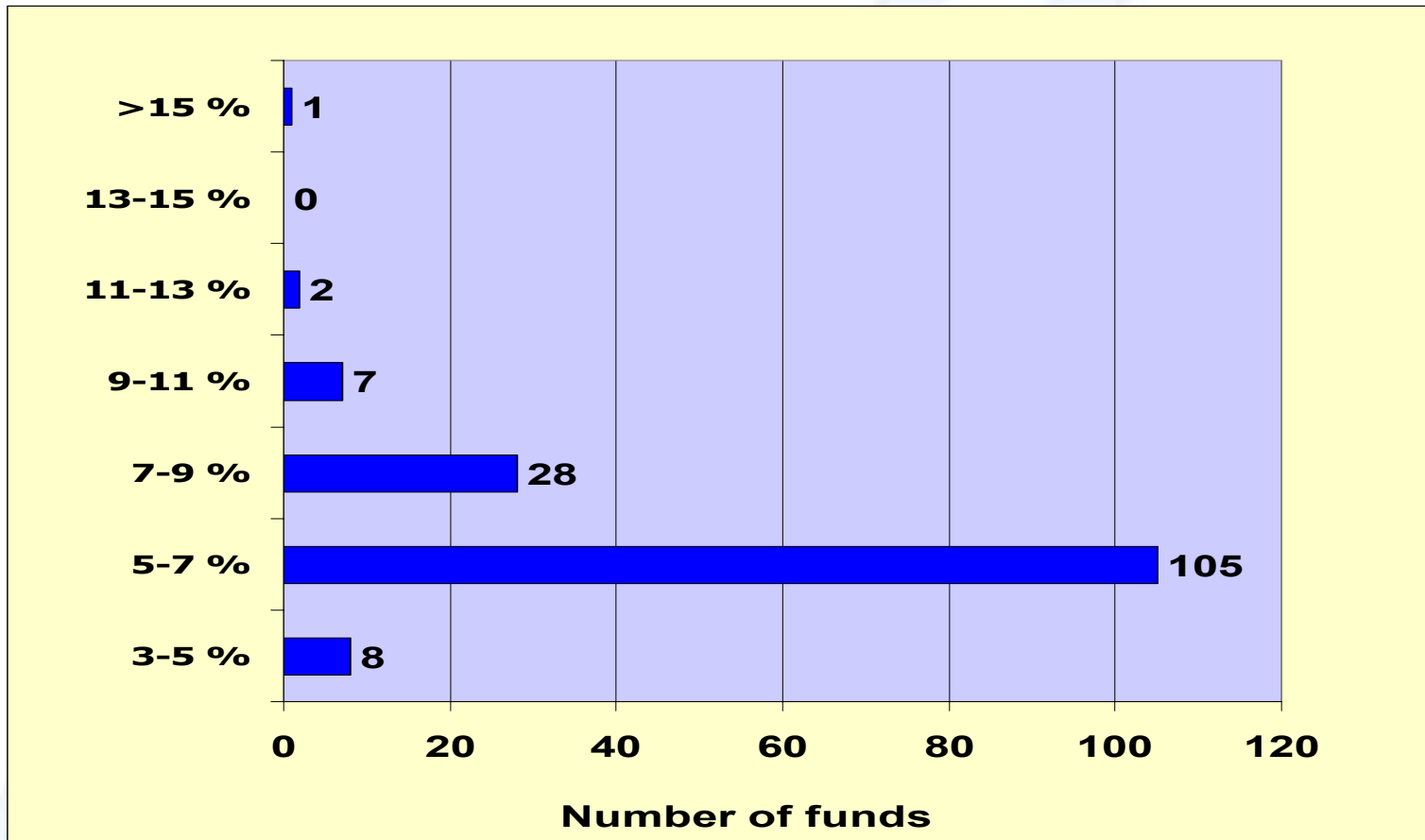
The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

Average performance of pension funds investments (sample), in percentage, 1996 - 2000



The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

Average long term expected performance of all investments, pension funds (sample), in percentage, 1996 – 2000



The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

■ **Distribution of excess investment returns to the employer and the employees, in Switzerland :**

- ↪ Excess returns can not be taken out of the pension scheme and refunded to the sponsoring company
- ↪ They can be kept in an employer's contribution reserve
- ↪ They can be distributed to the employees' accounts in the form of additional capital. This is what happened in many cases.



