OPTIONS FOR ACHIEVING DIVERSIFICATION IN THIN AND WEAKLY REGULATED MARKETS

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THE WORLD BANK
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Road Map

- Common challenges

- The choice of Asset Classes
  - Public versus private assets
  - Deposits versus bonds
  - International diversification

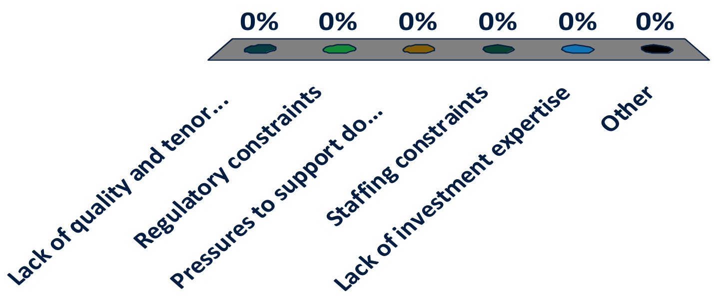
- Important Considerations for Investment Policy
  - What does the true diversification mean?
  - How liabilities could be taken into account?
  - How much active should pension fund managers be?

- Practical recommendations and country examples

CLICKER QUESTION

OUR MAIN INVESTMENT CHALLENGE IS

A. Lack of quality and tenor of domestic assets
B. Regulatory constraints
C. Pressures to support domestic economy and institutions
D. Staffing constraints
E. Lack of investment expertise
F. Other



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Typical Asset Classes for EM Pension Funds

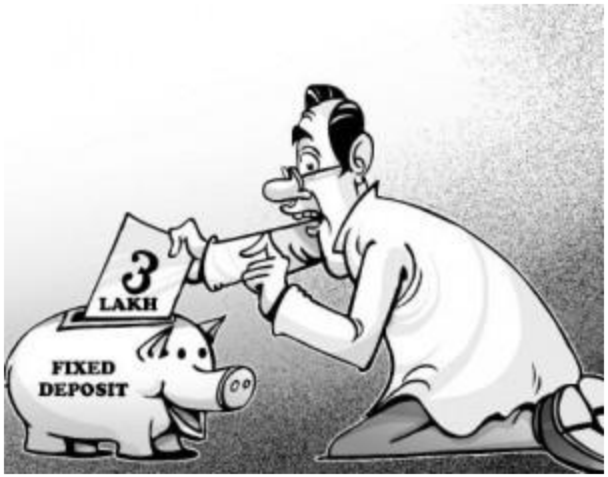
- Deposits in commercial banks
- Government Bills and Bonds
- Local Real Estate
- Domestic Shares (private and public)

Selection of Eligible Asset Classes

- **Considerations influencing choice of eligible asset classes:**
    - Alignment with the objectives (return enhancement, risk diversification, specific outcome focus e.g. inflation hedging, liability matching, cash flow stability, etc.)
    - Institutional capacity (governance, staffing, skill mix, and information systems)
    - Headline/Reputational risk issues

- **Focus should be on total portfolio risk and return – not the riskiness of individual assets in isolation**

Eligible Asset Classes - Deposits in Commercial Banks



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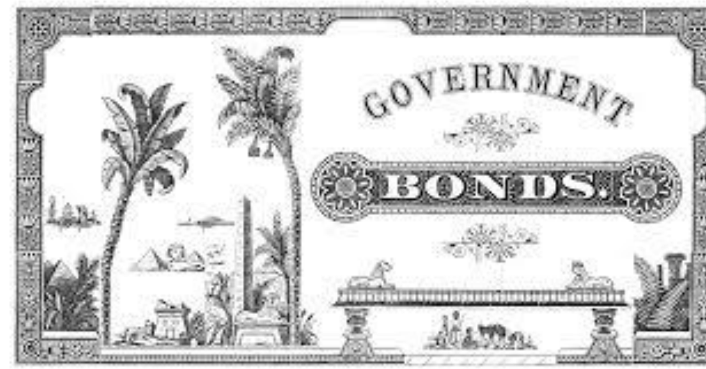


