# ‘Prudent Man’ & European Pensions

*A collection of essays*

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# Preface

The debate over the prudent man rule is central to the future development of pension funds across Europe. I am delighted that so many distinguished authors have contributed to the first publication of the newly formed European Asset Management Association, whose members' largest clients are Europe's current and future pensioners.

If the Single Market in financial services is to operate for the benefit of pensioners and other investors, rules governing pension funds must be limited to those that advance their interests. The importance of pension funds to individuals and to society dictates a certain level of regulation. But in seeking to protect individuals, regulation must not prevent pension funds from growing to their full potential. It would be disappointing if pensions regulation were used to advance extraneous economic or national causes.

It is welcome that in its consultations on pensions regulation the European Commission has identified the prudent man rule as the guiding principle for pensions regulation that best meets these objectives. As a number of the following articles make clear, the interests of Europe's current and future pensioners are diverse and changing, according to pensioners' individual circumstances. A prescriptive approach could not reflect this diversity.

With Europe facing up to the challenge of future pensions provision, its peoples must have confidence in the system of pension regulation. They must know that their interests are protected, but also that regulation does not hold them back.

The prudent man rule is especially appropriate for pan-European pensions regulation because it is a concept that has strong resonances in a number of European cultures. It is true that for pensions regulation, the principle has come to be viewed as an Anglo-Saxon approach. But the concept of 'bon père de famille' is part of the French cultural bedrock, just as the principle of the prudent management of another's estates has been recognised in all cultures for as long as there have been estates to manage.

With this broad heritage in mind, it has been particularly rewarding to draw together contributions to the prudent man debate from a wide range of different national and professional perspectives.

Contributors were not given specific or individual briefs beyond giving their view on the prudent man rule in the regulation of pension funds. Some have written of practical experiences with pension fund regulation, whilst others have approached the topic from a more theoretical perspective. Articles have been published in full without any interference as to opinion or content. All articles are included in the language in which they were written, although for the sake of continuity the main body of text contains English translations of articles originally written in French. For those that are able, I would urge readers to tackle these articles in their original language in the appendix, the vagaries of translation having inevitably diminished the subtlety of their content.

An international co-production does not come about without the assistance of many hands. I am particularly grateful to all the authors, and to Pierre Bollon, Ann Fitzgerald, Michael Haag, Alain Leclair, Klaus Mössle and Thomas O'Malley, for their roles in bringing this series of essays to publication. It is appropriate that many of those who have contributed to the birth of our new Association have also had a hand in its first publication.

The European Asset Management Association has been formed to represent the distinct interests of investment managers at a European level. Its founder members include the asset management trade associations of France, Ireland, Italy, Spain and the United Kingdom; with around thirty of Europe's largest asset management companies as corporate members. We shall work with the institutions of the European Union, and where appropriate its Member States, to ensure a strong European investment management industry.

**Donald H Brydon**
*President, European Asset Management Association*

January 2000

# The philosophy of risk & the 'prudent man principle' in relation to pension funds

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## 1. Introduction

By joining European Monetary Union on 1/1/1999, the member states have moved another step closer together.[1] This applies not only to the monetary environment, it also holds true at the economic and social policy levels. The latter must also be seen against the background of the increasing mobility of labour, which leads to a competition of different systems.

On closer examination, we see that there are two conflicting financing methods for company pension plans within Europe: Whereas in the Anglo-Saxon world, especially, the principle of external financing predominates, occupational pension plans in other countries – and here we would like to mention Germany, in particular – rely on internal financing.

In countries such as the United Kingdom, Ireland and the Netherlands, pension funds are the pillars of company pension schemes. There, the persons responsible for investing are 'relatively free' to decide on the investment of the available pension assets. We will take a closer look at this 'freedom' in this article and compare it, primarily, with the strict investment regulations imposed on pension funds in Germany, for instance.

Especially in the light of the 'pension fund debate' that has arisen in the area of occupational pension plans in Germany, these considerations ought to be taken into account when discussing the introduction of alternative financing methods for pension schemes.

For the purpose of analysing risk structures and with respect to investment policy considerations, we will assume an **'ideal pension fund'** in the following. It shall be an autonomous facility whose assets are managed and controlled by the institution of a trustee in a 'relatively free' and 'independent' manner.[2]

We will not go into other features of an ideal pension fund, such as legal structure, tax difficulties, etc.

Rather, we will carry out in-depth analysis of the previously mentioned characteristics; 'relatively free' and 'independent' investment. This overall analysis includes the problems connected with the 'prudent man principle' about to be discussed.

## 2. Benefit system of a pension fund

As regards the benefit system of an ideal pension fund, we distinguish two approaches. For practical reasons, we will restrict our analysis to systems that are exclusively sponsored by the employers (plan sponsors).

With a **'defined contribution plan'**, the plan sponsor undertakes to make a contribution to the fund, during defined periods, that is either fixed or can be determined objectively. This amount is 'credited' to the employee. Once the contribution has been transferred to the fund, the sponsor is released from any other liabilities. His 'commitment' only extends to paying the respective amount.

The fund itself is then faced with the problem of investment. The actual utilisation of the assets will also depend on any additional agreements that have been concluded. For instance, it may be agreed that the entire contribution shall be invested at the capital market. When a pensionable incident occurs, the individual beneficiary will receive a fairly large amount, provided the performance has been good; if the investment has been less successful, the output will naturally be lower. It is also possible to feed the said contribution into an insurance. This could be done, for instance, for the purpose of hedging specific risks (premature death, disability). Further, there may be plans that combine these two designs.

A **'defined benefit plan'** gives priority to the primary definition of the beneficiaries' pension entitlements. These are documented in a benefit plan. If the entitlements shall be satisfied through the fund, this raises the question about adequate contributions. Here, the required allocations can be determined on an actuarial basis. If the fund has invested the calculated contribution, and the performance – for whatever reason – has been insufficient to ensure payment of the pension benefits, the resulting pension gaps must be closed. This is where the classical defined contribution and defined benefit systems are fundamentally different.

In the following section, we will analyse the risks in more detail and especially address the question who has to bear them. Note that in Germany, the defined contribution model is currently not promoted by the government. This means that *de jure* – i.e. with regard to labour and tax law – occupational pension schemes are restricted exclusively to defined benefit plans.[3] Only the recent reform proposals have tried to introduce defined contribution systems in the area of occupational pensions.[4]

## 3. Risk structures

We will now look at the beneficiaries of an underlying collective who expect to receive benefits from an ideal pension fund.

In the case of a **defined benefit plan**, the promised benefits have to be converted into adequate contributions, which the sponsor must make to the fund. As explained above, this conversion takes place on an actuarial basis. It is founded on statistics drawn from past experience (mortality tables, disability tables, etc.), possibly modified to reflect developments expected in the future (projectivity).

At the technical controlling level, a so-called actuarial reserve, also known as premium reserve, has to be calculated in parallel. This figure tells us how much money must be available / have accrued arithmetically from past contributions, so that, together with the expected contribution payments, it will be sufficient for paying the benefits expected according to the benefit plan. If benefit units are always financed by means of lump sum contributions, we also speak of the projected unit credit method. In Anglo-Saxon countries, reserve calculations usually take pay and pension trends into account (projected benefit obligation).

So what are the 'risks'? The calculation itself, as is explained above, is based on statistics and / or expectations. If the actual developments deviate from the forecasts, the liability will be insufficiently covered. This makes it necessary to alter the actuarial assumptions and make appropriate adjustments to raise the amount of existing assets up to the level that is required according to the calculation. Temporary fluctuations in biometrical developments may also make adjustments necessary.

This 'pending' risk of having carried out the required calculations with too optimistic data therefore represents a permanent threat to the lasting operations of the pension fund (**actuarial risk**). We will discuss risk policy methods that are designed to counteract this risk.

There is no actuarial risk in the case of **defined contribution plans**, because there, the entire actuarial background for determining the 'equilibrium' between contributions and reserves on the one hand and contributions and benefits on the other is lacking. For here – as mentioned above – the promise consists in the primary determination of the contributions, whereas the benefits paid out to a beneficiary are derived solely from the available assets.

As soon as the pension fund has received contributions from the sponsor, the trustee has to tackle the problem of investment. In this context, we speak of the **‘investment risk’** as the pending threat of failing to obtain the forecast yields and causing financing gaps. In principle, the available capital has to be invested in a way that the liabilities associated with it can be met lastingly.

If, for instance, the contributions to a **defined benefit plan** have been calculated on the basis of a specific interest rate, the return on the invested money must by no means be lower than this rate. Otherwise, an additional financing requirement would arise technically. As the plan design is based on a defined benefit pension promise, it is the plan sponsor who would be obliged to close any financing gaps. The investment risk in a defined benefit system is therefore borne by the employer.

This is different with a **defined contribution plan**. Since the expected benefits depend solely on the existing assets, the investment risk is borne by the employee. With this plan design, the employer is definitively released from liability in case of under-performance.

This is the point of view of the *classical* defined benefit and defined contribution plans.

A more elaborate approach is found in the more recent pension fund model ‘second pillar’ (‘Zweite Säule’), put forward by the German association of occupational pension plans in Heidelberg, which is being discussed in Germany. This model complements the contribution-based system with a **minimum benefit** for the employee, which consists of the nominal amount of promised contributions minus any portions that have been used for installing additional risk protection (net contributions). As far as the pension assets of the fund to be allocated to an employee fall short of the prescribed minimum, the employee is entitled to receive compensation for this difference from the employer. This model in the framework of the defined contribution pension promise ensures that the risk is adequately distributed between the two sides, the employer and the employee.

Further, the insolvency law framework is laid out in this model in a way that ‘defined contribution pension plans, in the same way as defined benefit pension plans, are subject to insolvency protection according to sections 7 ff. of the Company Pension Plans Act (BetrAVG)’[5] with respect to the employer's existing accountability or remaining subsidiary accountability for pension benefits.

## 4. Risk management and the prudent man principle

We will now discuss different approaches towards risk management. We are going to compare the approach typical for German Pensionskassen with the more liberal 'prudent man principle' that is taken up by the ideal pension fund.

*4(a) Risk management explained with the example of a German Pensionskasse*

Risk management for a German Pensionskasse is primarily rooted in a catalogue of **regulations**, which must be observed by the investor responsible for the Kasse or by the legal fiduciary status.[6] This refers, first of all, to the rules directed at the capital investment itself, but it also applies to the area of so-called solvability requirements.

Investment of the pension assets by the Pensionskasse is subject to the stringent rules set forth in the Insurance Supervision Act.[7] 'The assets of the Deckungsstock [fund] (section 66) and the other restricted assets .. shall .. be invested in a way which ensures maximum security and profitability, while maintaining ... liquidity at all times, through adequate diversification and spread.'[8] Besides this provision, section 54a of the Insurance Supervision Act enumerates and explains specific types of investment and imposes ceilings on some of them in the form of quotas. The best-known example for such restrictive investment rules is, in simplified terms, the upper limit of 30 per cent stipulated for investment in equities.

It is in this context that we have to place the principles of securities allocation and currency matching. These principles govern investment abroad. Essentially, only securities located in the European Community can be used as cover,[9] and investments in currencies that do not match the currency of the liabilities are, in principle, limited to a maximum of 20 per cent.[10]

Pensionskassen had to fulfil the **'solvability requirements'** by 31/12/1999 at the latest.[11] These conditions set forth in the Kapitalausstattungsverordnung (similar to the Minimum Funding Requirement) represent an element of risk management which shall serve to take actuarial and investment-related uncertainties into account.

In simplified terms, the solvability range can be expressed by the following sum: 4 per cent of the actuarial reserve plus 0.3 per cent of the risk capital.[12] The percentage of the reserve (1st summand) serves to hedge the investment risk, whereas the percentage of the risk capital (2nd summand) shall take the uncertainty of the statistical basic data into account.

*4(b) Prudent man principle in the ideal pension fund*

The regulatory rigour which we portrayed in the example of investment principles for German Pensionskassen contrasts with the 'prudent man principle' as a **liberal code of conduct**. This principle affects the sphere of administration and investment principles in a qualitative way initially.

Whilst there is no catalogue of fixed or statutory guidelines, we can cite patterns of conduct and characteristics that define the 'prudent man'.[13] We might say that it is his highest duty under this principle to safeguard the interests of the beneficiaries and to protect their objective entitlements. Hence, it is of key importance that he ensures that the fund can provide the benefits lastingly. Characteristically, the available capital is invested with the aim of obtaining the required return whilst avoiding unnecessary risk.

But what are the instruments with which 'prudent principles' can be realised? First and foremost, of course, there is the requirement of appropriate asset diversification and spread. When analysing the category of 'performance', we will have to refer to a number of factors which, in the context of investment policy, have a crucial impact on achieving growth.

Let us first mention the allocation strategy, i.e. the problem of distributing the investment of assets among various countries, currencies and sectors. Of particular importance, also with respect to the associated volatilities, is the decision how to weight individual asset classes (equities, bonds, cash, etc.). As regards the actual selection of instruments, the size of the represented companies may also be relevant to a certain degree (size effect). In addition, credit quality (rating) plays a special role as well. Finally, general aspects of duration have to be taken into account; i.e. the time-horizon of the investment needs to be adjusted to the liquidity requirements.

The investment process also occupies a special position with regard to the expected performance. Here, it is especially the investment approach (active / passive) selected by the fund management that must be inspected, team consistency must be examined, and questions concerning the creativity and flexibility of the fund managers have to be answered. Timing and selective deviations from a defined benchmark are relevant here, as are hedging strategies and, naturally, the research basis. We also have to remember that the cost structures eventually impact on overall performance. This shows that professional asset management research is indispensable. But it requires expert knowledge.

Modern instruments, such as professional asset-liability management (ALM), are particularly relevant to a suitable asset allocation strategy. ALM combines the actuarial requirements on the liability side with the financing possibilities within a concrete portfolio strategy, especially taking into account expected cash flows and the fulfilment of required funding levels.

But what we derive here, in particular, is that the 'prudent man' must be competent in both fields, i.e. in actuarial as well as investment matters.

Aspects of securities allocation and currency matching, such as apply to Pensionskassen, should play no special role with the 'prudent man principle'. The requirement of calculable risk structures automatically determines the inherent objectives.

Special consideration must be given, finally, to professional controlling of the aggregate investment, which calls not only for performance measuring, but also for periodic alignment of assets and liabilities, and this once again touches the ALM level. In this way, questions as to strategy and allocation may be raised anew and necessary corrections can be made in due time.

**5. Conclusion**

Rigid investment policy rules make it impossible for a pension fund to seize opportunities in an appropriate manner, especially against the background of the increasingly rapid changes which the markets are undergoing.

A more liberal approach towards application of the 'prudent man principle' could be the basis for enhancing performance lastingly.

With this principle, investment decisions are made on the basis of a standardised code of conduct. While taking calculable risks, fund managers protect and optimise the beneficiaries' interests (a central element). The deployment of modern pension and financial instruments (asset liability management) is of fundamental importance in this context. This also implies, however, that we must demand special skills in the most diverse fields from the persons responsible.

[1] It is worth noting that this statement certainly goes beyond the 11 countries which joined to become founding members of EMU. For instance, the United Kingdom and Denmark had fulfilled the convergence criteria, but they opted out of EMU for political reasons.

[2] The pension fund should be adequately funded; an assumption which we can consider as fulfilled if the liabilities are covered according to actuarial methods.

[3] Cf. Ahrend, Förster, Rößler: 'Steuerrecht der betrieblichen Altersversorgung mit arbeitsrechtlicher Grundlegung', 4th ed., Cologne 1997, Part 1: pp. 11 ff., for the legal definition of 'Betriebliche Altersversorgung' (company pension schemes).

[4] Cf. 1) 'Zweite Säule' [second pillar] model, Arbeitsgemeinschaft für betriebliche Altersversorgung (aba) [German association of occupational pension plans], Heidelberg, June 1998, 2) „Bericht des Arbeitskreises ‚Betriebliche Pensionsfonds' im Auftrag des ‚Forums Finanzplatz' beim Bundesministerium der Finanzen', series of publications by the Federal Finance Ministry, vol. 64, Bonn 1998

[5] Cf. 'Zweite Säule' [second pillar] model, Arbeitsgemeinschaft für betriebliche Altersversorgung (aba) [German association of occupational pension plans], Heidelberg, June 1998: p. 29

[6] Cf. VAG [Insurance Supervision Act], sections 70 ff.

[7] Cf. VAG, sections 54 ff.

[8] Cf. VAG, section 54 subsection 1

[9] Cf. VAG, section 54a subsection 6

[10] Cf. VAG, section 54a subsection 3, in conjunction with Annex C of the VAG

[11] Cf. 'Publications of the Insurance Supervisory Authority', vol. 1996: p. 273

[12] Cf. 'Publications of the Insurance Supervisory Authority', vol. 1997: p. 219. We will refrain from an exact derivation of the term 'risk capital' here.