The problem is part of these assets are now missing....

■ **Building high enough securities fluctuation reserves to limit the effects of securities market drops:**

In the 90's, most pension funds had built up significant securities fluctuation reserves, which were supposed to buffer the negative effects of a bear market. As it now appears, these reserves could cover 1 or 2 years of bad performance, not 3, i.e. not a prolonged bear market as we experience it now

The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

- **Situation at the end of 2001, pension funds:**
At the end of that year, 237 funds (8% of the total) had a technical deficit (liabilities higher than assets) of 3% on average, according to official estimations. Some funds had difficulties, but on the whole the situation was under control.
- **Situation at the end of 2001, insurance companies:**
The situation was already tense with the life and pension insurance schemes, which have to guarantee at all times that their liabilities are fully matched by corresponding assets. Insurance companies were losing money in collective pension business for several years already. This triggered a "pension crisis" in summer 2002.

The consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium

- **Situation at the end of 2002, pension funds:**

It is now assumed according to official estimations that about 50% of all funds (including the public sector ones) have a technical deficit, most of them in the range between 90% and 99%, but we do not have many details so far. Most pension funds have now "eaten up" the reserves for securities fluctuations. As a result they have to adopt a more conservative asset allocation.

- **Situation at the end of march 2003, pension funds and insurance companies:**

Due to the drop in equity markets, the situation has worsened further. The government is preparing changes in the legal framework. The measures to be taken might be painful to the employer, the employees and the pension beneficiaries, but hopefully will be limited in time.

CONTENT

- 1. Introduction: Overview of the Swiss Pension Fund Market**
- 2. The Swiss Pension Fund Market: Graphs & Tables**
- 3. The Consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium**
- 4. Action Check-list: Liabilities
(and Assets Liabilities Management)**
- 5. Action Check-list: Assets
(and Changes in Asset Allocation)**

Action Check-list for pension funds: Liabilities (and Assets Liabilities Management)

- **Have an actuarial valuation redone with value date 31.12.2002, to have an up-to-date picture**
- **The same holds true for the assets & liabilities analysis:**
check all your assumptions very carefully, on the assets and liabilities sides
- **Do not hesitate to take painful decisions (for the employer and the employees):**
make sure these are provisional only and limited in time.

Action Check-list for pension funds: Liabilities (and Assets Liabilities Management)

- **All accrued and expected benefits should be fully accounted for in the liability side of the balance sheet, do not expect excess investment returns ("le 3e cotisant") to bail you out in the near future:**

Many Swiss funds used excess investment returns (above the technical rate of 4%, now 3,25%) to finance benefits which were not accounted for in the liabilities side of the balance sheet: to increase running pension benefits in line with inflation, to bridge individual financing gaps due to salary increases (in defined benefits schemes), etc.

Action Check-list for pension funds: Liabilities (and Assets Liabilities Management)

- **Reduce the interest rate on accrued savings:**
Such a measure is meaningful mostly in defined contribution schemes. For the compulsory schemes providing the minimum benefits required by the law, the rate was 4% and is now 3,25%. For all benefits exceeding the minimum, the rate was reduced in many cases (sometimes to 0%) in 2002 and the same measure might be taken in 2003
- **Introduce restriction in the transfer of vested benefits, in the rights to make use of individual occupational savings to buy a home or a flat**
- **Reduce the expected future benefits:**
This implies only future beneficiaries will be hurt, not existing ones. This measure has a large impact on the equilibrium and has the advantage that nobody is "hurt" now.
- **Reduce the running benefits:**
This is going to be more difficult, because such pensions are usually taken to be granted („droits acquis"). The Swiss authorities are likely to change the legislation in this respect, fast.