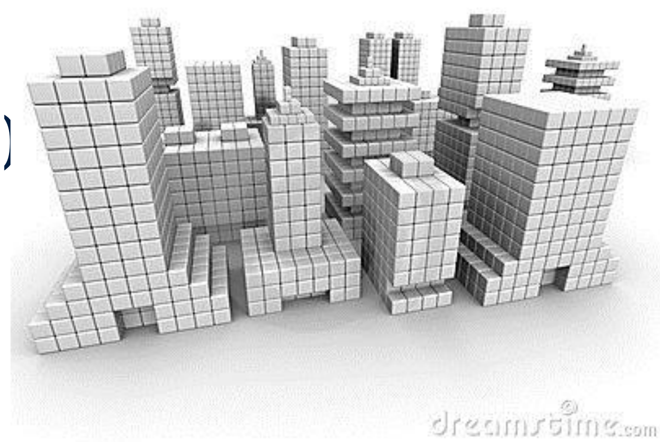
Relevant Risks

- Credit Risk (bank default)
- Constrained Liquidity

- Market risk (loss in value if interest rates increase)

Eligible Asset Classes - Commercial Real Estate

- Aligned with liabilities’ characteristics for a typical pension fund (stable cash flows and possible inflation protection)



- Key considerations include liquidity constraints and required expertise (acquisition and professional management)
- Risk and return of investments in commercial real estate vary widely
- Appropriate public accountability structure is very essential, including Board oversight, investment expertise, independent valuations, avoidance of conflict of interest

Eligible Asset Classes - Unlisted Shares

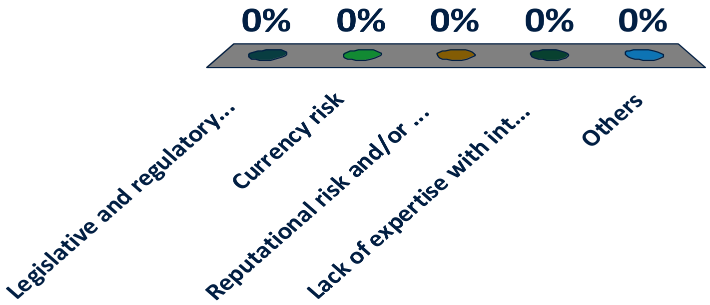
- Investments in unlisted shares by pension funds are typically driven by:
  - Lack of publicly traded alternatives
  - Higher expected return
  - Domestic economic development; e.g. priority industries, privatization of state enterprises
- Require professional investment expertise in decisions whether to invest and ongoing monitoring
- Liquidity/exit options are typically limited
- Public accountability mechanism is essential (oversight, valuations, minimum reporting requirements, no controlling position)

International Diversification

- Can mitigate country-specific economic and political risks and improve the risk-return profile of a pension fund's overall portfolio
- International diversification is especially important if the domestic economy or capital markets are small relative to a pension fund's size
- Future contributions and liabilities could be taken into account to assess benefits and determine the currency composition of overseas investments
- Implementation strategy needs to be gradual and could take into account the coordination with domestic monetary authorities

OUR MAIN HURDLE TO INVEST OVERSEAS IS

A. Legislative and regulatory constraints
B. Currency risk
C. Reputational risk and/or political opposition
D. Lack of expertise with international investing
E. Others



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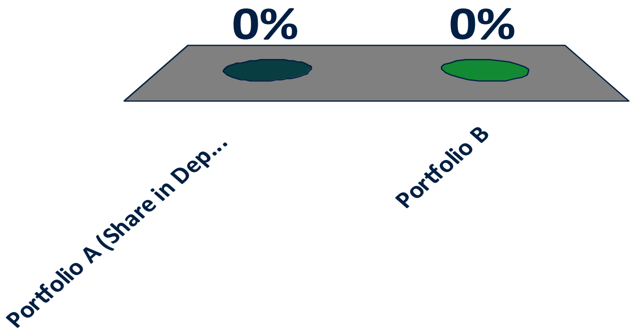
CLICKER QUESTION

WHICH PORTFOLIO WOULD YOU CHOOSE?