[13] Of course, this need not be a person in the narrower sense in this context. 'Prudent man' may also refer to an institution or the members of a board of trustees, for instance, in their function as trustees.

# Some thoughts on the prudent man rule

**André Babeau**

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The prudent man rule is a good example of a customary law, which is based less on written rules than on practicalities, and which therefore goes against the written law of countries where the influence of Roman law was the strongest. This rule, to our knowledge, has been applied since the turn of the twentieth century, in Anglo-Saxon countries, to managers of pension funds, life insurance contracts (for contracts in EURO as well as for those in national currencies). More generally, it applies to all managers of investment companies who have to render accounts to third parties.

In many continental European countries relatively strict regulations developed, firstly between the two wars and especially since the Second World War. These imposed limitations on the freedom to invest, in particular in asset management corresponding to investments within the framework of life insurance contracts. Several aspects of these regulations have either hardly been used, or have led to rather disappointing results. It is therefore understandable that the different authorities responsible for ensuring both security and effectiveness of funds management, and in particular the authorities of the European Union (Commission, Parliament, special European commissions), have questioned whether it would be preferable to free themselves of written rules in order to allow greater flexibility within the framework of the 'prudent man' approach, applied as comprehensively as possible.

The prudent man rule is often translated as 'gestion en bon père de famille' (management like the father of the family). From a philosophical point of view, the *pater familias* as depicted by Saint Thomas, could without doubt shed some light on the 'sense of responsibilities', the exercise of a natural foresight, but also caution, the practice of dialogue in the family, etc.

To pass from philosophy to reality, it is clear that the recent lowering of interest rates and the need to increase the proportion of shares in portfolios to increase returns probably introduces a need for a broader application of the prudent man rule and the exploitation of opportunities in this area.

In a concrete way, the prudent man rule appears to have a very wide application since it also concerns:

- accounting principles (for example, the accruals concept and reference to market value);
- the rules of management (for example, provisions, spread of investments, covering short-term liability by liquid securities, etc.);
- a guaranteed and controlled environment – in which context there is still a long way to go before the 15 countries of the European Union become harmonised, despite the directives which have already been enacted in certain fields.

For its part, the Legal Affairs and Citizens' Rights Committee of the European Parliament, in its report on the Green Paper of the Commission concerning supplementary pensions in the single market (December 1998), cites no less than six areas in which the principle of the prudent man would applied.

Reference to the 'prudent man rule' is certainly useful and liberalising in as far as it leads to the questioning of certain unhelpful or even harmful regulations. But its translation into reality and into practice requires a lot more reflection and this will take time.

# Prudent man rule

**Denis Chemillier-Gendreau**
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The idea of imposing investment restrictions on pension funds is natural and understandable. Advocates of such restraints can always come up with an example where freedom has led to detrimental results. It may well be natural and understandable, but it is also difficult to judge the effects.

Put briefly, the question is, can prudence, which represented by the 'father of the family' image, legitimise or lead to the institution of restrictions on investment (spreads, diversification, asset allocation, matching)?

Putting to one side for the moment all the less respectable reasons which an MP from the South West of France might find for investment in wine production or an Italian senator for keeping a portion of assets aside for the shoe industry. We must nevertheless be aware that the principle of investment restrictions is a Pandora's box which we may open citing prudence but into which we risk falling in the name of regional or professional interests.

What is prudence? Some say it is 'to take the least possible risk'. But if prudence is a virtue it is only such in as much as it can be measured. When it is confused with fear it ceases to be a virtue.

Prudence is rather the art of taking **measured and proportionate** risks at the wish of the investor. Prudence therefore is not an absolute but a **relative** concept.

But what is it relative to?

In the first place it is relative to the personality of the investor, to their 'degree of aversion to risk', which is as subjective as tastes or colours. To some extent this depends on the state of the investor's affairs. A 'father of the family' who already has first and second homes and an inheritance will be more ready to take a risk with his retirement savings than his neighbour who has no capital.

But age, and therefore the duration of the investment, is a key variable because financial assets change their nature over time. Shares, specifically, are very volatile in the short term, but their volatility diminishes the longer they are held. The paradox of investment management is that the **same** prudence which recommends fixed interest products in the short term would recommend, for the longer term, investment in shares.

That is why any quantitative or qualitative restriction on investments and on their allocation would only be acceptable in as much as it was compatible

with the infinite diversity of the wishes and personal situations of investors. Put in this way the question has an obvious answer: such restrictions are not desirable because they cannot provide, or be suitable, for all situations. The same asset allocation cannot satisfy **both** the well-paid young employee, who is eager to take risks, and the employee on a modest income nearing retirement, who is strongly 'risk averse'.

The Thomas law failed; despite being flawed it was a welcome attempt. The proposals attempted to adjust the freedom of the investment manager to the duration of the liability. Although commendable, the result was cumbersome and impractical.

As restrictions cannot suit everyone they must be abandoned. Perhaps that is not such a bad thing. Surely the role of investment managers is precisely to manage investment risks according to characteristics and needs of their clients.

It is worth looking at one last argument: the role of the state as lender of last resort (if the pension fund goes bankrupt, the state bear the consequences, via, for example, the state pension). This creates the danger of moral hazard. It would therefore be necessary to impose investment restrictions on the investor for his own good, in order to prevent him becoming a burden on the public authorities in case of failure. Let us acknowledge that this risk is low, since future pensioners scrutinise the management of their pension funds carefully.

In fact, the true 'prudent man' rule lies in the duty of information, of reporting, of transparency in the management of a portfolio, rather than in the restrictions – which are devalued by wanting to treat everyone in the same way, thereby adding to their opponents.

# Stand by your prudent man!

**Koen De Ryck**
*Managing Director, Pragma Consulting*

The prudent man rule reaches far beyond the application to investments for which it is best known. We suggest looking at surrounding and broader aspects of prudence by considering, related to pension provision, a few items that are not or may not be prudent.

The most worrying policy issue for the future is how to cope with the ageing process. Is it prudent that a number of governments, even today, persist in the thinking that there is no problem with unfunded Pay-As-You-Go (PAYG) pensions and that everything will fall into place? Countries must stop promising their future elderly populations state pensions which cannot be remotely met by present taxes and social security contribution rates. Is it not time to reveal the whole story to the younger population and to admit that choices will have to be made, i.e. that either state pensions will have to be substantially decreased or that we have to accept that a far bigger slice of national income will have to be devoted to pension financing? Should we not consider what the consequences thereof are on future growth, employment and competitiveness?

The younger generation should be made aware of the reality that such pensions may be a bad deal for them; that descending solidarity from the elderly to the young (mainly 'social capital' in the form of education) is much smaller than ascending solidarity from the young to the elderly, in the form of big ticket items like pensions and medical expenses, which are particularly costly for the very old. The elderly are not poor; their average investment income, for example, is about four times larger than that of active employees. Inheritance is a descending benefit for the 'young', but the average age when one inherits from his or her parents is now about 56 and will reach age 60 in 2015, which is not young. Mrs. Martine Aubry, a French Minister of Employment and Social Solidarity, suggested several years ago that current policies were not prudent considering the ageing process and that there should be more descending solidarity from the elderly to the young.

Considering the inevitable ageing process, would it not be more prudent to combine PAYG with funding in the social security pillar so as to avoid excessive contributions which might inhibit growth and employment and therefore accelerate poverty?

Depending on the assumptions made about real returns on investment, a McKinsey study a few years ago revealed that the same level of pensions could be provided with a funded system at one third of the cost of an unfunded one. Consequently are Italy, France and a whole series of other EU Member States going to pay 40% of salaries for state pensions one generation from now or are they going to pay one third of that amount? The impact of this difference on their economies and the well being of their citizens will be enormous. Is it, therefore, prudent to stick to old methods of financing or should we face the reality and change the financing mechanism? Are we merely day-dreaming? Will we always have such solid real returns on investment? Nobody can predict the future, but the chances that over the long-term, with open economies and global investment markets, there will be solid real returns, are quite good.

Naturally there will be market corrections and short-term volatility but over the long-term it is now sufficiently proven, by among others the American Professor Jeremy Siegel of Wharton School, that equities are not more volatile than bonds and that they produce much higher returns.

The Belgian scholar and actuary Professor Jean-Jacques Gollier has calculated that, with a 5% real return, contributions can be considerably reduced if there is partial funding in the first pillar. The same of course goes for the second funded pillar. Is 5% real return exceptional? The experience is, for example, that over the last 10 years (1989-1998) Dutch pension funds, which have the reputation of being prudently invested, have earned 7.7% real return p.a. with an asset mix well balanced between bonds and equities and 11.4% real return p.a. on equities alone. Should we therefore invest 100% in equities? Of course not, because that would not be prudent.

The young, as indicated already, risk not obtaining a fair deal if we are too dependent on unfunded pensions, which is worrying for the future as it may lead to a disruption of intergenerational solidarity. They inherit three types of substantial debt; firstly government debt in the classical sense; secondly unfunded pension liabilities which are, in a number of countries, much larger than the first type of debt; and thirdly the environmental debt which has not even yet been quantified, but is for certain huge. Have the current and previous generations not been prudent enough? Have they lived beyond their means?

Whatever the answer, it seems that a new equilibrium must be found and we must engage in more serious generational accounting than has been the case

up until now. It is encouraging that countries participating in the Euro have committed to long-term discipline regarding public sector deficits and that the Americans, big spenders as they are, now consider attributing their budgetary surpluses, which are going to pile up massively, to pension financing in order to avert the old age crisis in the first pillar.

European countries, with some exceptions, cannot yet benefit from budgetary surpluses; they first have to further reduce their debt. A majority of European countries should, however, do more and start reinforcing their three-pillar pension system without delay because it allows for a good mix of funded and unfunded pension provision. This is more prudent and at the same time more efficient / less expensive than the current emphasis on PAYG pensions in some countries. Europe has on average high savings rates which could be put to much better use and benefit current and future generations in terms of growth and jobs *quasi* immediately. That would be prudent, fair and just. There is no alternative, unless we accept the risk of disruption.

Europe needs enlightened politicians, trade unionists and employers working together on a new objective: funded pensions for all, on top of state pensions which need to be reformed themselves if we want them to survive in the 21st century. We believe that this is an absolute necessity. European governments must stop fooling themselves and their people, as the German Professor and Chief Economist of Deutsche Bank AG, Norbert Walter, recently wrote in an article for the Wall Street Journal '… the traditional promises that state pensions are safe have to stop because pensions are not safe under the current system'. Could this lead us to conclude that a prudent man rule should be imposed on governments?

The prudent man rule is a concept as old as mankind and can be traced as far back as the Roman Empire and Roman law. It is entrenched in Continental European regulation and practice, one needs only to think of the 'bon père de famille' concept in France and in other countries whereby the person who takes care of the estate or finances of someone else should do it with the same care as he would for his own affairs.

It is true that in the Anglo-Saxon countries the application of the prudent man concept is more embedded in investment practice and that these countries have generally refrained from intrusive and therefore often negative interference in the investment process by means of investment restrictions.

It is expected that an increasing number of countries will move to a general application, admittedly in different forms, of the prudent man rule. The reason for this is perhaps simple, but also powerful: the investment world is increasingly complex and that makes it difficult to maintain investment restrictions imposed by regulation. Policy makers, legislators and regulators are increasingly aware that in this matter 'one size does not fit all'.

Prudence is not always easy to define. It refers to risk, which itself is related to all human acts and omissions. Peter Bernstein in his fascinating book 'Against the Gods – The remarkable story of risk' gives the following historic definition of risk: 'The word 'risk' derives from the early Italian 'risicare' which means to dare. In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about'.

We need to be free to take calculated risk. Freedom to take risk brings the potential of higher return. Freedom, when we are in charge of managing money for others, particularly pension money, implies responsibility and accountability, which are the two cornerstones of the fiduciary duty we have in managing a pension fund. It implies adequate supervision, which is the third leg of making the prudent man concept applicable in practice. Therefore responsibility, accountability and adequate supervision form the basis of good pension fund governance.

The prudent man rule is a rule of trustee conduct, not of performance. About 170 years ago, in 1830, Justice Putnam of the Massachusetts Supreme Judicial Court delivered the opinion of the Court in the case of Harvard College v. Amory and formulated what has come to be called the prudent man rule, which has not fundamentally changed since then. 'All that can be required of a trustee to invest, is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.'

In 1974, a version of the prudent man rule was adopted in the American Employee Retirement Income Security Act (ERISA). According to this Act, a fiduciary must discharge his or her duties 'with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting

in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims'.

Keith P. Ambachtsheer and D. Don Erza in another remarkable book 'Pension Fund Excellence' explain that the phrase 'familiar with such matters' is usually interpreted as meaning that the fiduciary must be assumed to be knowledgeable. In particular, when advice from an expert is available, prudent trustees will avail themselves of this advice. Hence, the standard is usually called the 'prudent expert' standard. Prudent experts are the Board members of the pension fund (the trustees), but also their external or internal money managers, actuaries, investment consultants, etc. The members of the plan are not experts and therefore need or may need more protection particularly in the event when they take the investment risk directly.

Since the future is unpredictable, a decision made today, even with the best of advice and soundest of judgement, may turn out poorly. This does not negate the prudence of the decision, as Ambachtsheer and Erza correctly state. Thus, subsequent returns are not the basis by which prudence is judged. Instead, it is judged by the degree of care with which the decision was made.

There is a distinct possibility that the application of the 'prudent man rule' will be generalised throughout the European Union as the European Commission has clearly indicated in its Communication 'Towards a Single Market for Supplementary Pensions', issued in May 1999.

Seen from an EU-wide perspective, the prudent man concept is very important, because it respects freedom of investment and lays the responsibility for the asset allocation and for investment decisions, including risk appraisal, where it should be, i.e. with the fund itself. All European initiatives are a matter of give and take. If we want the European Union to be a single market also for funded pensions, all Member States will have to sacrifice some of their own vision and practice for the greater common good. The formula to construct Europe without destroying the Member States seem to be more than ever legitimate as Mr. Dominique Strauss-Kahn, the former French Minister of Economy, Finance and Industry said. This is particularly true for a generalised prudent man concept, which could be developed on the EU-level, implemented by each fund and supervised on the national level; a perfect example of subsidiarity.

# On the regulation of pension funds – a German perspective

**Alexis Eisenhofer**
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As a consequence of unfavourable demographic trends, pension schemes based on pay-as-you-go financing are increasingly endangered. Therefore many national legislators have taken measures to strengthen funded pension provision. The establishment of new, and the fortification of existing, pension funds is under consideration all over Europe. Nevertheless there are large differences in the legal basis – especially in terms of regulation – and the extent of provision of funded pensions in different European countries. Within the regulatory framework of pension funds one of the most prevailing questions is whether to apply the 'prudent man' principle or to establish quantitative investment restrictions. Different national rules already point out that this issue is seemingly quite controversial. While pension funds in the UK and in the United States are subject to prudent man rule, pension funds in Sweden, Denmark, Switzerland and France are regulated by legal portfolio guidelines.

In the following article the relevance and practical application of both regulatory concepts are discussed. When addressing this issue subsequently the relevant German rules of regulation are portrayed. Thereby the outcomes of the analysis can be validated by positive or negative experience.

The article is structured as follows. At first both regulatory concepts and the understanding of a pension fund are outlined. Subsequently the German private pension system is portrayed. Thereafter the usefulness of both regulatory concepts with respect to different German pension schemes is discussed. A concluding paragraph summarises the main results.

The concept of prudent man gives the trustee who is in charge of the management of a fund the right to decide the investment strategy of the fund without being liable to any legal requirements regarding a certain proportion of specific asset classes. The only restriction the trustee has to consider is that his decisions are made prudently. The opposite of the prudent man principle is therefore legal quantitative investment restrictions. Such rules prescribe a certain minimum or maximum proportion of the fund that can be allocated to a specific asset class. Usually the maximum percentage of assets that can be subject to currency risk is also ruled.

According to the Anglo-American comprehension a pension fund is a separate pool of assets put aside to provide collateral for the promised benefits. Pension funds are constituted for occupational pension schemes. Within defined benefit pension plans the sponsor promises a certain amount of later pension. Thus the sponsor of the plan or an insurance company absorbs the investment risk. In a defined contribution plan, by definition the value of the benefits corresponds to that of the assets. Consequently those plans are always fully funded.

With respect to the mentioned features of a pension fund, the German company pension scheme is portrayed in the following. The law of occupational pension provision (*Betriebsrentengesetz*) comprises four main types of scheme:

The largest are direct commitments (*Direktzusagen*) on the balance sheet of the company. In 1996, the amount of raised capital totalled DM292 billion (57 per cent of total assets). Within this scheme the assets remain in the company. Therefore *Direktzusagen* are incompatible with the above understanding of a pension fund.

