Seventh Annual Senior Level Policy Seminar on:
Pension and Investments 2002 Future Benefits through Effective and Efficient Investment and Management in the Caribbean

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Session #2

Opportunities/Obstacles for the Investment of Pension Funds in the Caribbean

Good morning, chairman, fellow panelist/speakers, ladies and gentlemen. I don't know which is more difficult trying to hold your attention prior to lunch or just after. Well in good cricketing form, I am going to dig in and hope to not loose my concentration or my wicket prior to the close of the session. An intermittent shout of "No" from the audience might help to see my through.

Before I make my contribution on this particular topic, I would like to first thank the Caribbean Centre for Monetary Studies as well as the co-sponsor CAlC for the gracious invitation for me to make a presentation at this seminar. It is indeed a pleasure for me to have this opportunity to engage in a dialogue with such a representative and esteemed gathering here in the region and on such a very important topic.

As I anticipated several of the earlier speakers covered much of the key issues already. For that reason and due to the limited time available, as well as because I tend to prefer an exchange of views rather than a one-way flow of information, I will be fairly brief in my presentation. And I will reserve most of the more involved or detailed issues that I would like to discuss with you to come in direct response to questions whether in the formal Q&A segment or otherwise.

I would like to make just a few key points that in my opinion are central to the issue of opportunities and obstacles to the Investment of Pension Funds in the region. While as we are well aware that the provision of pension benefits at retirement may come from a variety of sources namely, individual retirement accounts, employer sponsored programs, labor union and trade association programs, as well as municipal and nationally sponsored programs. You are also well aware of the distinctions between the defined benefit vs. defined contribution and pay-as-you-go vs. funded or partially funded plans. I want to focus my comments on the defined benefit national insurance/social security type pension funds. Mainly because these are the type of arrangements we all can relate to.

The opportunities and obstacles to the investment of these funds are probably best analyzed from a review of the core strategic objectives of these funds. Based on my ongoing discussions with defined benefit plans in North America and in developing countries such as Caribbean and Africa, the core objective of the investment of fund assets seems to revolve around the requirement that those assets are sufficient to meet the defined benefit liability obligations when they come due. All other objectives appear to be a subset of this core mandate.

The opportunities and obstacles or threats arise when either the assets don't behave the way we expected them to or the liabilities don't behave the way we expect them to. Either they do better than we expect worst than we expect or just behave different.

The specific obstacles that I have observed in relation to the Investment of Public Pension Funds in the Caribbean are as follows:

1. They are often the single source of pension benefits to most persons in the country. They are unlike the layered or multiple source arrangements in North America. This has a limiting effect on the particular risk profile/tolerance of these institutions and consequently the ability to generate returns sufficient to meet the actuarial hurdle.

2. There are also either psychological, policy or legal limits on external investments that result in a lack of diversification of the fund. One of the key developments in modern portfolio theory is the concept of diversification. Simply put, the theory holds that what is important is portfolio risk and not individual risk of securities in the portfolio. Thus, a diversified basket of individually risky securities combined in a portfolio could result in higher risk -adjusted returns due to the co-variance and correlation between the paired securities in the portfolio. Basically, a long-winded way of saying what my grandmother knew and that is you can't put all your eggs in one basket. The lack of diversification and concentration of investment exposes these funds to significant levels of systemic risk. I would even go further to say that restricting both the liabilities and the assets to domestic market investments begs the question as to whether the fund in fact provides insurance at all (I will expand on ad hoc basis).

3. Limited investment opportunities domestically. In most of the countries in the Caribbean the investment instruments and opportunities are quite limited in relation to the quantum of assets that these institutions need to invest. There are limits on the absorptive capacity of various domestic markets to handle the amount of funds to be invested as well.