A. **Portfolio A** **(Share in Department Store (DS) - unlevered)**

B. **Portfolio B**

- **Real estate** where DS is located;
- Private equity in levered buyout of DS;
- Investment grade debt of D;
- Mezzanine debt in DS;
- High-yield debt of DS)



These two portfolios could be very well identical but Portfolio B <u>sounds</u> more diversified

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Consideration for Investment Policy - Diversification

- Diversification across less-correlated risk factors improves a portfolio's risk and return characteristics

- Heterogeneous mix of asset classes is essential for true diversification

- Overconcentration in government bonds or bank deposits violates basic precepts of portfolio diversification and bears a high opportunity cost for the country

- Investment cost is an important consideration in long-term investing

Consideration for Investment Policy - ALM

- Many pension plans have liabilities characterized by a long average maturity and, possibly, indexed to inflation

- Asset universe is many countries is limited to short-term instruments; therefore, the duration mismatch between the plan's asset and liabilities is common

- Practical solutions:
    - Include existing domestic long-duration assets, e.g. real estate
    - "Create" new domestic instruments through partnership and serving unsatisfied domestic demand, e.g. housing financing or infrastructure bonds

Consideration for Investment Policy – Active Management

- Active management attempts to ‘beat the market”, therefore requires significant investment expertise
- Benefits of passive management include clear accountabilities, lower cost, and typically lower risk; however, there could be circumstances when passive management is not practical
- Typical questions
  - Should pension fund managers be barred from holding operating equity positions?
  - Who should manage investments in real estate (in-house versus third parties)?
  - How pension funds should invest in international markets (active manager versus passive investments)?

Practical Recommendations

- No “one size fits all" solution, sound governance practices are paramount to avoid the risks of political interference and unproductive investments
- Investment decisions should be aligned with a long-term plan, which needs to be developed taking into account pension plan’s specific characteristics
- Finding creative investment vehicles, e.g. through collaboration with government authorities, could be a “win-win” for the plan’s beneficiaries and the country
- Hiring adequate number of professional staff is essential, and not all functions could be outsourced
- Ongoing and proactive communication with stakeholders and members is important

Fiji National Provident Fund

- Largest financial institution and major investor in Fiji, about 2B US$ equivalent in size
- Compulsory contributions for all workers and employers, include non-retirement benefits (e.g. housing and education assistance)
- Investment objective is to achieve returns, after fees in excess to inflation by a minimum 1% per annum, rolling over a three-year period
- Invest in real estate, local companies, commercial loans, offshore, including Fiji USD bonds and foreign equities

Seychelles Pension Fund

- Designed as a pay-as-you go state retirement system

- Governance is comprised on three layers: Board of Trustees, Investment Committee and staff headed by the CEO

- So far invest primarily domestically: fixed income and private assets, such as real estate and local companies

- Investable asset universe grows as the local financial market develops, e.g. securities exchange opened in 2013

Questions/Comments

Appendices

Passive Portfolio Implementation

	Pros	Cons
ETFs	•Easiest to implement	•Higher fees for large size mandates •Higher TE with benchmark •Limited benchmark choices
Passive fund	•Lower resource requirements and shorter ramp-up time than for a managed account	•Limited flexibility as have to accept the fund’s terms
Managed passive account	•Lowest fees (5-7bps for 100M+ equities) •Highest flexibility •Potential tax benefits	•Time and resource intensive to set up and monitor

Typical Investment Objectives

- Maintain and grow the plan surplus, which is the difference between the value of assets and liabilities
- Maintain and grow the funded ratio, which is the ratio of assets to liabilities
- Achieve long-term real return investment performance targets

- Examples:
    - Rwanda SSB - “achieve a long-term return on the Fund’s investment portfolio sufficient to meet the funding objective”
    - Seychelles PF - “maximize returns and maintain sufficient liquidity to meet members' withdrawal and the operating costs of the Fund”

Typical Investment Risks

I. Market Risk

Potential change in market value of assets due to:
- interest rate changes (interest rate risk)
- change in spread to an underlying security (spread risk)
- change in expectations of future earning potential (equity risk)
- change in FX rates (currency risk)

II. Credit Risk

The risk of default on an obligation by the counter-party or the issuer

III. Liquidity Risk

The risk that assets cannot be converted into cash in a timely manner or incurring reasonable transaction costs in order to meet any and all forecasted and unpredicted cash flows

Disclaimers