The second company scheme is direct insurance (*Direktversicherung*), whereby a company takes out a life policy on behalf of the beneficiary. By the end of 1996, *Direktversicherungen* had amounted to DM67 billion (13 per cent of total assets). Like *Direktzusagen* this form may also not be considered to be a pension fund.

Thirdly, the company may assign a legally independent institution, a so-called *Pensionskasse*. With DM114 billion raised in 1996, nearly one out of four pension plans (23 per cent of total assets) was financed using *Pensionkassen*.

Fourthly, there exists the possibility of commissioning a provident fund, also called a support fund (*Unterstützungkasse*). In 1996, *Unterstützungskassen* contained DM42 billion (9 per cent of total assets).

In contrast to a *Pensionskasse*, an *Unterstützungskasse* grants no legal claim concerning later pension provision. Therefore most international comparisons of pension funds only cover *Pensionskassen*.

Besides the company pension system, the German legislator has recently permitted *Altersvorsorge-Sondervermögen* that are investment funds with the special purpose of pension provision. Even though advocates often draw a parallel to Anglo-American pension funds, *Altersvorsorge-Sondervermögen*

do not match the requirements of a typical pension fund. *Altersvorsorge-Sondervermögen* are not company pension schemes. These investment products address the individual who wants to obtain supplementary pension provision.

As for the regulation of the above schemes, the particular rules are portrayed and appraised in the following. When discussing the relevance and practical application of the particular regulation agency and portfolio, theoretical arguments are used.

Principal-agent problems arise when there is imperfect information, either concerning what action the agent has undertaken or what he should undertake. In terms of agency theory the asset manager has to be hindered to exploit his discretion at the expense of the investor.

On the one hand this can be achieved by monitoring the agent's actions. Monitoring requires that the principal is able to exercise efficient control at adequate cost.

On the other hand the discretion itself can be narrowed by setting quantitative portfolio regulations either by the principal or by law. This alternative is reasonable, if the principal is not able to efficiently monitor the agent. This could be the case if the principal is lacking expertise or if monitoring costs are disproportionately high.

The control problem is serious when the ownership of the fund is very fragmented and therefore a free rider problem occurs. With regards to *Altersvorsorge-Sondervermögen* the legislator has therefore set many quantitative portfolio restrictions. For instance the proportion of funds invested in tangible assets such as equities or real estate may not fall below 51 per cent and may not exceed 75 per cent, whereas property is limited to a maximum of 30 per cent. The remaining funds are invested in loans. Moreover only 30 per cent of the total portfolio value may be subject to currency risk.

Indeed quantitative portfolio regulations may have a detrimental effect as far as incentives of funding are concerned. The humble acceptance of *Pensionskassen* may be attributed to strong quantitative regulation. Since they are subject to the state supervision of insurance companies they succumb to quantitative investment restrictions. As pension schemes with self-

investing restraints for the sponsoring company, *Pensionskassen* are less attractive than *Direktzusagen*.

The importance of *Direktzusagen* can be attributed to the fact that in practice this company pension scheme is a significant source of internal financing. Since providing occupational retirement pensions is an *ex gratia* payment in Germany, the legislator has to create incentives to strengthen pension funds. From that point of view the legislator should desist from restricting investment policy by means of setting portfolio guidelines.

From the perspective of portfolio theory any quantitative investment restrictions appear to be improper. Portfolio theory suggests that each investment has to be considered having regard to the other assets. Since only the asset manager knows the respective consistence of the portfolio, the legislator should leave the choice to him. In doing so, proper diversification can reduce any idiosyncratic risk resulting from holding a single asset. Because national markets are imperfectly correlated international investment can even eliminate otherwise undiversifiable 'systematic' risk. Therefore constraints on foreign investment may restrain the asset manager from realising an efficient portfolio. As for *Atlersvorsorge-Sondervermögen* the upper limit of foreign investment which is 30 per cent of total assets invested has lost importance as a consequence of the European Monetary Union.

Legal portfolio guidelines may hinder the portfolio manager's ability to appropriately react to changing economic circumstances. In times of declining stock prices *Altersvorsorge-Sondervermögen* still have to invest at least 21 per cent of the fund into equities.

If legal portfolio restrictions make it possible for the manager to take advantage of private information, then both market efficiency is weakened and competition among managers is being distorted.

Moreover, legal portfolio constraints might lead the manager just to comply with law but to forget about other investment objectives such as an adequate return of the investment. The low performance of *Pensionskassen* during the past years as compared to international pension funds is mainly due to the fact that equities are limited to a maximum of 20 per cent by regulation.

In case of restrictions which constrain pension funds to invest in government bonds there may not be sizeable benefits to corporate financing. Since

government bonds must be repaid from taxes the 'funded' pension schemes may degenerate to a pay-as-you-go system at a macroeconomic level. Thus the process of capital formation may be inhibited.

Some proponents of portfolio guidelines may argue that restraining or excluding certain asset classes may limit the investment risk. Using this argument one has to bear in mind that lowering investment risk normally lowers the expected return on investment. Nevertheless the degree to which such quantitative restraints actually contribute to benefit security is open to doubt. Beside the risk of holding assets, pension funds also face the risk of increasing liabilities.

The analysis has shown that the usefulness of both concepts cannot be affirmed generally but depends on the special investment relationship. While agency theoretic arguments may favour portfolio guidelines portfolio theory may not. The legislator therefore should take account of who actually is the principal in the investment relationship. Whenever there are professionals to monitor the asset manager the neediness of protection of the principal is minor. In that case the legislator should desist from setting quantitative portfolio guidelines. Since providing occupational pensions is voluntary the legislation has to consider the incentive effect of the regulation. The fact that German pension funds play an insignificant role compared to Anglo-American pension funds may be attributed to the small incentives of strong quantitative regulation. The exceedingly positive rate of return of Anglo-American pension funds in the past shows that the beneficiaries have not been at a disadvantage and therefore their neediness of protection plays an inferior role in investment practice.

In Germany legal innovations concerning pension funds are expected within the fourth law to improve the general conditions of the financial market. (*Viertes Finanzmarktförderungsgesetz*) that is likely to go into effect in 2002. One will be anxious to see what the new German pension funds and their regulation are going to be.

# Transparency and efficiency: two elements of 'the prudent man' rule of management

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A prudent man takes decisions which are most likely to benefit his family. To make fund managers follow the 'prudent man' rule is to ask them to select asset portfolios which maximise their clients' interests. The theory of modern finance, based on individual risk preferences, has developed a number of rules of active management which lead to presumed maximum satisfaction for clients. These rules are well known and need not be repeated here. Nevertheless it is worth underlining a central point: the need for diversification of the portfolio across different sectors, different countries and different periods.

The world is made up of individuals with differing tastes, preferences and objectives. Contrary to popular opinion, economists recognise these differences. It would not make sense to recommend one single investment strategy for the 'prudent man'. In fact there are as many correct strategies as there are investors in the market. It is important that fund managers are well aware of the degree of risk aversion of each client in order to organise individualised management. Assuming there is no problem with delegation, all frameworks to limit investment strategies will necessarily harm the household. Flexibility is a necessary corollary of efficiency.

History teaches us however that delegation problems exist between fund managers and their clients. Among the problems it is important to note specifically the one of the manager with limited liability who could implement a 'bet for resurrection' strategy, as happened in the American 'savings and loans' crisis. In addition, because not all households monitor their managers in the same way the market is not always able to reward the most efficient. This reduces the incentive for the latter to act prudently for their client, as defined above. The existence of these 'market failures' reintroduces the need for a central monitoring body for investment funds. The imposition of restrictions on the structure of investment funds is just a makeshift solution compared with a more effective system of transparent and mandatory regulation including solvency margins. The regulator's role should be above all to guarantee transparency and information for the public.

# Prudent man principle – a question of clarity & certainty

**John Kay**
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Utility regulation is largely the creation of economists, financial services regulation has been driven by lawyers. Yet many of the issues which arise are common to both. In the utility sector – which began by giving a high degree of discretion to individual regulators – the exercise of this discretion has been much resented by the industries affected. In the financial services sector, there is a resentment of overly prescriptive rules.

There is an inevitable tension between the desire of both regulators and regulated firms to achieve clarity and certainty in their rule systems, and the need to avoid inappropriate interference in the management of businesses. At first sight paradoxically, regulatory discretion and an emphasis on principles rather than specifics can give managers more freedom, not less. The following fairy tale – written to illuminate an issue in utility regulation – is intended to make this point.

But its thesis applies equally to financial services and to the investment management business. For 'suitable business dress', read 'prudent investment strategies'. And then see how familiar, and depressing, are the consequences of insisting that the meaning of prudence be spelt out in ways that can be clearly identified and clearly maintained.

*The following article first appeared in the 'Financial Times' in 1996:*

Don Cruickshank, the UK telecoms regulator, has proposed that the licences of BT (and other telecom companies) should be modified to include a general prohibition on anti-competitive behaviour. This proposal is strongly resisted by BT, which argues that practices that cause concern should be the subject of specific prohibitions, which would be inserted in the company's licence, subject to a right of appeal to the Monopolies and Mergers Commission. Now read on.

The story of BT's dress code deserves to be more widely told. After privatisation, the company decided it was time to shake off the sloppy dress habits of the public sector. A directive went round telling senior employees that they should adopt suitable business dress.

The directive caused some resentment. Those who opposed it demanded greater clarity and certainty. When they went to the wardrobe in the morning,

how could they know what would represent suitable business dress. After advice from its legal and regulatory affairs department, the company agreed to promulgate a dress code. Senior male employees were expected to wear smart suits, shirts with collars, and ties.

It was not long before someone came to the office in a red suit. When criticised, he pointed to the terms of the dress code. The suit was undeniably smart; but it was the smartness of a nightclub rather than a boardroom. So the dress code had to specify colour. Red was out, grey was in. But what of blue? Some blues were clearly acceptable. The chairman's favourite suit, in fact, was a fetching shade of navy. But bright blues could not be admitted. So how bright was bright?

BT research came up with an answer. Brightness is determined by how much light a fabric reflects. A machine could measure this, and one was soon constructed and installed in the reception areas.

But ties posed a more intractable problem. It was simply impossible to define which colours and motifs were acceptable and which not. A clearance procedure seemed the best answer. Anyone who bought a new tie could submit it to the dress code department, which had 42 days to rule on whether or not it was suitable business dress. This was difficult, since the appropriateness of a tie might depend on the context – the suit and the shirt that went with it. So decisions were rather conservative.

This raised the issue of an appeal mechanism. Of course all changes in the dress code had to be agreed by the main board. But discretion over approval of ties had been delegated to the dress code department. That made them judge and jury in implementing regulations they had themselves devised. This violated natural justice.

The company agreed that a small group of senior directors, with an independent fashion adviser, would hear complaints from employees who felt their ties had been unreasonably rejected. Some of these directors were heard to mutter that this was not what they were paid large salaries for. But since no-one knew what they *were* paid large salaries for, the criticism did not go much further.

But there was the more general problem of changing fashion. After all, it was not so long since every gentleman had gone to work in a wing collar and frock coat. Not only were other forms of dress now acceptable, but wing collars had probably ceased to be acceptable. Not the image of a modern information

company. A well-known fashion designer agreed to chair a standing working party to advise the company on fashion trends.

By this time, the dress code extended to 50 pages, largely impenetrable. No sensible employee read it, and when they were given a copy they were told that if they only behaved sensibly they would probably be all right. Knowledge of its contents was confined to the dress department, which by this time consisted of twenty people, mostly lawyers, the union representative who negotiated over it, and a few cranks who enjoyed pointing out inconsistencies and anomalies in the code.

Eventually a new management came in, determined to sweep the dress code department away. They quickly realised there were two alternatives. One was to supply a uniform to all employees. This was obviously an intolerable interference in personal affairs. The other was to sweep away the dress code and renew the instruction to everyone to wear suitable business dress.

If anyone was in genuine doubt as to what suitable business dress was – and not many people were – they were advised to have a word with the dress regulator. He had been given this role precisely because of his sound judgement and range of business experience. What the regulator said bound no one, but to ignore his advice was injudicious and might prejudice advancement in the company.

The demand for clarity and certainty in regulation has great superficial plausibility, and it is because it is difficult to argue against clarity and certainty that it is best to resort to parable. The world is rarely clear and certain, and if it seems so today it will have ceased to be so tomorrow. It is no more possible or sensible to give an exhaustive description of what constitutes anti-competitive behaviour than to give an equivalent description of suitable business dress. When is it competitive and when is it predatory to charge a low price? Or different prices to different customers? In both cases, you can exemplify things that are, and illustrate things that are not. But what you are trying to promote is an attitude and a style of behaviour. For those who understand that, formal rules are irrelevant; for those who do not, they have very little value.

The demand of clarity and certainty comes from two sources. It comes from naïve people who do not realise that effective regulation which eliminated discretion would ultimately lead to intrusion into every aspect of business life. And it comes from those who are very far from naïve, and who understand that the sheer impracticality of what they seek would emasculate regulation in interminable legalism.

# The prudent man principle

**Sir Gavin Laird**
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In the UK, pension schemes are overseen by groups of trustees. These trustees are responsible for protecting the members' interests and, amongst other things, investing the assets of the scheme. Although there is relatively little regulation in relation to the investment of the scheme's assets, general trust law requires the trustees' actions to be consistent with those of a prudent man.

Given such a background, need there be a debate regarding the prudent man principle as it applies to pension scheme investment?

In recent years the volume of pension scheme legislation in the UK has increased at an alarming rate. Lawyers and actuaries now spend a considerable time interpreting pensions legislation and attempting to ensure compliance. The area of investment has, however, escaped relatively unscathed. Is this an indication that the UK Government believes that the prudent man principle works well in relation to pension fund investment in the UK?

There are a number of possible explanations for the lack of regulation in this area.

1. The UK Government believes that the prudent man principle will ensure that pension schemes' assets are appropriately invested.

   Although this is possible, the almost unbelievable level of bureaucracy involved in most other areas of pensions suggests that the UK Government does not believe that pension schemes will be satisfactorily run if left to their own devices. It is hard to believe that investment has been singled out for lenient treatment.

2. Legislation has been considered but put in the 'too hard' category.

   Again this is possible but it is more likely that some 'meddling' would have taken place had the matter been considered seriously.

3. The matter has been considered but rejected on the grounds that regulation would be inappropriate.

   Again this is possible. The diverse nature of UK pension schemes means that any statutory investment framework would be to be so 'loose' that it

would have no significant effect. The alternative approach of imposing severe restrictions on investment strategy is likely to result in an inappropriate investment strategy for a great number of schemes. In short, strict regulation would be in nobody's interests.

It is not clear which, if any, of the above reasons explains the fact that in a sea of bureaucracy investment should be an almost unblemished island. Although it is possible that the UK Government is a supporter of the prudent man principle, it seems likely that this is the only explanation for the lack of investment regulation relating to the UK pension schemes.

In the main, UK pension fund trustees are professionally advised in relation to investment. It is unlikely that prescriptive legislation could achieve the same end.

It must not be forgotten that in the UK company pension schemes are provided voluntarily. Following the implementation of the Pensions Act 1995, many companies are expressing concerns regarding the ever increasing cost of pensions bureaucracy. It is quite possible that were prescriptive legislation to be introduced into the area of pension scheme investment, with the resulting cost of monitoring compliance, many companies would turn their backs on company sponsored pension provision. This would clearly not be in the interests of the many thousands of UK employees who enjoy the benefits of their employer's pension. It is therefore important to consider all possible avenues and prescriptive legislation should be a last resort. The prudent man principle may not, in itself, be sufficient to justify the avoidance of further legislation. However, taken in conjunction with the other arguments above, it justifies the argument that there should be no further legislation at least in the short to medium term.

In the UK, we are almost certainly at a cross roads in relation to company-sponsored pension provision. The jury is still out following the huge upheaval of recent years but it is already looking quite possible that some companies will make alternative arrangements in future. This is extremely unlikely to be to the benefit of the many members of good company pension schemes. Further legislation could be all it takes to turn a gentle stream into a raging torrent particularly given the growth of money purchase schemes at the expense of final salary schemes.

All of that said there are many other issues and I instance a few.

1. Should pension fund trustees / sponsors be paying greater attention to the asset / liability mix? A great deal of attention is given to the investment

performance of one manager against another – e.g. CAPS Median returns – rather than whether or not the assets will meet the liabilities. The continuous assessment of managers can benefit pension consultants who will receive fees for conducting manager searches and appraisals.

2. The generation of 'excess returns' or a surplus can be beneficial to the employer as this may reduce the level of future contributions. This potential financial benefit may encourage a higher risk investment strategy.

3. The implications of the increasing trend away from defined benefit to defined contribution schemes are far-reaching. Does the transfer of the financial liability for the pension form the employer to the employee create a need for greater safeguards / controls / safety nets?