CONTENT

- 1. Introduction: Overview of the Swiss Pension Fund Market**
- 2. The Swiss Pension Fund Market: Graphs & Tables**
- 3. The Consequences of the 2000-2003 Bear Market on the Pension Funds Equilibrium**
- 4. Action Check-list: Liabilities
(and Assets Liabilities Management)**
- 5. Action Check-list: Assets
(and Changes in Asset Allocation)**

Action check-list for pension funds: Assets (and the Asset Allocation)

- **Use the reserve for securities fluctuations (if it has not yet disappeared)**
- **Use the employer's contribution reserve (if existing)**
- **If there is an employer's financing foundation, convince them to do a special payment to the pension fund**
- **Extraordinary cash or asset contribution by the employer to the fund:**
The contribution could take the form of a loan or a cash payment
- **Check whether all assets are accounted for at their market value:**
Sometimes assets are posted in the accounts at the acquisition value, check whether you could book some specific assets (e.g., real estate) at a higher price.
- **Increase temporarily the contribution rate and share it in a fair way between the employer, the employees and the pension beneficiaries :**
Make sure the measure is limited in time and may be changed at a later stage

Action check-list for pension funds: Assets (and the Asset Allocation)

- **Change the asset allocation and reduce the investment risk profile:**
If the pension fund has used its securities fluctuation reserves, it might need to adjust the asset allocation and to reduce the investment risk profile, e.g. by having more bonds, mortgages, etc.
- **Adjust the return expectations of the major asset classes to take into account the new economic and financial environment:**
Return expectations based on values from the 90's are no longer appropriate and must be adjusted to realistic values
- **Think of asset management in tactical, not just strategic terms:**
Maybe the good old days of "buy and hold" are over for a while. In the new environment, you might need to change your asset allocation more often, based on tactical rather than strategic considerations
- **Set absolute return targets:**
The overriding target of institutional investors is to achieve an investment return which is higher than the sum of the technical rate and the different costs (for administration, asset management, etc.). Their investment target is asymmetrical (they can not afford negative returns). This fact must be fully reflected in investment targets.

Action check-list for pension funds: Assets (and the Asset Allocation)

- **Give your asset managers the freedom to hedge and/or to increase the cash positions:**
Amend the investment guidelines of your mandates to make sure your managers can hedge their securities positions (equities, bonds, currencies) and can have very significant cash positions.
- **Check whether your managers are willing to take asset allocation bets or are just stock pickers:**
Banks and asset management firm usually tend to focus on stock picking and do not like to take huge asset allocation bets. In the new financial environment, such an approach might be inappropriate.
- **Make use of alternative investment strategies and products (e.g. hedge funds):**
Diversify your investment approach by including alternative, non-traditional investment strategies and products, like hedge funds.
- **If they do not add value, change your asset managers ... and your consultants:**
Do not stick to investment professionals who do not deliver added-value, just change, even after a relatively short period (1 or 2 year) !

CONTACT

Lusenti Partners Sàrl ▪
Rue Juste-Olivier 22 ▪
CH-1260 Nyon

Tel. ++41-22 365 70 70 ▪
Fax ++41-22 361 07 36 ▪
g.lusenti@lusenti-partners.ch

Consulting in Bear Markets : a Swiss consultant perspective.

**Your feedback is important to us in shaping the direction of future seminars.
Please take a few minutes to fill out the questionnaire below and return to
seminar staff.**

How would you rank the following aspects of this presentation ?

	Excellent	Good	Fair	Poor
Content	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Presentation (including visual components)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Length	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Relevance of topic	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Additional comments :

Disclaimer

This document is published purely for the purposes of information and contains no offer for the purchase or sale of financial instruments, neither is it a confirmation of any transaction unless expressly agreed otherwise. The information contained in this document is derived from sources that are considered reliable. All opinions and estimates in this document are based on the opinion of Dexia AM and can be changed without notice. It is up to investors to make their own investment decisions in the light of their own financial circumstances and investment aims and taking account of any laws and/or regulations that apply to them. The past performance of a product is by no means a guarantee of future results and the value of investments may increase or decrease. Dexia AM cannot be held liable for any direct or indirect damage or loss resulting from the use of this document. The contents of this document may be reproduced only with the prior written agreement of Dexia AM. The intellectual property rights of Dexia AM must be respected at all times.