4. Short-term public policy objectives may take precedence over long-term fiduciary obligations. There are often calls for increased benefits or structural changes that while appealing to perhaps short-term political and other public policy requirements may run contrary to the prudent long-term fiduciary requirements. Governance and accountability framework (the agency issue) of accepting under performance in relation to requirements by large well known money managers. These actions and decisions safeguard the positions of the individual management and policy makers, but do little to meet the benefit requirements of beneficiaries.

5. Perhaps a need to strengthen the internal investment management capacity and understanding of these institutions would also be useful. Here I am not suggesting that attempts be made to replicate the investment management function as undertaken by money managers. Rather I am suggesting the

provision of sufficient capacity (skills) to more adequately monitor and control the process, as well as to effectively communicate key issues to policy makers.

6. The tendency to use packaged products vs. tailored asset management strategies that are more relevant to the specific nature and structure of the liabilities of these institutions. E.g. NIS's have a combination of insurance like and pension liabilities. In North America these institutions tend to have a good understanding of their particular risk and return objectives and are in a better position to select from the grocery list of canned products available. They then do the tailoring that is required themselves. This is certainly not the case in most developing country situations that I have seen.

7. How these institutions measure risk of the portfolio, can lead to some portfolio structures that would on the surface seem quite safe but when considered in the context of the particular liability obligations may be quite risky. Here the challenge is to evaluate the situation not based on individuals personal perspectives on risk and risk aversion, but instead what is relevant, suitably and prudent for the institution.

The good news is that while these challenges exist there are also several opportunities that these institutions could take advantage of as well, namely:

1. Most of the major asset classes and their sub-classes/styles and a variety of related investment strategies display low correlations with emerging markets. In addition, several offer superior returns relative to domestic investments. This presents the opportunity to enhance returns, while reducing risk via judicious allocations of the total investment fund to external markets. These allocations could be undertaken incrementally or from positive cash-flow in order to limit any negative impact on the domestic markets.

2. Externally there is a wider range of available investment opportunities with differing characteristics in terms of risk and return profile. This allows flexibility in tailoring appropriate investment programs that not only meet the risk and return profile of the fund, but also can address changes in those requirements going forward. Risk tolerance generally does not remain constant, it has to be regularly reassessed and may change to such an extent that adjustments to the structure of the portfolio are required. These adjustments are much easier to make in the external liquid capital markets.

3. Portfolio/investment management has developed a range of tested mechanisms for structuring portfolios that meet specific requirements for performance while limiting downside risk. Modern best practices in investment management have developed a range of tools for effectively measuring and efficiently managing risk in the investment process that allow for better asset management in order to meet client requirements. For example; benchmarking, portfolio insurance, hedging techniques, and rigorous risk management practices are now accepted best practice in investment management.

4. The long time horizon of these funds allows the opportunity to structure portfolios that target performance in excess of the actuarial hurdle with low volatility and

take advantage of compound returns. Here I am not suggesting as some do in the more developed markets in North America that this means there should be a large exposures to equities because the inherent volatility can be withstood by the long time horizon. Instead my preference is for a more steady and consistent approach that uses. the time horizon to grow the assets at an exponential rate due to compounding of consistent positive returns.

5. The regional capital markets are developing and will continue to present opportunities in the future. I have spent ten years working for the development and integration of capital markets in the region and I am a firm believer that there are currently opportunities for investment within the region and that these opportunities will grow. However, investments have to be sufficiently liquid to be able to take advantage of these opportunities in a significant way when they become available. Thus holding some assets in liquid external or foreign investments not only generates the benefits indicated earlier, but allows these funds to be responsive to domestic or regional opportunities that will emerge.

I would just like to conclude by reminding us that the one constant that we must take account of in all of this is the issue of change and the ability to respond effectively to change and in many instances to be proactive. There have been so many fundamental changes in various aspects of the human condition over the last two decades (Berlin Wall, etc.). It may be useful to adhere to the risk management posture of the prudent investor - "When times are good, get worried. As the decisions you make then will determine how you do when times are bad".

Thank You

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