4. If Unilever is successful in their case against Mercury Asset Management, this would open up active fund mangers to a potential monetary liability for under-performance. This would generate more risk-averse investment strategies and even greater interest in indexation.

5. The lack of knowledge among the general public is a major concern, particularly at a time when individuals are increasingly being asked to make greater provision for their own future financial requirements. Should financial matters, especially pensions, form part of the school curriculum?

6. If the 'prudent man rule' is not accepted in Brussels, will governments be required to be the main providers of pensions and pension products?

7. If the 'prudent man rule' is adopted, pension fund trustees / sponsors will need to pay greater attention to the issues raised in (1) above.

8. Should the trustees of pension plans have greater representation from the workforce? In many instances, the trustees are mainly from the senior management team and this is potentially a conflict of interest given the issues in (2) above. I suggest that the positive impact on pension schemes that employee trustee representatives have had fully justifies member-nominated trustees being the majority in every occupational scheme.

In my view the UK Government (or for that matter Brussels) should do nothing that encourages the growing trend to money purchase schemes. Excessive legislation would do just that.

In short what the UK needs is not more legislation but more transparency, more employee trustees, and more attention to asset / liability matching. Coupled with the continuing operation of 'The Prudent Man Principle'.

# The prudent man role

**Richard Lapthorne**
*Vice Chairman, British Aerospace*
*Deputy Chairman, Nycomed Amersham*

The objective of a pension fund is to provide over the long-term, the best possible benefits for members at the lowest cost.

This statement encapsulates all the constraints and opportunities that should be provided to the prudent man whether he be involved in administering a pension fund or regulating it.

Let me start with the timeframe. By definition, the long-term is the only term over which the objective may be applied, for this is the only time frame in which a fund can balance the different returns offered by different investment products with differences in liquidity and differences as to certainty of cash value should investments be realised at short notice. Focus on short-term liquidity places equities into a high risk category and cash into a low risk category when over the long-term the reverse is the reality given the relationship between equities and real economies. Bonds as a surrogate for cash are themselves risky over the short term given that their capital values adjust (mechanically) with movements in long-term interest rates and (emotionally) with world economic and political events. It is very important for the long-term needs of pension managers to be recognised in regulatory frameworks and this is particularly important too when considering the growth in money purchase schemes and portability of pension rights and comparing these phenomenon with defined benefit schemes. Provided the cashing-in of rights remain long-term then the investment principles built up over the years to support defined benefit schemes remain valid for the other forms of pension provision.

The second element to justify is the concept of a pension 'fund'. Pooling the provision of individual's pension rights into funds provides substantial benefits built around the portfolio nature of a fund and the consequent spreading and sharing of risk. On the benefits side no one member can create a liquidity problem. In other words, it is unlikely that the fund as a whole would need to explicitly match the precise timing of cash realisation from investments with the precise timing of cash payments for individual benefits. Any one individual's private savings plan has to be built in such a way as to produce cash when required. As such, an individual will gradually increase the near-term certainty of the cash value of realisations the closer he gets to retirement age. This means that on his own he is going to sacrifice investment return in return for lower risk. Collectivism in a fund means that liquidity is not an issue and any changes to investment return can be much more gradual

driven by the maturing profile of all the individuals in the fund rather than of one person on their own.

This collectivism has a beneficial knock-on effect to the investment manager. Matching the cash flow from each investment to the cash flow required by each individual would lead to massive loss of return because any investment with an equity risk presents a realisation timing risk. However, matching the additional total return to the fund from an equity-biased portfolio with the individual risk of realisation timing in order to meet any one member's cash benefits is a much simpler task. Over time funds may become mature but consequential changes to investment strategy will be very gradual. Meanwhile, the individual's pension account will be benefiting from a higher risk return than he could justify on a stand-alone basis.

Maximising investment return over the long-term automatically implies 'consistent with acceptable risk' for not to take into account this rider would run counter to running at lower cost. Accidents cost money; so would taking unacceptable risks. Minimising the cost of providing pension benefits is essential to the well-being of members. It underpins confidence in the system by making it look affordable; non-affordable approaches will be quickly found out and publicised. Without confidence that the pension promise will be delivered there can be no basis for pension arrangements. Conditions will change, however. Age expectations will extend; social legislation will intervene. In the UK, a number of changes have occurred over the past decade which have all been absorbed by a pension funding system that was low cost and not an embarrassment to the providers of contributions to pension schemes. A further benefit of aiming for lowest cost is that it can provide pools of surplus which can be used not only to absorb these changes in the social environment but also can be used to improve benefits.

Providing the best possible benefits to members has to be the objective of any pension system. It ensures commitment by those members to providing for themselves; underpinning their aspirations through a genuine partnership with other providers of funding and with the managers of their money. A realistic debate which establishes the relationship between personal cost and benefit promise is an essential building block for this trust, as is transparency in how money is managed.

In order to make the provision of pensions work, there is need for a regulatory framework to reinforce the long-term nature of the provision and to ensure that transparency is evident. There is a need for different schemes which

allow the individual to make some choices over the trade-off between spending today and making provision (above a minimum level which should be mandatory) for retirement. There is a need for an investment framework which enables the lowest cost at acceptable risk principle to be applied.

In this paper the importance of keeping together all the elements of the opening paragraph has been emphasised. 'Lowest cost' means not just keeping the costs down but also stopping them rising. It is the glue which makes the rest of the system work.

I have been involved in various aspects of pension fund management since 1969; this has included membership of trustee bodies and investment committees in the UK, consolidation of funds in the United States, and submission of the evidence of the UK's senior finance directors to the Goode Commission on pension reform. In all that time, it has become clear that investment performance sets the tone for all other debates. First of all, the investment manager must be accountable for his performance. Arbitrary constraints not understood by the manager become excuses for underperformance. For this reason the establishment of investment committees is fundamental. Hence, the investment manager makes recommendations and prudent men debate with him. Recommendations and outcomes may be different but the arguments are understood and accepted; no space is left for performance excuses.

Two elements drive investment performance – asset allocation and stock selection. In general, the former is driven by a strategic macroeconomic debate and the latter is better managed tactically by the fund manager. In addition to the macroeconomic issues, the stance of any one fund on asset allocation is also influenced at the margin by the long-term maturity profile of the membership.

Asset allocations do alter from time to time – the balance between equities and bonds; the balance between index-linked and market traded bonds; the balance between domestic equities, US equities, Japan, Continental Europe; the use of property, unquoted equities and convertibles. Economic cycles require that investment policies are flexible in order that these shifts in asset balances can take place. Does this matter? Is it just another need driven by the fee aspirations of the investment managers? My view is 'yes it does matter'. I have emphasised earlier in this paper the need to engender support and confidence in the whole pensions system.

It is important that members' contributions are seen to be invested in assets appropriate to the economic circumstances of the time. There are times to 'invest' more heavily in bonds; there are times when it is not appropriate. Confidence of members would be totally destroyed and / or there would be wholesale abstention from the pension system were contributions to be directed into asset classes inappropriately.

Long-term commitment to pension funding is essential; short-term rigidities which fail to allow the prudent man's common sense to prevail will constantly work to undermine the long-term by destroying the balance so necessary to build the confidence of the stakeholders and, hence, make the entire system of pension provision work effectively.

# The prudent man rule

**Guillaume Leroy**
*Associated Actuary, Joël Winter & Associates*

The question of asset allocation – and the parameters for asset allocation to ensure the most profitable and prudent management for the beneficiaries – arises with regard to pension funds as for any other form of asset management. There are two concerns in the pursuit of this objective for the funds:

- financial concerns, which aim to maximise the return on the fund for the beneficiaries; and
- prudential concerns, which aim to minimise the inherent risks in the management of the assets.

The co-existence of these two objectives is at the heart of the logic behind the prudent man rule, which guides investment managers' decisions.

### 1. *The objectives of financial management of pension funds and the prudent man rule.*

Pension funds aim to provide optimum management for the beneficiaries through the selection by the investment managers of profitable, safe and liquid assets.

In other words, it is a question of optimising each of those three elements of the assets, namely profitability, security and liquidity with regard to the funds' primary objective which is to provide pensions. The economic theory based on standard financial models (Markovitz *et al*) teaches us that an optimum allocation in terms of the risk-reward ratio is best obtained without restrictions, the investment manager therefore being in a position to achieve the optimal diversification of his investments in a totally free environment. The rules which may be imposed on managers in effect restrict their active allocation, which limits choices, and therefore performance. The result is a reduced return on the funds invested for the beneficiaries, or more rarely, a reduction in their liquidity or in their security.

### 2. *The regulatory authorities have generally restricted the management of funds for reasons of security.*

Beyond the concerns of the profitability of the assets, the regulatory authorities have often restricted bodies such as OPCVM (Organisme de Placement Collective en Valeurs Mobilières) or insurance bodies managing pension schemes, for reasons of security and without concern for short-term profitability.

Among the most frequently mentioned restrictions are those of currency matching: for every liability in a given currency there must be a corresponding asset in the same currency.

All the same, selection of assets must be made by asset class, bearing in mind that:

- certain assets are not permitted (works of art, gold coins);
- others are subject to a ceiling (in the case of insurance, property must not represent more than 40 per cent of total liabilities); and
- others can be subject to the restrictions of an investment floor (generally government bonds, for example in investments by independent mutual funds in France).

Finally, apart from diversification by asset class, there is generally a rule on diversification by issuer.

Moreover, accounting arrangements can create an imbalance in the choice of assets by managers. The clearest example of this type of arrangement permitted by the Accounting Directive for insurance companies is the non-provisioning for the temporary unrealised depreciation of bonds, as opposed to other assets in the capitalisation reserve.

So, in the name of prudential security, regulations frequently restrict investment manager's scope for investment and so reduce the profitability of the asset allocations for the beneficiaries of the pension funds.

***3. These restrictions often apply in similar conditions to liabilities of a different type.***

The rules mentioned above have to be understood through analysing the type of liability assumed by pension funds. The commitments of pension funds full into two distinct categories:

- defined contribution: this means pension funds with defined contributions and pension liabilities in the form of life insurance contracts for individual accounts; the fund manager must optimise the management of the funds for which he is responsible, he does not have an explicit target;
- defined benefit: this is a matter of commitment based on variables of a non-financial character (salaries…), this most resembles pension systems, or commitment in terms of financial results: life insurance investments with guaranteed interest rates in some European Union currency.

From the difference in type of the liabilities mentioned above must flow an appreciable difference in the prudential rules applicable to pension funds.

4. ***Certain regulations seem consistent with the choice of an optimisation of the investments for the benefits of pension funds.***

Sometimes regulations coincide with the demands of pension fund asset managers who are concerned with profitability.

The rules relating to type of asset include – the elimination of non-income generating assets such as gold coins of works of art seems appropriate, and does not seem to inhibit asset allocation.

In the same way, some quantitative restrictions by issuer seem appropriate. The prohibition on holding more than 5 per cent of assets coming from one single issuer, commonly retained in the European rules for the OPCVM or life insurance business, seem logical and do not present problems since it is generally in accordance with the financial theory of diversification.

On the other hand, the rules regarding minimum investment in government securities which exist in certain regimes should be proscribed. They are not justified on financial or prudential grounds.

Furthermore, such regulations do not necessarily seem relevant to defined contribution schemes. In this area the only constraint on the manager is to act in the interest of the beneficiaries without guaranteeing the results, so it seems logical not to increase the initial constraints in order to avoid the risk of limiting the end results.

5. ***Certain complementary rules seem appropriate in the context of defined benefit schemes.***

When pension funds provide for defined benefits (of a financial character or not) the third constraint mentioned above, that is the liquidity constraint, cannot be ignored. At a previously defined date the pension fund would in effect have to provide a benefit the total amount of which was defined from the start. In this context, it seems appropriate to add a complementary liquidity constraint to the constraints of profitability and of security of the assets which are generally those of prudential regulations to ensure that the triple aim of profitability-security-liquidity is optimised.

In this connection, from a quantitative angle, the only financial instrument which can guarantee such a benefit in the medium term is probably a bond.

In this context a favourable treatment of bonds for funds with defined benefits seems appropriate. On the other hand, the particularly poor liquidity of real estate can logically justify stricter constraints. In this way, from a quantitative angle, the stricter constraints for property and less strict ones for bonds can seem logical in the case of pension funds with defined benefits.

From a qualitative perspective, in particular in the accounting domain, a differentiated treatment of assets seems suitable: consideration of the technical characteristics of bonds can in this way lead to a specific accounting treatment linked to the fixed duration of bonds as opposed to other assets.[1] At the same time, a mechanism for taking into account the average duration of pension fund liabilities in the accounting treatment of other assets seems appropriate. The determining factor here is the short or long-term nature of the liabilities.[2]

**Conclusion**

The prudent man rule in pension fund asset management requires different solutions according to whether the fund manager is faced with a commitment as regards results or a commitment as regards means. When a commitment as regards results exists, the consideration of the constraints of liquidity must lead to different treatment for different categories of assets, even if it does not lead to distortions as significant as those in French insurance law.

In particular, the very long duration of pension fund liabilities must lead to a limited exemption in the financial and accounting treatment of different types of assets in the funds selected by fund managers.

1 However, even though it permits bond returns to be smoothed and mutualises the returns between generations of beneficiaries, the unusual accounting treatment of liabilities that exists in French insurance law (capital reserves, in particular) could be said to be a dead hand upon, and damaging to, the beneficiaries in the case of a sustained fall in interest rates (as in France, 1982 to 1998).

2 The rules that apply in French insurance law are inappropriate in that they do not take into account the extent of the liquidity of the commitments of insurance companies *vis-à-vis* their customers: if this makes sense for liquid savings products, it is less likely to suit retirement pensions.

# Pensions under the prudent man rule – the Irish experience

**Anne Maher**
*Chief Executive, The Pensions Board, Ireland*

The Irish Pensions Act 1990 specifies that the trustees of pension schemes shall provide for the proper investment of the resources of the scheme in accordance with the rules of that scheme. If the trust deed governing the scheme does not contain a specific clause outlining the investment powers, the trustees must invest the fund in accordance with the Trustee (Authorised Investments) Act 1958. As this significantly limits the investments which may be undertaken by the fund, nowadays virtually all deeds creating pension funds contain a clause outlining the trustees' powers of investment. The likelihood is that this clause will contain few, if any, restrictions on the type of investments which may be held.

An unrestricted investment clause does not mean that trustees can invest however and wherever they wish. In relation to the investments of the fund, trustees must invest with the care which an ordinary prudent person would take in investing for the benefit of other people for whom he / she felt morally bound to provide. As the purpose of the scheme is the provision of benefits for members and other beneficiaries, trustees must invest solely in the best interests of the members and their beneficiaries. In this context 'best interests' is taken to mean best financial interests.

**Operation of the prudent man rule**

Irish pension funds are organised under the trust system with the trustees being the responsible parties. Regulation of pension funds is focused on the trustees. One of the primary duties of the trustees under trust law and under the 1990 Act is the investment of the funds. Trustees take this responsibility very seriously and in almost all cases employ professional advisors to assist them. The advent of member trustees, introduced in Ireland in 1994, has if anything sharpened the trustee focus on their responsibilities. In particular, member trustees take strong interest in their investment responsibilities and in the security and performance of the funds for which they are responsible. Over half of the larger pension funds in Ireland now have member trustee representation.

The Irish Pensions Board has produced Codes of Practice to assist trustees. These Codes of Practice, in addition to incorporating mandatory statutory duties and responsibilities, also set out recommended good practice. The

Codes of Practice say that trustees should agree an appropriate investment policy for the fund and where relevant place limits on the fund's investments in specific sectors, markets, currencies, shares and other securities. The trustees should also set an investment performance objective for the fund which is both appropriate and unambiguous. In particular it should specify the period over which the performance is to be achieved. Generally speaking, performance objectives are set relative to returns achieved by other funds in an appropriate performance measurement service. However, in some instances trustees, pursuing investment policies specific to the characteristics of the fund, may set their unique benchmark which reflects these policies. Specifically, the Codes of Practice say that the trustees should set an appropriate performance objective for the fund which, among other things, has regard to the level of risk acceptable to them.

Trustees should be aware of the variability of investment returns and should therefore diversify the investments of the scheme so as to minimise the risk of large losses. In particular, the trustees of a defined benefit scheme must have regard to the need to satisfy at regular intervals the minimum funding standard set down in the Pensions Act. This requires trustees to arrange for an actuary to carry out a valuation of their scheme's liabilities and assets at regular intervals and to arrange for actuarial funding certificates to be submitted to the Pensions Board within prescribed time limits.

The calculation of a pension scheme's assets for the purposes of meeting the funding standard imposed by the Pensions Act must exclude self-investment or concentration of investment in excess of a prescribed percentage of the scheme assets. The amounts to be excluded for schemes (other than small member-controlled schemes) are self-investment in excess of 5 per cent and concentration of investment in excess of 15 per cent, which latter figure will drop to 10 per cent after 31 December 2000.

