MANAGEMENT OF PENSION FUND ASSETS PUBLIC VS PRIVATE SECTOR

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1\Introduction

•Pension assets tripled in 1990's – US$12.2 Trillion
•A source of business and gov't capital for infrastructure
•Help to develop the capital market
•Role of pension fund management is to
–Improve returns
–Reduce the contribution rates
–Preserve benefits

2\Role of Public and Private Sectors

•What is the Cooperation?
–Gov't
•To set rules and regulations
•Establish operating framework
•Education of public
–Private Sector
•To implement and manage within the rules and regulations
•Education of members
•The sales process
•Collect the funds and keep accurate records
•Safeguard the member's benefits and rights

3\Performance of Pension Investments Public vs. Private Sectors

•**International Evidence**
–Private sector, professionally managed funds achieved higher real returns and better service than public sector
•Especially so where
–"rule of law" is weak or absent
–public service is inefficacy or corrupt
•**World Bank Study – Year 2000**
–22 countries - developed and developing - where funds were managed in public sector
–Based on assumption that higher risks would be rewarded with higher returns
•**Result**
–Half the countries held risky portfolios <u>but</u> had negative real returns

–Half had positive but low returns (between 1-2%)
–Only Malaysia and Korea had positive returns for risk in excess of 3%
•**More Results**–The real rate of return for Chile (private sector) was over 10% (1982-1997)
–Worst were – Uganda, Peru and Zambia with negative returns -50% to -30%
–Comparing pension fund returns to short-term bank deposit for 20 countries
•Simple average returns are 1.8% lower than bank deposit rates
•More than half had returns less than short-term interest rates
•Sweden, Philippines, Korea & Japan had rates more than 1% higher than deposit rates
•**What should we expect?**
•**Since pension assets are really long-term savings – they should earn higher returns in exchange for lower liquidity rather than the riskless rate of return on liquid assets**
•**Pensions should be able to earn something close to the economy's long-term return on capital or greater than income growth**
•**Public managed funds were under-performers**
•**Comparing real annual compounded returns on publicly managed pension funds and real income per capital growth in the 22 countries produced the following results:**–Average returns were 8.4% below income growth
–Only 2 countries had bigger than income growth – Philippines & Morocco
–19/22 had returns lower than income growth
••**Research showed politically motivated investments don't work!**–Gov't pension plans dedicated to economically targeted investments (claim social & economic development objectives but there are inefficiencies in the capital market)•Had returns that averaged between 1.0% and 2.5% below those funds that operated in the best interest of the members

•**Where members funds were managed in the private sector**
–Market based returns did produce results 3 to 5 times higher than those promised in the gov't system
–Most Latin American private sector plans had real returns of between 7% to 11%
–Chile's real return for 22 years was 10.4%
–The average return are in private sector is more than 4% in excess of growth of incomes over the long run
–In Sweden and Japan, the private sector plans were better than public sector plans by 3% and 5% respectively

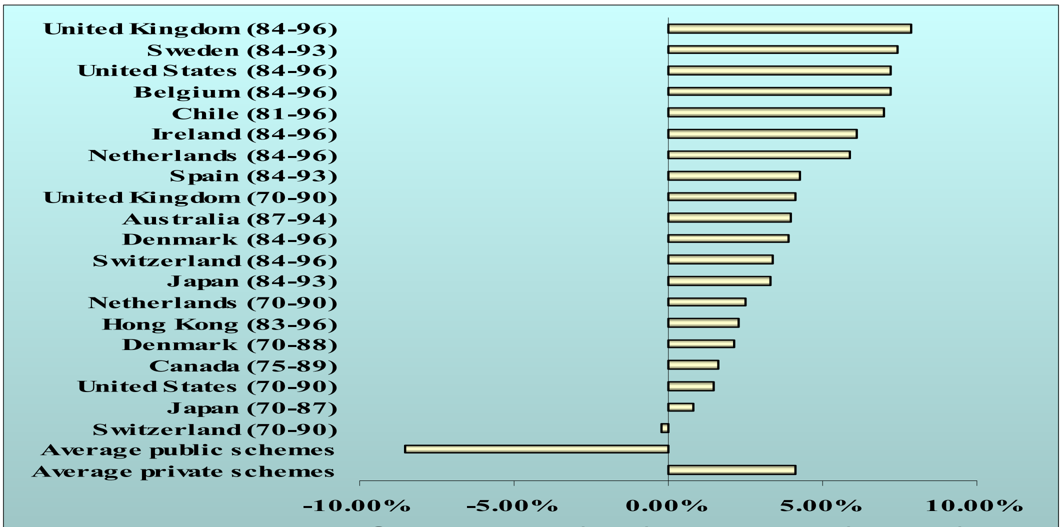

Figure 3

4\Why are Results Lower in the Public Sectora) Gov't run agencies have to balance conflicting aims

–Sometimes required to buy gov't securities at below market rates, e.g.

•USA – in 1985 Treasury ordered the sale of long-term bonds in trusts and converted the assets to non-interest bearing cash accounts ($28 Billion)

•Korea – late 1980s law channeled 2/3's of the National Pension Plan assets to "special loans"•Malaysia – Asian Financial Crisis – used EPF assets to support gov't projects

b) Governed by additional investment restrictions or directions–World Bank study of 34 Public Sector Plans•Average holdings of gov't bonds or fixed bank deposit was 75% of total assets

•1/3 of countries including Canada, Switzerland, India & USA, 100% of assets were invested in gov't bonds or fixed bank deposits

•Only 3% of portfolios were invested in shares

•–In private sector investments in ten OECD countries•Unweighted average in equities was 32% (1996)

•Weighted by assets – 50%

•Peru & Argentina – 22% and 35%

•Chile – 30%

c) Gov'ts take advantage to finance economically targeted investments

–Venezuela – 1980's bought State Enterprise Bonds

–Egypt & Morocco – pension assets invested in development banks

–Iran – several industrial units are financed by pension resources

–Jordan – in "development dimension" projects (infrastructure that may or may <u>not</u> be economically viable)

5\Risks of Politically Directed Investments

There are many debates on the risk of politically driven investments

a) Pension managers have responsibility to make best decisions in interest of the

members
–If the gov't manages the funds, and if the gov't has a policy, the fund managers will have to follow the policy
–May not be in best interests of the members
b) Gov't controlled investment open doors to corruption by steering resources in a certain direction
c)Gov't controlled investments invites "politically correct" decisions at the expense of retirees
d)d)Gov't controlled investments could allow gov't to purchase significant share of publicly traded companies
–Could use it's power to interfere in management
–Political incentives could be more important than economic incentives
•**Summary**
–Even well intentioned policy-makers are not qualified to invest pension funds and manage money
–Poor investment decisions have dire consequences on the benefits
e.g. Singapore – public sector 3%average returns
–Hands off by gov't can be positive – e.g. Hong Kong
•Guaranteed funds must be offered along with other market based funds but all in the private sector
•Quality of investments is mandated

6\Concerns Regarding Private Sector Management
•**Costs of private sector management are higher but are offset by better returns**
••**Effective Regulation is essential**–Licensing investment managers
–Restrictions on quality and diversification
–Close monitoring

7\Conclusions
•**World Bank Report shows**–Public managed plans are often used to achieve politically correct objectives
–It is hard to avoid political interference for a variety of reasons
–Funds earned lower returns
–Usually with inefficient service relative to the private sector
–Investment professionals, even with rules and regulations, will do better than gov't
–Fiduciary responsibility for members benefits prevails with better performance