The Codes of Practice also set out that the trustees should monitor the performance of their appointed investment manager, or of their fund where they are managing the assets themselves. Even if members' contributions and benefit levels are defined, and the employer has consistently met the contribution rate recommended by the actuary, overall investment return is still relevant to the members of a defined benefit scheme. There can be little doubt that good investment performance enhances the security of pension promises, while bad performance weakens that security. Under a defined contribution scheme overall investment return is even more relevant since

members' benefits will be directly determined by the return earned on the contributions paid.

It is important that trustees know that their fund is maximising its investment return within the objective set. The normal measure of the investment performance of a fund is a comparison with other pension funds of a broadly similar nature and this is usually done through participation in a performance measurement service. In monitoring investment performance, the manager's performance should be monitored on an on-going basis having regard to the objectives set. Such monitoring should include, not only the actual investment return achieved by the manager, but also the investment strategy which was pursued on behalf of the scheme.

The Codes of Practice say that the trustees should have an investment management agreement and should satisfy themselves that the agreement is consistent with their scheme's trust deed and rules. Where the trustees have documented their investment policy and objectives this should be appended to the formal management agreement and referred to therein as appropriate. The trustees should also be aware of the main issues to be considered by them in assessing the security of their pension fund assets and the legal relationship with their custodians.

The new opportunities offered to pension funds by the Euro zone should not, in principle, affect the successful operation of the prudent man rule. It is still, of course, too early to judge the impact of the new opportunities and the Pensions Board will be watching developments to see if it needs to take any action.

**Irish pension fund investment**

The total assets of Irish pension funds at end 1998 were approximately IR£31 billion. At end 1998, the combined capital value of the Irish equity and gilt markets was equal to 108 per cent of GNP and the then current value of Irish pension funds was equal to almost 53 per cent to GNP. At the same time equity exposure accounted for 60 per cent of total investment. Exposure to fixed interest investments had fallen over recent years to 28 per cent at end 1998.

Pension funds have played a major role in the Irish economy for some time now and at end 1998 constituted 20 per cent of the Irish equity market and 29 per cent of the Irish fixed interest market.

Ireland has had no investment constraints on pension fund investment. The small size of the Irish stock market, where 65 per cent of the capitalisation is accounted for by five stocks, does not give pension funds the scope they need

within Ireland. This inevitably led to an outward investment flow by Irish pension funds. The pattern of increasing outward investment flows attracted comment and questions over the years on whether, from a national point of view, a greater proportion of pension funds should be applied to investment in Ireland. The amount invested outside Ireland stabilised in recent years at almost 40 per cent, most of which was invested in European and non-European equities.

In 1996, a major study was funded in Ireland by the Irish Association of Pension Funds, the Irish Association of Investment Managers and the Minister for Finance. This study, known as *The Scope for Increasing Investment Opportunities for Irish Pension Funds in the Economy of Ireland*, by Deloitte & Touche and Peter Bacon & Associates made recommendations on the steps necessary to develop existing investment opportunities and create new opportunities in Ireland which would be commercially viable. Ireland also conducted a study on pension fund investment in venture capital. This was entitled *Pension Fund Investment* and was completed in 1993 by Michael Walsh and John Murray. The outcome of this was that there was an increased flow of pension fund investment into venture capital within Ireland. This revitalised the venture capital market and is spoken of by most parties involved as a success story for both the pension funds and those seeking investment monies through venture capital.

The performance of Irish pension funds has been excellent. Irish pension funds showed an average return of 34.2% in 1997 and 18.6% in 1998. Adding to the attraction of these returns is the level of inflation in Ireland which was 1.5% in 1997 and 2.4% in 1998. Freedom of investment, subject to the prudent man principle, is generally accepted as a main contributor to the satisfactory performance of Irish pension funds. This performance has benefited employees in the form of improved benefit provision and employers in the form of reducing employment costs.

**Conclusion**

The prudent man principle for pension fund investment, supported by good prudential rules and supervision from the regulatory authorities, has contributed to the development of well-developed funded occupational pension schemes in Ireland covering more than half the employed workforce. This formula has provided a platform for further pension development which will be encouraged by a new Irish Pensions Bill to be introduced in 2000. The Irish pension scheme structure, based on the prudent man principle, has been generally good for members of pension schemes, employers, and indirectly for the Irish economy as a whole.

# How can the financial management of pension funds be liberated?

**Michel Piermay**
*President, FIXAGE*
*President, Syndicat des Actuaires Conseils et Actuaires Experts Indépendants*

At the start of the 1990s, investment limits for many institutional investors were liberalised, but their asset allocation has still not developed.

The obstacles which restrict pension fund management today are less obvious to identify than investment quotas, because they are more technical and sometimes operate more indirectly. There are three obstacles:

**1. Accounting differences between shares and bonds**

When interest rates rise the depreciation on bonds does not give rise to provision (article 332-19 of the CA). Depreciation on shares, on the other hand, must be provisioned for by the net amount of depreciation.

This difference constitutes a severe restriction on asset allocation. If there is a clear need to invest over a long term this conflicts with the stronger need to protect the solvency margins each year, which shortens the horizon of effective management.

The debate over the 'Thomas' law which attempted to bring pension funds under the regime of insurance regulations, brought to light an insoluble contradiction between this accounting difference and a requirement for a minimum quota of shares.

**2. Assessment of liabilities**

The practice of discounting liabilities according to the rate of interest prevailing at the time the contract was signed gives a strong rigidity to the regulatory value of the investment.

The lack of actuarial consistency between the valuation of assets and liabilities causes an artificial volatility in the accounts and in the apparent solvency of the institution, and reduces the proportion of shares in the asset allocation.

It would be simple to correct this anomaly, by replacing the accounting basis of calculating solvency ratios with an economic or actuarial basis. A well-balanced pension fund will thus see the current value of its liabilities move in line with the market value of its assets.

### 3. The insurance approach

The success of American pension funds can be attributed in part to the fact that in the 1920s the prudential insurance regulations were abandoned in respect of pension funds.

It does not make sense to apply the same rules to a life insurance contract which can be redeemed from one day to the next, and to a pension fund whose capital is segregated and which only needs to be paid out gradually in 20 or 30 years.

The rules should specifically take into account the following:

- the commitment of the contributors to a fund is irrevocably very long term;
- the annualised volatility of performance decreases considerably over time;
- the purchasing power of pensions should be protected against the risk of inflation; and
- pension funds can even out the risks by adopting a certain amount of intergenerational mutualisation.

It is therefore advisable to avoid not only investment limits but also all regulatory obstacles to good long-term investment management.

# Prudent person to win Europension contest?

**Tom Ross**
*Principal & Actuary, Aon Consulting*
*Chairman, Scottish Life*

On the face of it, the Eurovision Song Contest has little in common with Europe's ageing population. But scratch the surface a little more and parallels emerge. Culture and tradition play as important a part in the way European nations tackle the problem of providing income in retirement as they do in coming up with a song for Europe.

Of course, issues such as the demographic time bomb, changing work patterns and economic and monetary union are somewhat more serious challenges facing pensions professionals than coming up with a particularly catchy tune. Any one of these issues will have a profound effect on the way the continent's pension arrangements are structured as we move into and beyond the Millennium.

And linked to all of these comes one of the most interesting aspects relating to the future investment behaviour of the continent's second and third pillar (i.e. supplementary) pension funds. Namely, the application of the prudent person principle.

Rebranded by Eurocrats from the less politically correct prudent man version, the principle was recently defined in the European Commission's Communication *Towards a single market for supplementary pensions* as follows: 'Prudent person rules are general guidelines for those responsible for the conduct of pension fund and investment activities (e.g. fiduciary agents, trustees, asset managers). These rules are of a qualitative nature. The aim is that the responsible persons behave as careful professionals in making investment decisions, but at the same time are aware of the need to earn an adequate return on investments. Prudent person principles require that the fund does not assume unnecessary risk. In fact, it aims at diminishing risk through diversification.'

The EC Communication, which itself was a result of consultations on the Green Paper on supplementary pensions in the single market, revealed that the principle of 'prudent person' management drew wide support during its consultation period. It estimated that assets held by pillar two pension funds in EC member states (i.e. from occupational schemes) were equivalent to approximately 23 per cent of the EU's gross domestic product. Yet at the

same time, no specific community rules existed guaranteeing application of free movement of capital and freedom to provide services.

The introduction of the Euro, the communication argued, has created a broader capital market for investors, which was more liquid yet devoid of exchange risk.

In a nutshell, the prudent person principle leads to a greater exposure to equity investment. The European Commission believes pension funds should put more money into publicly quoted companies and less into government bonds. The Commission's thinking behind such an approach is straightforward enough; over the long term, equities offer superior, less volatile returns. Pension funds are long term investors, therefore pension funds should invest more in equities.

So why does the Commission hide such a logical reasoning behind such a confusing and outdated title? After all, the philosophy of maintaining a decent standard of welfare protection is one shared by all member states of the European Union.

In the long term of course, it is better to have a principle than a fixed goal. In addition, the principle of investing in the manner of a prudent person is robust. Some may view such a notion as analogous to the legal system's dependence on interpreting events through the eyes of a reasonable man. And that method has served well for several centuries.

In the short term, this piece of jargon also helps the European Commission to fight those nations, political affiliations and even internal resistance opposed to its policy. Euphemisms cause less offence than bold statements and the prudent person principle can be modified to mean different things to different people. As jargon for higher equity investment however, the principle is not popular with socialist europoliticians, the European Trades Union Congress and Member States such as Denmark, France and significantly, Germany, potentially Europe's largest provider of supplementary pensions.

Left-wing politicians fear that encouraging greater equity investment will strengthen capitalism across Europe. Some member states shy away from being forced into new ways of providing for retirement.

This brings us the deeper significance of the prudent person principle. It implicitly supports the funding of retirement provision, which runs contrary to the social welfare system in several Member States.

It may be difficult for pensions professionals in countries such as the Netherlands or the United Kingdom to understand why opposition to funding exists.

Investments in securities – bonds or equities – generally outperform inflation over the long term, and therefore seem the most appropriate way to build up a pot of money with which to finance the golden years of retirement. There is a general argument to temper this approach. And that is that securities ultimately carry no guarantee as witnesses to the Black Monday crash of 1987 and more recent crises in the Asian markets will willingly testify.

A state welfare system on the other hand is more capable of providing rock solid guarantees. Thus it is dangerous to do away with some kind of universal, state-backed benefits system (Chile is now world famous for total funding but even in this South American country there is considerable state interference and guarantees within the privatised system).

European countries have more specific national reasons for opposing funding. For the French, it breaks with the notion of universal solidarity. Those that work pay for those in retirement and thus the bond between generations is strengthened.

Meanwhile in Germany, there is a mistrust of equity investment since the hyperinflation between this century's two world wars. Such mistrust has typically led individuals to seek comfort by buying property and even engendered a serious interest in Swiss bank accounts. Otherwise the German economic recovery of the 1950s was fuelled by reinvestment of income by companies. The prudent person principle upsets such a notion because it suggests diversification into investment in other companies often based abroad and therefore away from the domestic arena.

Denmark is another interesting member state. It taxes pension fund investment returns above a certain threshold, currently 3.5 per cent, a move which only encourages investment in government bonds at the expense of other asset classes such as equities.

Belgium, however, last year relaxed restrictions requiring a minimum 15 per cent investment in domestic government debt. And Portugal has raised equity investment to 50 per cent of assets in recent years. Just ten years ago, and still basking in the aftermath of a post revolution environment it was commonplace in that country to come across pension payments to individuals

which were larger than the corresponding wage in employment. Such a move towards greater equity exposure is a great step indeed.

In reality, state systems also have inherent risks (future taxpayers may refuse to pay the bills) so a balance between funding and pay-as-you-go makes sense.

Of course there is much debating yet to be carried out. After all, the EC has not stated categorically whether there should be any quantitative limits on equity investments by pension funds. Moreover, the proposals for adoption of the prudent person principle have been developed by the department responsible for Europe's single market. Such proposals still have to be approved by the full Commission, then the European Parliament and finally the Council of Ministers.

There is plenty of time for horse-trading. One thing is clear, the topic of retirement planning has never been so high on the agenda of so many governments throughout Europe as it is presently. No-one can be sure how well the prudent person will be able to protect himself from politicians and national interest.

# The problem of pensions and the prudent man principle: Prudence according to Lazard Freres Gestion

**Jean-Pierre Thomas**
*Consultant, Lazard Freres Gestion*

The question of pensions is addressed in economics by Samuelson's 'generations' model. The problem is simple, that it is not strictly possible to preserve wealth. You cannot leave your wheat in the barn for 30 years. The only way to guarantee your old age is to have a stake in future production, i.e. the harvest of 30 years' time.

First we will analyse the fundamental distinctions between funded and pay-as-you-go systems. In the light of this reasoning, we will see what 'prudent management' can mean, firstly in terms of asset allocation, then in terms of investment strategy.

## 1. Funded, pay-as-you-go, investment

*Investment enriches our futures*

The first notable difference between funded and pay-as-you-go systems is that in the former the money contributed today is theoretically invested immediately; in the latter it is redistributed (to those who contributed in the past). Since the level of pensions depends in essence on future production, investment today benefits the pensions of tomorrow. By enabling the means of production to strengthen it increases the expected volume of future contributions. Therefore the funded system is complementary to that of pay-as-you-go; it reinforces it and makes it solvent.

*Diversification is a necessity*

The second difference between the two systems is geographic. By its nature, the system of pay-as-you-go bets future pensions on future national production. On the other hand, a pension fund by its nature is invested in a diversified manner across the world. As a consequence it is the level of worldwide production which determines the value of these assets.

If there are not enough young French people in the future to pay for French pensions, the young Chinese, Koreans or Americans will pay, because we will

have invested in their industries. The funded pension system allows one therefore to guard against regional demographic risks, counting on the demographic success of emerging countries and even the USA.

It follows clearly from this that it is essential not to limit geographic diversification of pension fund investments. That would in effect make them of no interest, since it would not help the solvency of the pension system which, as it stands, is hardly solvent. This is the first golden rule of prudent investment according to Lazard – international diversification is essential.

## 2. Asset allocation

*The principles of prudent management*

Prudence should not lose sight of the objective: the maximisation in the long term of wealth in real terms (let us examine this question of wealth in real terms). In fact, when one thinks of prudence one thinks too often of safety of capital in nominal terms. But let us take as an example the asset class that has been most profitable in the long term, the New York Stock Exchange. Much has been said about the staggering advance of the Dow Jones this century. But one has to be aware that in real terms; the picture is less flattering.[1] The level reached by the Dow in 1981 (808 points) is the same, in real terms, as that in 1927 (about 160 points). As for the level before the crash of 1929 (380), it is about the same, in real terms, as that before the crash of 1987 (2600).

*It makes sense to invest in production*

Let's get back to the subject. If pensions of the future cannot fundamentally be worth more than the level of future production, it is thus prudent to invest directly in production, in industry generally, in the creation of wealth, that is to say in shares. In the long term (more than a decade – *see below*) there is no reason to have any other investments, or take any other route to have a stake in future wealth.

*Our studies confirm this*

The asset allocations of our quantitative teams clearly arrive at the same results. The return on shares is greater, over any given period of 5 years, than that on bonds. There is no better way of projecting the returns and the risks expected over the long term than historical research. Classical portfolio optimisation models, for a portfolio with a 30-year horizon, allocate 100% to

shares, with a probability of more than 99.5% of not losing capital. The results point in the same direction for all time horizons of over 10 years.

How can we be more prudent than these models? We have introduced the simple solution of making hypotheses about shares which are less favourable than the historical data, and in testing our models against these assumptions. For example, by supposing that the return on shares will be 7% rather than 8% per year, and in attributing them with a volatility of 18% rather than 15%.

The results are not significantly different. Beyond a 15-year investment horizon it hardly makes sense to invest in anything other than shares. As the date of maturity approaches, it is of course advisable to control the risk more tightly, and to lock in the gains already achieved: the proportion of bonds is gradually increased.

So we come to our second golden rule of long term prudent investment management – invest in shares.

### 3 On investment strategy

*Stay on course*

Most equity fund managers are not able to beat the index consistently. Each year, only a handful of them achieve it. The same do not necessarily do so the following year. The reason, according to in depth and serious research,[2] is that most managers do not manage to hold to a stable and definite strategy. Many do not have an exact strategy; many others have one which they change as soon as it does not work. That is exactly the wrong time to change an intelligent strategy. That is the way to sell at the lowest price.

The index itself only beats most managers because it reflects a constant strategy which is valid and determined: to choose the highest market capitalisations and the most liquid stock. Several investment strategies are completely valid, but they must be adhered to. This is the case of all the large funds, which have been consistently over a period of decades (Soros, Zweig, Lynch / Fidelity, etc.).

So the third golden rule of prudent investment management – stay on course. A prudent pension fund therefore must have precise and strict investment principles. A process must clearly reflect this in practice; one further argument for transparency.

## Conclusion

So the three golden rules of prudent management of pension savings are:

- to be heavily invested in shares;

- to have a clear and constant strategy; &

- to be internationally diverse.

From this one sees that all restrictions on investment management freedom in the form of asset allocation restrictions are less than optimal and therefore risky. To require a proportion to be invested in bonds would lead to a substantial risk of poor performance. To require investment in national or regional industry would increase the risk of insolvency. What is more, considering the financial services industry has a demonstrable capacity for innovation, the regulation of investment and savings is in general bound to be ineffectual.

In essence, prudence is confidence. The fact that pension funds, as opposed perhaps to other investment vehicles, are entirely focussed on the very long term is the better guarantee of their prudence and their responsibility. The main effort should be channelled towards improved information, financial education, and an equity culture. Understanding of basic financial realities is in not widespread. By alerting everyone to their responsibility for the pensions problem, it would be a step towards a sense of common purpose.

[1] Martin Zweig, Winning on Wall Street, New York 1997, ed. Warner Books

[2] O'Shaughnessy, What Works on Wall Street, New York 1998, ed. McGraw Hill

# The prudent man principle

**Iain Saunders**
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The European Supplementary Pensions industry is at a very early stage of its development. We all hope that it will grow up to be a strong healthy industry providing good pensions for retired people and making a valuable contribution to European economic growth.

For the industry to develop properly it is necessary for it to be built on secure foundations. One of the most important elements of these foundations is, I would like to suggest, the 'prudent man' principle.

We hear a lot about the 'prudent man principle' in the context of pensions. It is a very Anglo-Saxon concept and, like many Anglo-Saxon concepts, it is very difficult to define. The prudent man is an elusive creature but I would like to try to pin him down because he has many virtues, at least in the investment world, and I think he improves on further acquaintance and is capable of being useful, not just in the Anglo-Saxon world but also over the Channel where I think he would be admired if he were better known.

So what are the defining characteristics of the prudent man who looks after our Anglo-Saxon funded pensions, on whom so many British and American people are dependent for a satisfactory pension in their old age? How do we recognise him? By his bowler hat, furled umbrella, polished shoes and pinstripe suit? I think there are five key characteristics. I propose to examine each of them and hope that this examination will aid his recognition – perhaps even his cloning.

These characteristics which he exhibits in the investment world are:

- that he is law abiding;
- that he takes account of the liabilities for which he is responsible in deciding his investment strategy;
- that he looks at assets before investing in them;
- that he keeps risk to acceptable levels; &
- that he is independent minded.

I am now going to look at each of these characteristics. Some of them are perhaps more impressive than you might at first think.

**Law abiding –** we all know what that means although in practice it is not as easy as it sounds. It may be a surprise to learn that in the UK, apart from the Pensions Act 1995 which consolidates lots of previous legislation governing pensions, over 50 statutory instruments have been issued since 1995. Not an easy task to know what the law is, let alone abide by it.

**Taking account of liabilities** in deciding what is an appropriate investment strategy is complicated because you are looking not at a single figure but at how those liabilities are structured. You are looking at the maturity profile of those liabilities, that is at what times and in what numbers will retired people come along and say, 'please can we have our pension?'. You are looking at the currency in which these retired people are going to want their pensions paid – simple enough for a small domestic pension fund but less easy for the pension fund of a large international company – and companies are becoming increasingly large and increasingly international these days. Economic and Monetary Union should help make this easier but there will still be European multinationals with subsidiaries and employees outside the European Union who want their pension paid in their local currency.

The prudent man looks not just at the size and structure of the liabilities as currently constituted but he looks ahead by analysing the dynamics of those liabilities. Are they growing? If so, are they growing in line with inflation or in line with average earnings? If they are growing in line with inflation, that is a powerful argument for investing in real assets such as equities. If they are growing in line with average earnings that is an even more compelling argument in favour of investment in equities. But those are arguments for another day. Returning to the elusive prudent man and his liabilities, he should also be taking account of the liquidity requirements of the fund for which he is responsible. He cannot tell the pensioners that he has a wonderful investment strategy in place but that they must come back for their pension the year after next.

All these aspects of taking account of liabilities in deciding investment strategy might appear so dauntingly complex as to frighten any prudent man. The situation is not so bad as it appears. Help is at hand. The actuarial profession has developed expertise in analysing assets and liabilities and is therefore able to provide reliable advice on the structure of a portfolio that is appropriate to particular liability profiles. The prudent man will listen to and act on this advice.

So, I think that we have established that taking full account of the liabilities for which the fund is responsible, in all their aspects, is one of the essential

characteristics of the prudent man in the world of pension fund investment.

**Looking at assets before investing** funds in them is also of vital importance. This is generally a two stage process. The first stage involves deciding the allocation of assets between different classes of assets: equities, fixed interest, real estate and also some judgement about regional asset allocation and currency exposure. The second involves deciding in which particular securities to invest. Investment managers will differ in the importance which they attribute to particular factors and this will be reflected in the price they are prepared to pay for particular securities. That is the essence of a free market. But there are certain factors which most investment managers will accept as having some bearing on the value of an investment: creditworthiness, the earnings prospects, the quality of the management, the strength of the balance sheet, the way earnings are affected by the economic cycle.

The prudent man will take account of all these factors before deciding whether or not to make the investment. This will usually involve considerable research: looking at the published accounts of the possible investment, comparing them with those of its competitors, perhaps meeting the company's management to question them on their prospects. The research effort, however, does not stop there. It is important that the performance of the investee company is monitored against expectations and expectations are revised in the light of changing economic circumstances. It is important also that such influence as the investor is able to exercise is brought to bear on a company's management to secure its long-term profitability – what is nowadays usually called corporate governance.

All this asset allocation, research effort, monitoring and corporate governance activity may well be beyond the resources of the individual or company which is responsible for a pension fund. So those responsible, if they are realistic, will recognise their limitations and delegate some or all of these responsibilities to professional investment managers. They will first satisfy themselves as to the competence of possible investment managers and then select the most suitable – for this professional advice is available, if necessary, from consultants. They will set investment guidelines and then give the appointed investment manager the authority to make investments on behalf of the funds, subject to those guidelines. They will thus be fulfilling the duty to know what they are investing in and, although they will be delegating some of the responsibility, will be acting in accordance with the prudent man principle.

**Keeping risk to acceptable levels**. The prudent man, however, is not just looking to get a good return. He is also keeping a sharp lookout on the risks that are being run and ensuring that they are acceptable. Risk is a highly complex topic. It is difficult to define and even more difficult to measure. I would, however, like to emphasise one point strongly. That is, when one is talking about risk in the context of pension funds, we are not interested in the volatility of the portfolio and its returns in absolute terms but in the volatility relative to the liabilities which that portfolio is funding. In other words: the confidence with which one can say that the portfolio of assets is going to be able to meet the liabilities of the pension fund.

One of the key skills of the competent investment manager is being able to secure higher returns without increasing portfolio risk. He does this through investing in a broad range of asset classes which do not correlate in terms of return.

There are two other aspects of risk management which I will touch on in the context of pension funds, although thankfully these are rather more straightforward. The first is that a fund should not be too highly geared, that is it should not borrow too much to finance its investments. For a pension fund, the prudent man principle, perhaps reinforced by the constitution of the fund, dictates that gearing should be minimal.

Secondly, the prudent man principle dictates that a pension fund should not accept unlimited liabilities. An unlimited liability may be assumed, for example, by writing an uncovered option. Although I do not wish in any way to criticise the use of options which are an invaluable tool of portfolio management, both for hedging risk and for gaining exposure, the writing of uncovered options exposes a fund to a degree of risk which is unacceptable to a pension fund. The prudent man will therefore avoid this type of risk.

**Independence of mind**. The final defining characteristic of the prudent man is his independence of mind. He does not allow himself to be pushed into unsound investments which his financial judgement tells him to avoid. We live in a society where the rule of law is fairly well established. Indeed it is unlikely that pension funds could function properly without the rule of law. Pressures to make unwise investments come, however, not from villains or criminals or Mafia style mobsters. They come often from the law makers themselves, that is from central government which has a lot of power in its hands but is itself subject to electoral and fiscal forces. These government pressures may take the form on occasion of compulsion to invest in the

national bond market or encouragement to invest in new growth industries with promising job creation prospects or to bail out a major company or industry which is in danger of going bankrupt. It is important that these pressures are resisted because they can have a very damaging effect on pension funds, usually without doing much good to the intended beneficiary.

The prudent man will be able to resist these political pressures as long as the legal framework under which he operates gives him the strength to do so. If the legal framework is such as to deprive him of the ability to do so – and here I am referring to the quantitative restrictions on investment that are still in place in several European countries – the prudent man will be faced with a conflict between obeying the law – which, you may remember, was the defining characteristic of the prudent man which we started off with – and independence of mind. Our prudent man will, of course, obey the law because that is the overriding requirement. But he will do so without any sense of satisfaction that he is doing a good job for the funds for which he is responsible.

**Quantitative restrictions**. The harmful effect of quantitative restriction on investment goes, however, I think deeper than this. Quantitative restrictions encourage the obeying of rules rather than the achievement of useful objectives such as securing good returns and avoiding risk. There is a very real danger that, by insisting on compliance with regulations, they will lead to the more important objectives being overlooked.

Let me end by demolishing some of the myths surrounding quantitative restrictions. Firstly they do not reduce investment risk. They may well have the opposite effect by preventing the degree of diversification necessary to achieve a well balanced portfolio. Secondly, they are not usually for the benefit of the beneficiaries of the fund. They are usually in place to facilitate the funding of government borrowing requirements. The growth of funded pensions should help reduce borrowing requirements, but it would be naive to suppose that this type of pressure will ever disappear altogether.

**Conclusion**. I hope that I have set out the merits of the prudent man principle as opposed to quantitative investment restrictions and made clear that the adoption of the prudent man principle is most likely to lead to the achievement of objectives which those on both sides of the Channel share: good returns and reduction of risk, leading to high pensions for retired people.

# External prescription or the prudent man

**Sir David Walker**
*Chairman, Morgan Stanley Dean Witter (Europe)*
*formerly Chairman, Securities and Investments Board*

The last few years have seen continuing rapid growth in the array of products designed to enable market participants to manage their risk / return profiles more closely in accordance with their financial objectives. This has special relevance for pension funds in Europe, and those who oversee and manage them, given the combination of demographics and widespread under-provision for retirement. As a result, an increasingly insistent question is how to ensure satisfactory returns, in terms of some combination of capital appreciation and earnings streams, while maintaining the underlying financial soundness of schemes.

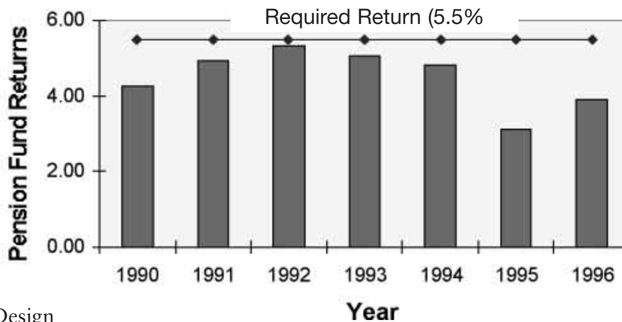
At opposite ends of the spectrum, there are two broad policy approaches. One involves some form of external prescription, more or less detailed, limiting the exposure of a fund to various categories and subcategories of investments through the imposition of specific boundaries or limits. In this way a degree of diversification is built into the asset mix, with the object of preventing an undue concentration of assets in any particular area. The alternative is the so-called 'prudent man' approach. Sceptics about this approach frequently cite the definition of what is 'prudent' as a major difficulty. After all, they argue, what might be regarded as prudent in one situation or culture might not be so considered in another. The very nature of prudence and its implication of judgement mean that there will always be scope for those of an adventurous nature to strain the flexibility of the system.

But externally imposed prescription is clearly problematic. Financial theory shows that artificial restrictions on asset allocation will tend to lead to an outcome falling short of the efficient frontier. Sub-optimal investment leads to sub-optimal returns. For a demonstration of this in action one need only look at the recent history of pension fund performance in Japan.

The shortfall in the Japanese pension fund provision has prompted the current substantial efforts for reform. While the precise scale of the pensions shortfall is unknown, analysts estimate it to be in the region of Yen 60 Trillion (Euro 560 Billion). Demographics are clearly a big factor in the ballooning deficit – almost 17% of Japan's population is now over age 65 and this number will increase to 22% by 2010. However, poor returns have aggravated the position. Over the decade from 1985 to 1995, Japanese pension funds earned a return on average of only 5% per annum, barely one-third of the returns achieved by the average US pension plan over the same period.

Returns were hampered by restrictive investment regulations. Until late last year, Japanese pension funds were subject to the '5-3-3-2' rule. This required pension funds to invest a minimum of 50% of their portfolios in Japanese bonds or cash, to place no more than 30% of funds in foreign assets, to invest no more than 30% of assets in domestic equities and to limit exposure to real estate to a maximum of 20%. Separate restrictions meant that only 50% of a pension fund's assets could be managed by an external investment manager other than a life insurer or trust bank, while all funds were required to target a realised return of 5.5% per annum. Consistent failure to meet this last target has led to the recent abolition of all three restrictions.

**Figure 1**




Source: Life Design

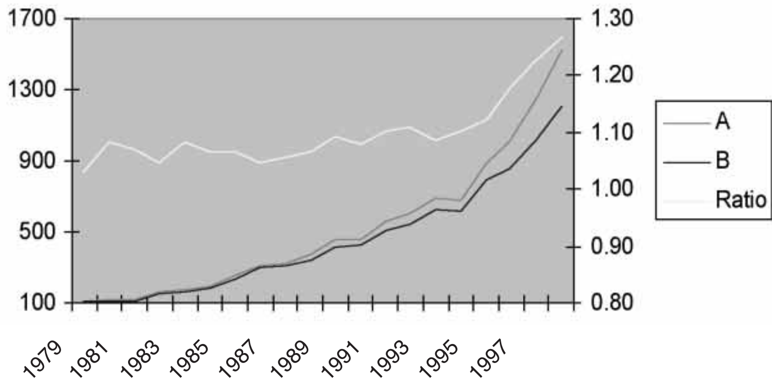
It seemed instructive to review what the effect of this 5-3-3-2 restriction might have been when applied to a market regulated on a prudent man approach. In a deliberately simple but relevant comparison we have looked at the returns that might have been achieved if the average asset allocation of US pension funds had been subject to such a rule over the last twenty years. Specifically, we have taken a typical asset allocation of US pension plans today, and compared it with that of twenty years ago and assumed a linear progression thereafter. This gives the following start, average and ending asset allocations:

| Asset Class | Starting Allocation | Average | End Allocation |
|---|---|---|---|
| Bonds/Cash | 50% | 40% | 30% |
| Domestic Equity | 45% | 50% | 55% |
| Foreign Equity | 0% | 5% | 10% |
| Real Estate | 5% | 5% | 5% |

Using, respectively, US long-term government bond indices for bond performance, the S&P 500 index for US equity returns, and the MSCI EAFE index for foreign equities, the progression of an initial investment of 100 is shown below as line A.

Using the same data but restricting the asset allocation by class, we then re-ran the numbers in line with the 5-3-3-2 rule, again with a base of 100. Where the level of US equity has been 'capped out' at 30%, we reallocated the excess between foreign equities and bonds in a manner consistent with the asset allocation at the time. This is shown as line B. The ratio of returns is also shown (right hand scale).

**Figure 2**




Source: MSDW

The 'actual' strategy significantly outperformed the 'constrained' strategy over the period, achieving a return of 14.6% per annum versus 13.3% per annum for the latter. It is also interesting to note that the volatility of the 'actual' strategy (10.6%) is fractionally less than the volatility of the externally prescribed or constrained strategy (10.7%). Thus, the constraints would have cost 1.3% per annum in return with no reduction in risk.

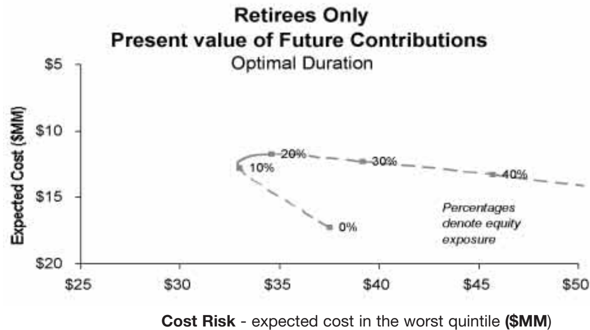
It is clear that, in the US market at least, the imposition of a rule such as the Japanese funds have been subject to would have had a material impact on pension fund returns and, through this, the financing cost of pensions.

So, if a restrictive approach brings some degree of security, but at a potentially significant cost, what of the alternative? How serious is the risk that a regulatory environment based on the prudent exercise of judgement, as opposed to external prescription, would be abused.

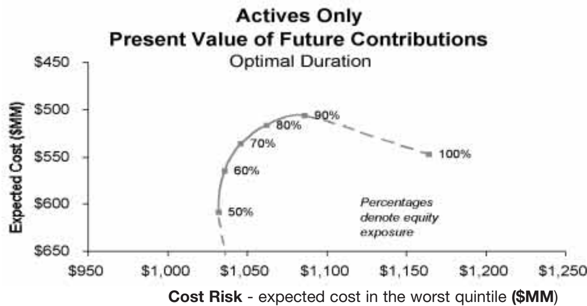
A prudent man rule relies on the use of judgement, and judgement based on knowledge, as the basis for decisions. Those charged with supervising assets in such an environment must have due regard to the risks and dangers inherent in managing those assets; if not, they will be held legally liable. For the custodians or trustees of the assets therefore, the prudent man approach is actually more demanding, requiring more knowledge and more real risk assessment than would be required under the constraints of an externally prescribed approach.

The issue then becomes what tools or techniques can be used to help supervisors of assets at all levels to understand their risks better and to be both prudent and efficient. The traditional view of risk as an 'asset only' consideration is plainly outmoded. For pension funds, the behaviour not just of the assets but also of liabilities – and crucially how these inter-relate – is how risk must be reviewed and understood, with asset / liability modelling as the key technique. Specifically, such modelling helps to answer the question how asset allocation can be safely and sensibly tailored to individual scheme circumstances by creating a rational, neutral benchmark, with the means of monitoring the deviation from this.

To illustrate this, consider two very different scenarios. Fund 1 is a closed fund and has no active members remaining: its liabilities consist entirely of known, fixed payments to pensioners. Fund 2, by comparison, is that of a young company. So far, it has no pensioners and indeed its first pensioner is still some years in the future. While externally prescribed constraints would apply equally to both funds, asset / liability modelling combined with a 'prudent man' approach allows us to see clearly that the minimum risk position for each fund is significantly different.




**Fund 1**




**Fund 2**

The charts show the bond / equity split appropriate for each fund (percentage of equity shown) where the axes represent the expected cost of the fund over its lifetime (in $mm) against the average cost in the worst 20% of simulations – which gives a very real measure of financial risk. It is clear from looking at the charts that for Fund 1, equity exposure greater than 20% is not justified. Both expected costs and risk rise with higher equity levels. For Fund 2, an equity exposure of less than 50% will be sub-optimal, while an equity content of up to 90% may still be prudent.

It is concepts such as this which provide muscle to the prudent man approach. A flexible, prudent man approach would seem to offer the best way forward in terms of optimising performance and thus of keeping down the real costs of pension provision. Of course, this sets high standards for the capabilities of those charged with managing pension fund assets and for the regulators who have to determine that such capabilities are fully and continuously in place. But given the potential opportunity cost of the external prescription approach, this seems to be a price worth paying.

# Quelques réflexions à propos de la «Prudent Man Rule»

**André Babeau**

*President du CREP (Centre de Recherche sur L'Epargne)*
*Professeur émérite à l'Université de Paris Dauphine*

La « *Prudent Man Rule* » est un bon exemple de ce droit coutumier qui repose moins sur les textes que sur des pratiques et qui s'oppose donc au droit écrit des pays où l'influence du droit romain a été la plus forte. Cette règle, à notre connaissance, a été appliquée, dès le début du siècle, dans les pays anglo-saxons aux gestionnaires de fonds de pension, de contrats d'assurance-vie (aussi bien pour les contrats en U.C. que pour les contrats en monnaie nationale), plus généralement à l'ensemble des gestionnaires de sociétés de placements ayant des comptes à rendre à des tiers.

Dans beaucoup de pays d'Europe continentale, des réglementations assez strictes se sont développées d'abord entre les deux guerres et surtout depuis la seconde guerre mondiale, qui imposaient des limites à la liberté de placements en particulier dans la gestion d'actifs correspondant aux engagement pris dans le cadre des contrats d'assurance-vie. Plusieurs aspects de ces réglementation ou bien n'ont guère eu l'occasion de s'employer, ou bien ont conduit à des résultats plutôt décevants. On comprend donc que les différentes instances chargées d'assurer à la fois la sécurité et l'efficacité de la gestion pour compte de tiers, et en particulier les instances de l'Union Européenne (Commission, Parlement Européen, commissions spécialisées), se soient posées la question de savoir s'il n'était pas préférable de s'affranchir de certaines règles écrites pour développer plus souplement des pratiques dans le cadre d'une application aussi compréhensive que possible de la «*prudent man rule*».

On traduit souvent «*prudent man rule*» par «gestion en bon père de famille». Du point de vue philosophique, on pourrait sans doute retrouver chez le «Pater Familias», tel que le dépeint Saint-Thomas, des éclairages intéressants sur le «sens des responsabilités», l'exercice de la prévoyance naturellement, mais aussi de la précaution, la pratique du «dialogue» dans la famille…etc.

Pour passer de la philosophie aux «circonstances», il est clair que la baisse récente des taux d'intérêt et la nécessité d'accroître la part des actions dans les portefeuilles pour accéder à des rendements plus élevés oblige probablement à élargir les perspectives d'application de la «*prudent man rule*» et à s'inspirer des expériences disponibles dans ce domaine.

De façon concrète, le champ d’application de ma «prudent man rule» paraît en effet très large puisqu’il concerne aussi bien:

- des principes comptables (par exemple, le fonctionnement du cantonnement et la référence aux valeurs de marché) ;
- des règles de gestion (par exemple, réserves venant compléter les réserves mathématiques, dispersion des placements, couverture des engagements courts par des titres liquides…etc.);
- un environnement de contrôle et de garantie dont on constate, par exemple, qu’il est encore très loin d’être harmonisé dans les 15 pays de l’Union Européenne, en dépit des Directives déjà édictées dans certains domaines.

De son côté, la **Commission juridique et des droits de citoyens** du Parlement Européen, dans son rapport sur le Livre vert de la Commission concernant les retraites complémentaires dans le marché unique (Décembre 1998), ne cite pas moins de six domaines dans lesquels le principe du «bon père de famille» devrait trouver à s’exprimer.

La référence à la «*prudent man rule*» est certainement utile et génératrice de liberté dans la mesure où elle conduit à remettre en question certaines réglementations inutiles ou même nuisibles. Mais sa traduction dans les faits et dans la pratique exige encore de nombreuses réflexions et sera, par la force des choses, très étalée dans le temps.

# Prudent Man Rule

**Denis Chemillier-Gendreau**
*L'épargne salariale et l'épargne retraite, Paribas Asset Management*

L'idée d'imposer aux fonds de pension des contraintes de placement est naturelle et compréhensible. Tel partisan de ces contraintes trouvera toujours un exemple où la liberté a conduit à des dérives préjudiciables. Naturelle et compréhensible, elle est aussi difficile à juger.

La question se résume ainsi : la prudence – vertu dont le « père de famille » semble la figure emblématique… – peut-elle légitimer ou conduire à l'instauration de contraintes de placement (dispersion, diversification, allocation d'actif, congruence, …)?

Mettons de côté, au passage, tous les motifs moins avouables que tel député du Sud Ouest trouvera à investir dans les entreprises viticoles ou tel autre sénateur italien trouvera à réserver une part de l'actif dans l'industrie de la chaussure. Soyons néanmoins conscient que le principe de contraintes de placement est une Boîte de Pandore que l'on ouvre en invoquant la prudence mais dans laquelle on prend le risque de tomber au nom des intérêts régionaux ou professionnels…

Qu'est-ce que la Prudence? Certains répondront: «de prendre le moins de risques possible». Mais si la prudence est une vertu, elle ne l'est que pour autant qu'elle soit mesurée. Lorsqu'elle se confond avec la peur, elle cesse d'être vertueuse.

La prudence est donc plutôt l'art de prendre des risques **mesurés et proportionnés** aux souhaits de l'investisseur. La prudence n'est donc pas un concept absolu mais **relatif**.

Relatif à quoi?

En premier lieu à la personnalité de l'investisseur, à son «degré d'aversion au risque», qui se discute autant que les goûts et les couleurs. Pour partie, ce degré d'aversion au risque dépend du caractère; pour partie, il dépend aussi de la situation patrimoniale de l'investisseur. Un «père de famille» disposant déjà de ses résidences principales et secondaires et d'un patrimoine de rapport sera prêt à assumer sans doute plus de risques sur son épargne retraite qu'un voisin sans patrimoine.

Mais l'âge, et donc la durée de l'investissement, est une variable clé. Car les actifs financiers changent de nature avec le temps. Les actions, pour ne parler

que d'elles, très volatiles à court terme, voient leur volatilité diminuer à mesure que s'allonge la période de détention. Le paradoxe de la gestion est que la **même** prudence qui recommande, à court terme, d'investir en produits de taux recommandera, pour des durées plus longues, d'investir en actions.

Ainsi, toute restriction quantitative ou qualitative aux placements et à leur répartition ne serait acceptable que pour autant qu'elle soit compatible avec l'infinie diversité des souhaits et des situations personnelles des investisseurs. Poser ainsi, la question a sa réponse évidente: de telles restrictions ne sont pas souhaitables parce qu'elles ne peuvent matériellement couvrir - et convenir à – toutes les situations. Une même allocation d'actifs ne peut satisfaire **à la fois** le riche et jeune salarié, avide de risque, et le salarié modeste et proche de la retraite, fortement *risk adverse*.

Feue la loi Thomas avait été l'occasion d'une tentative qui mérite d'être saluée avant d'être enterrée: les décrets d'application avaient en effet tenté de proportionner la liberté du gestionnaire financier à la duration du passif. Louable, cette tentative avait conduit à un texte d'une lourdeur évidente et d'une application difficile.

Faute de pouvoir convenir à tout le monde, les contraintes doivent être abandonnées. Est-ce si grave? Les gestionnaires financiers ne sont-ils pas précisément là pour adapter les risques de leur gestion aux caractéristiques et aux souhaits de leurs clients?

Un dernier argument mérite d'être analysé: le rôle de prêteur en dernier ressort de l'Etat (si le fonds de pension fait faillite, l'Etat en assume les conséquences via, par exemple, le minimum vieillesse), qui créerait un risque d'aléa moral. Il faudrait donc faire le bien de l'investisseur malgré lui, en lui imposant des contraintes de placement, afin d'éviter qu'il ne revienne à la charge de la puissance publique en cas de défaillance… Convenons que ce risque est faible, dès lors que les futurs retraités scrutent avec vigilance la gestion de leur fonds de pension.

Précisément, la vraie *prudent man rule* est là, dans l'obligation d'information, de *reporting*, de transparence dans la gestion, plutôt que dans des contraintes d'autant plus inutiles qu'à vouloir ranger tout le monde sous la même bannière elles ne feront que des mécontents.

# Transparence et efficacité: les deux éléments d'une délégation de gestion en «bon père de famille»

**Christian Gollier**
*Professeur à l'Université de Toulouse*
*Maître de Conférence à l'Ecole Polythechnique*
*Membre junior de l'Institut Universitaire de France*

Un bon père de famille prend les décisions qui sont les plus favorables au bonheur de ses enfants. Exiger des gestionnaires de fonds pour compte de tiers une gestion en «bon père de famille», c'est donc leur demander de sélectionner des portefeuilles d'actifs qui maximisent la satisfaction de leurs clients. La théorie de la finance moderne, fondée sur l'observation des préférences individuelles face au risque, a dérivé un certain nombre de règles de gestion dynamique de portefeuille conduisant à une satisfaction à priori maximale des clients. Ces règles sont bien connues et ne peuvent être ici résumée. Néanmoins, soulignons un élément central : la nécessité d'une diversification du portefeuille à travers les différents secteurs d'activités, à travers les différents pays et à travers le temps.

Le monde est fait d'individus aux goûts, préférences et objectifs très hétérogènes. Contrairement à une idée répandue, les économistes reconnaissent cette hétérogénéité. Il serait insensé de recommander une et une seule stratégie de placement de «bon père de famille». Il existe en fait autant de bonnes stratégies que d'investisseurs sur le marché. Il est important que les gestionnaires de fonds disposent d'une bonne connaissance des degrés d'aversion au risque de chacun de leurs clients pour organiser cette gestion individualisée. En l'absence de problème de délégation, tout système d'encadrement des stratégies de placement des gestionnaires conduirait nécessairement à une perte de bien-être des ménages. La flexibilité est un corollaire nécessaire à l'efficacité.

L'histoire nous enseigne néanmoins que des problèmes de délégation peuvent exister entre les gestionnaires de fonds et leurs clients. Parmi ces problèmes, notons celui lié à la responsabilité limitée des gestionnaires, qui pourrait générer une stratégie de «*bet for resurrection*», comme on l'a vu dans la crise américaine des «*savings and loans*». De plus, parce que les ménages ne sont pas toujours à même d'observer les efforts des gestionnaires, le marché n'est pas toujours capable de récompenser les plus efficaces. Ceci réduit les

incitations de ces derniers à agir en bon père de famille pour leur client, comme défini ci-dessus. L'existence de ces «*market failures*» réintroduit la nécessité d'un contrôle centralisé des fonds de placement. L'imposition de contraintes sur la structure des placements des fonds n'est qu'un pis-aller par rapport à un système plus efficace de régulation transparent et coercitif incluant des marges de solvabilité. Le rôle du régulateur devrait être avant tout de garantir la transparence et l'information du public.

# The prudent man rule

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Dans la gestion de fonds de pension comme dans la gestion des actifs financiers en général, se pose la question de l'allocation d'actifs et des conditions d'allocation d'actifs par le gérant des actifs du fonds de pension afin d'assurer une gestion optimale des actifs pour les bénéficiaires, c'est à dire rentable et prudente. Or, dans la poursuite de cet objectif pour les fonds de pension, deux types de préoccupations existent:

- des préoccupations financières, qui visent à maximiser le rendement de l'opération pour les bénéficiaires des fonds de pension
- des préoccupations prudentielles, qui visent à minimiser les risques inhérents à la gestion d'actifs pour les bénéficiaires du fonds de pension

La coexistence de ces objectifs est au cœur de la logique de prudent man rule qui doit guider les choix des gérants.

## 1. Les objectifs de la gestion financière du fonds de pension et la prudent man rule

Les fonds de pension visent à obtenir une gestion optimale pour les bénéficiaires en poussant à la sélection par les gérants d'actifs rentables, sûrs et liquides. Autrement dit, il s'agir d'optimiser le triplé constitué par la rentabilité, la sécurité et la liquidité des actifs du fonds de pension au regard des objectifs qui sont les siens, à savoir servir des pensions de retraite. La théorie économique basée sur les modèles financiers standards (Markovitz et ses dérivés) enseigne qu'une allocation optimale sur le plan du couple risque-rentabilté est obtenue sans contrainte, le gérant étant alors à même d'obtenir la diversification optimale de ses placements dans un univers totalement libre. Les règles qui peuvent lui être imposées conduisent en effet à optimiser son allocation d'actif sous contrainte, ce qui limite ses possibilités de choix, donc ses performances, ce qui se traduit par une réduction de la rentabilité des fonds placés pour le bénéficiaires ou, plus rarement, de leur liquidité ou de leur sécurité.

## 2. Les autorités prudentielles ont généralement contraint la gestion des fonds pour des motifs de sûreté.

Au delà des préoccupations de rentabilité des actifs, les autorités prudentielles ont fréquemment contraint les organismes de type OPCVM ou les organismes assureurs gérants des engagements de retraite pour des considérations de sécurité et sans préoccupation de rentabilité à court terme.

Parmi les contraintes les plus fréquemment évoquées se trouvent les contraintes de congruence monétaire: à un engagement dans une monnaie donnée doit correspondre un actif dans la même devise.

De même, une sélection des actifs doit être faite par nature d'actifs étant entendu que :

- certains ne sont pas autorisés (œuvres d'art, pièces d'or),
- d'autres sont soumis à un plafond d'engagement (dans le cas des assurances, l'immobilier ne peut pas représenter plus de 40% des engagements totaux de l'entreprise d'assurance),
- d'autres peuvent être soumis à des contraintes de plancher (généralement des titres d'Etat, par exemple dans les engagements des caisses autonomes mutualistes en France).

Enfin, au delà de la diversification par nature d'actif, une obligation de diversification par émetteur est généralement retenue dans les réglementations prudentielles en la matière.

Par ailleurs, des dispositions comptables peuvent créer une dissymétrie dans les choix d'actifs des gérants: la réserve de capitalisation et le non provisionnement des moins values latentes à caractère non durable sur obligations par opposition aux autres actifs en matière d'assurance est l'exemple le plus clair de ce type de disposition permise par la Directive Comptable sur les assurances par exemple.

Ainsi, dans un objectif de sécurité, les exigences prudentielles de sécurité conduisent fréquemment à restreindre le champ des possibilités d'intervention pour les gérants et, ce faisant, à réduire la rentabilité des allocations d'actifs pour les bénéficiaires des fonds de pension.

**3. Les dispositifs ainsi évoqués s'appliquent dans des conditions souvent similaires à des engagements de nature différentes.**

Les dispositions évoquées précédemment doivent être appréhendées au travers d'une analyse distincte selon la nature des engagements pris par les fonds de pension. De manière schématique, les engagements des fonds de pension sont de deux natures:

- soit des engagements de moyens: il s'agit des fonds de pension à cotisations définies, et des engagement retraites sous la forme de contrat d'assurance-vie en unités de compte par exemple; le gestionnaire des fonds doit optimiser la gestion des fonds qui lui sont confiés, il n'a pas un but explicite à atteindre,
- des engagements de résultats, qu'il s'agisse d'engagements de résultats basés sur des variables à caractère non financier (salaires ...) ce qui se rapproche

le plus des régimes de retraite par répartition, ou d'engagements de résultats financiers : engagements d'assurance vie avec taux d'intérêt financier garanti dans une devise quelconque de l'Union Européenne.

De la différence de nature des engagements ainsi évoquée doit découler une différence d'appréciation sur les normes prudentielles applicables au fonds de pension.

**4. Certaines règles prudentielles paraissent cohérentes avec le choix d'une optimisation des engagements pour les bénéficiaires du fonds de pension.**

Les dispositions prudentielles peuvent parfois rejoindre les considérations de rentabilité qui sont celles des gérants des actifs de fonds de pension.

Parmi ces dispositions, on peut ainsi considérer les dispositions relatives au choix qualitatif des actifs: l'élimination des actifs non rentables tels que les pièces d'or ou les œuvres d'art paraît cohérente et ne semble pas être constitutive d'un biais dans l'allocation d'actifs.

De même, certaines restrictions quantitatives par émetteurs semblent cohérentes: l'interdiction faite de disposer de plus de 5% d'actifs provenant d'un même émetteur, couramment retenue dans les normes européennes pour les OPCVM ou les opérations d'assurance vie, semble ainsi logique et ne pose pas de problème puisqu'elle rejoint la préoccupation de diversification de portefeuille qui est celle de la théorie financière, en général.

A contrario, les règles de plancher d'investissement en titres publiées existant dans certaines réglementations doivent être proscrites. Elles sont incohérentes financièrement et prudentiellement.

Au delà, les contraintes ne semblent pas nécessairement pertinentes pour ce qui est des engagements à cotisations définies dans la mesure où, la seule contrainte du gérant étant celle d'agir dans l'intérêt des bénéficiaires sans engagements de résultats, il semble logique de ne pas accroître les contraintes ex ante sauf à risquer de limiter les résultats ex post.

**5. Certaines dispositions complémentaires paraissent cohérentes lorsqu'il s'agit d'engagements à prestations définies.**

Lorsque le fonds de pension a des engagements à prestations définies (à caractère financier ou non), la troisième contrainte évoquée précédemment, à savoir la contrainte de liquidité, ne peut être ignorée. A une date précédemment définie, le fonds de pension aura en effet à servir une prestations dont le montant est défini ex ante. Dans ce contexte, il paraît

cohérent d'adjoindre une contrainte complémentaire de liquidité aux contraintes de rentabilité et de sûreté des actifs qui sont celles des réglementations prudentielles en général pour assurer un optimum au triplé rentabilité-sécurité-liquidité.

A ce titre, et sur le plan quantitatif, le seul instrument financier en mesure d'assurer à moyen terme le service de tels engagements est vraisemblablement l'actif obligataire. Dans ce contexte, un traitement favorable des actifs obligataires pour des fonds à prestations définies paraît cohérent. A contrario, la liquidité particulièrement faible des actifs immobiliers peut logiquement conduire à des contraintes plus strictes en la matière. Ainsi, sur le plan quantitatif, les contraintes plus strictes pour l'immobilier et moins strictes pour les obligations peuvent sembler logiques dans le cas des fonds de pension à prestations définies.

Sur le plan quantitatif, en particulier dans le domaine comptable, un traitement différencié des différents actifs paraît pertinent: la prise en compte des spécificités techniques des obligations peut ainsi conduire à un traitement comptable spécifique lié à la durée définie des titres obligataires par opposition aux autres actifs.[1] Simultanément, un mécanisme de prise en compte de la durée moyenne des engagements du fonds de pension dans le traitement comptable des actifs non obligataires paraît cohérent: la plus ou moins grande liquidité des engagements est à cet égard déterminante.[2]

**Conclusion**

La prudent man rule en matière de gestion d'actifs de fonds de pension doit surtout conduire à des solutions distinctes selon que le gestionnaire a affaire à des engagements de résultats ou des engagements de moyens. Lorsque des engagements de résultats existent, la prise en compte des contraintes de liquidité doit conduire à un traitement différencié des différentes catégories d'actifs, même si elle ne doit pas conduire à des distorsions aussi importantes que celles existantes en droit français des assurances.

En particulier, la duration particulièrement longue des engagements des fonds de pension doit conduire à un décalage limité dans les traitements financiers et comptables relatifs aux différents types d'actifs détenus par les fonds, donc sélectionnés par les gérants.

[1] Toutefois, et même s'il permet de lisser le rendement des actifs obligataires et conduit à une certaine mutualisation des rendements entre génération de bénéficiaires, le traitement comptable très particulier des obligations tel qu'il existe en droit français des assurances (réserve de capitalisation, en particulier) paraît discutable puisqu'il conduit à la constitution de biens de main morte totalement indisponibles et potentiellement spoliateurs des bénéficiaires du fonds de pension en cas de baisse durable des taux d'intérêt (France de 1982 à 1998).

[2] Les règles applicables en la matière en droit français des assurances sont à cet égard peu adaptées car elles ne prennent pas en compte la plus ou moins grande liquidité des engagements des organismes assureurs vis-à-vis de leurs assurés : si une telle logique est pertinente pour des produits d'épargne liquide, elle l'est moins pour des pensions de retraite.

# Comment libérer la gestion financière des fonds de retraite?

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Au début des années 1990, les quotas de placement de beaucoup d'investisseurs institutionnels ont été libéralisés, sans que pour autant évolue leur allocation d'actif.

Les obstacles qui contraignent aujourd'hui la gestion des fonds de retraite sont plus délicats à identifier que les quotas de placement, parce que plus techniques et opérant parfois indirectement. Ils sont au nombre de trois:

**1. La discrimination comptable entre en actions et obligations.**

En cas de hausse des taux d'intérêt, les moins-values sur obligations ne donnent pas lieu à provision (article 332-19 du C.A.). Les moins-values sur actions, au contraire, doivent être provisionnés après compensation des plus ou moins-values.

Cette discrimination exerce une très forte contrainte sur l'allocation d'actif. Si la nécessité d'investir à long terme est claire, elle se heurte à la nécessité plus forte de protéger chaque année la marge de solvabilité, ce qui raccourcit l'horizon de gestion effectif.

Les discussions autour de la loi Thomas qui voulait créer des fonds de pension sous le régime du code des assurances ont fait apparaître une contradiction insoluble entre cette discrimination comptable et une exigence de quota minimal d'actions.

**2. L'évaluation des engagements**

Le fait d'actualiser les engagements en fonction d'un taux historique datant de l'origine du contrat donne à la valeur réglementaire du passif une forte rigidité.

L'absence de cohérence actuarielle entre les principes d'évaluation de l'actif et du passif conduit à créer une volatilité artificielle des comptes et de la solvabilité apparente de l'institution, et réduit la part des actions dans l'allocation d'actif.

Il serait simple de corriger cette anomalie, en remplaçant les ratios de solvabilité en valeur comptable par des ratios de solvabilité en valeur économique ou actuarielle. Un fonds de retraite équilibré verrait alors la valeur actuelle de son passif évoluer comme la valeur de marché de son actif.

### 3. L'approche assurantielle

Le succès des fonds de pension américains trouve une de ses sources dans le renoncement, dès 1920, à l'application aux fonds de pension de la réglementation prudentielle des assurances.

Il n'est pas naturel d'appliquer les mêmes règles à un contrat d'assurance-vie pouvant être racheté d'un jour à l'autre et à un fonds de retraite dont le capital est aliéné et qui ne donnera lieu qu'à des versements progressifs dans 20 ou 30 ans.

Les règles doivent notamment tenir compte des particularités suivantes:

- l'engagement des cotisants du fonds est irrévocablement à très long terme
- la volatilité de la performance annualisée décroît fortement avec le temps
- le pouvoir d'achat des retraites doit être protégé contre le risque d'inflation
- les fonds de retraite peuvent lisser les risques en adoptant une certaine dose de mutualisation intergénérationnelle.

Il convient donc d'éviter non seulement les quotas de placement, mais tout obstacle réglementaire à une bonne gestion à long terme.

# Les problèmes des retraites et la gestion de bon père de famille: la prudence selon Lazard Frères Gestion

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## Introduction

La question des retraites est thématisée en économie par le modèle dit «à générations» de Samuelson. Le problème est simple: il n'est pas possible, *stricto sensu*, de conserver des richesses. On ne peut pas mettre du blé de côté pour dans 30 ans. Le seul moyen d'assurer ses vieux jours est de prendre une créance sur la production à venir, sur la récolte «dans 30 ans».

Dans un premier temps, nous analysons les distinctions fondamentales entre régime de capitalisation et de répartition. A la lumière de ce raisonnement, nous verrons ce que peut vouloir dire une «gestion prudente» d'abord en termes d'allocation d'actifs, ensuite en ce qui concerne la stratégie d'investissement.

## 1. Capitalisation, répartition, investissement

*L'investissement enrichit les lendemains*

Première différence notable entre les régimes de capitalisation et de répartition: dans le premier, l'argent prélevé aujourd'hui est supposé investi immédiatement; dans le second, il est redistribué (à ceux qui ont cotisé hier). Puisque le niveau des retraites dépend pour l'essentiel de la production de demain, l'investissement d'aujourd'hui est favorable aux retraites de demain. En permettant à l'appareil productif de se renforcer, il augmente le volume espéré des prélèvements de demain. Donc le système de la capitalisation est complémentaire de celui de la répartition; il le renforce et le solvabilise.

*La diversification est une nécessité*

La deuxième différence entre les deux régimes est géographique. Par nature, le régime par répartition gage les retraites de demain sur la production nationale de demain. Au contraire, la nature d'un fonds de pension est d'être investi de manière diversifiée au niveau mondial. Par conséquent, c'est le niveau de la production mondiale qui déterminera la valeur de ses actifs.

Si les jeunes français ne sont demain pas assez nombreux pour payer nos retraites, les jeunes chinois, coréens ou américains paieront, parce que nous

avons investi dans leurs industries. Le système des fonds de pension permet donc de se prémunir contre le risque démographique régional, en comptant sur la démographie florissante des pays émergents et même des USA.

Il en découle clairement qu'il ne faut surtout pas limiter la diversification géographique des investissements des fonds de pension. Cela leur ôterait en effet tout intérêt, puisqu'ils ne serviraient pas à rendre solvable un régime de retraite qui, en l'état, ne l'est guère. C'est la première règle d'or de la gestion prudente selon Lazard : la diversification internationale est indispensable.

**2. L'allocation d'actifs**

*Les principes d'une gestion prudente*

La prudence ne doit pas faire oublier l'objectif: la maximisation à long terme d'une richesse réelle (parlons en passant de cette question de richesse réelle). En effet, quand on pense prudence, on pense trop souvent garantie nominale du capital. Mais prenons l'exemple de la classe d'actifs la plus rentable dans le long terme: la bourse de New York. On parle souvent de la progression faramineuse du Dow Jones dans le siècle, mais il faut être conscient qu'en termes réels, l'image est moins avantageuse.[1] Le niveau atteint par le Dow en 1981 (808 pts) est le même en termes réels, que celui de ... 1927 (environ 160). Quant au niveau d'avant le krach de 1929 (380), c'est à peu près le même en termes réels, que celui d'avant le krach de 1987 (2600).

*Le bon sens est d'investir dans la production*

Revenons au sujet. Si les retraites de demain ne peuvent fondamentalement pas valoir mieux que le niveau de production de demain, alors la prudence, c'est d'investir directement dans la production, l'industrie au sens large, la création de richesses, c'est-à-dire dans les actions. A long terme (au delà d'une dizaine d'années, cf. infra), il n'y a aucune raison d'être investi autrement, et de prendre un détour pour avoir une créance sur les richesses futures.

*Nos études le confirment*

Les allocations d'actifs de nos équipes quantitatives arrivent évidemment au même résultat. Le rendement sur les actions est supérieur, sur n'importe quelle période de cinq ans, à celui sur les obligations. On n'a pas grand chose de mieux, pour projeter les rentabilités et les risques espérés sur longue période, que les historiques. Les modèles classiques d'optimisation de portefeuille donnent, pour un portefeuille à horizon trente ans, une allocation à 100% en actions, avec une probabilité de capital garanti supérieure à 99,5%. Les

résultats vont dans le même sens pour tout horizon d'investissement de plus de 10 ans.

Comment être plus prudent que ces modèles? Nous avons apporté une réponse simple, en prenant des hypothèses sur les actions plus défavorables que les données historiques, et en faisant tourner nos modèles avec ces hypothèses. Par exemple, en supposant que le rendement des actions sera plutôt de 7% que de 8% par an, et en leur attribuant une volatilité plutôt de 18% plutôt que de 15%.

Le résultat n'est pas significativement différent. Au delà d'une quinzaine d'années d'horizon d'investissement, il n'est guère raisonnable d'être investi autrement qu'en actions. Au fur et à mesure qu'on se rapproche de l'échéance, il convient bien sûr de contrôler mieux le risque, et de conserver les gains réalisés : la part des obligations augmente petit à petit.

Nous tenons donc notre deuxième règle d'or de la gestion prudente de long terme : investir en actions.

### 3. Sur la stratégie d'investissement

*Garder le cap!*

La plupart des gérants de fonds action sont impuissants à battre l'indice de manière constante. Chaque année, un petit dixième d'entre eux y parviennent. On ne les retrouve pas forcément l'année suivante. La raison, d'après des recherches intensives et sérieuses,[2] en est que la plupart des gérants n'arrivent pas à s'en tenir à une stratégie définie et stable. Beaucoup n'ont pas de stratégie précise, beaucoup d'autres en ont une et la change dès qu'elle ne fonctionne pas. C'est précisément le mauvais moment pour changer une stratégie intelligente. C'est comme ça qu'on vend au plus bas.

L'indice lui-même ne bat la plupart des gérants que parce qu'il est le reflet d'une stratégie constante, valable et obstinée : choisir les plus grosses valeurs, et les plus liquides. Plusieurs stratégies d'investissements sont très valables, mais il faut s'y tenir c'est le cas de tous les grands fonds dont le succès est constant sur des décennies (Soros, Zweig, Lynch/Fidelity …).

La troisième règle d'or de la gestion prudente est donc: maintenir le cap. Un fonds de pension prudent doit donc avoir des principes de gestion à la fois précis et stricts. Un process doit évidemment le refléter dans les faits. Un plaidoyer de plus pour la transparence.

**Conclusion**

Les trois règles d'or de la gestion prudente de l'épargne retraite sont donc:

- etre investi massivement en actions

- avoir une stratégie claire et constante

- etre diversifié internationalement

De là, on voit que toute restriction à la liberté de gestion, dans le sens orientation réglementaire de l'investissement, est sous-optimale donc risquée. Imposer une part d'obligations induirait un risque énorme de piètre performance. Imposer l'investissement dans l'industrie nationale ou régionale augmenterait le risque d'insolvabilité. Qui plus est, la capacité d'innovation de l'industrie financière n'étant plus à démontrer, la réglementation de l'investissement et de l'épargne est en général condamnée à rester lettre morte.

En la matière, la prudence est la confiance. Le fait que les fonds de pension, à la différence, peut être, des autres véhicules d'investissement, soient entièrement tournés vers le très long terme est le meilleur garant de leur prudence et de leur responsabilité. Le vrai effort devrait porter sur les progrès de l'information, de l'éducation financière, et de la culture boursière. La connaissance des réalités financières simples est en effet peu répandue. En éveillant la responsabilité de chacun à la problématique des retraites, on ferait un pas certain dans le sens de la solidarité.

[1] Martin Zweig, Winning on Wall Street, New York 1997, éd. Warner Books

[2] O'Shaughnessy, What Works on Wall Street, New York 1998, éd. McGraw Hill