INVESTING PENSIONS FOR THE LONG TERM

Designing the right governance for investing in alternative assets

Presenter: Adrianus Vugs BSc, MBA, FIA
AGENDA

1. WHAT ARE ALTERNATIVE ASSETS?
2. WHY ALTERNATIVE ASSETS FOR PENSION FUNDS?
3. CASE STUDY – NAMIBIA
4. QUESTIONS/DISCUSSION?
What are alternative assets?

- **Alternative assets:**
  - *Equity and Debt (and everything in-between),* not traded on a formal exchange.

- **Characteristics:**
  - *Illiquid* - cannot be converted to cash easily (i.e. there is no formal secondary market for alternative assets);
  - *No objective valuation* - as there is no formal secondary market, there is no price discovery for alternative assets; and
  - *Higher risk and reward* - due to illiquidity premium and lack objective valuation.

- **Consequences:**
  - *Higher investment skill requirement* - due to the illiquidity and lack of objective valuation;
  - *Requirement for active investment management* - due to longer holding of the assets; and
  - *Higher requirement for due diligence* - due to greater scope for mismanagement and abuse.
Why alternative assets for pension funds?

- **Diversification:**
  - *Returns on alternative assets less correlated listed investment returns* – consequently alternative assets can improve the risk/return profile of pension fund investments; and
  
  - *Investment in new sectors/technology (mainly in developed economies).*

- **Pension investment:**
  - *Term of pension investment* – pension schemes have the ability to invest for the long-term and can reap the illiquidity premium.

- **The political economy of capital market development:**
  - *Increasing domestic investment* – where pension schemes have accumulated significant assets, there seems to be increased political pressure for investment in domestic alternative assets (especially in developing economies); and

  - *Increasing the stock of tradable assets* – the exit route for alternative assets (i.e. the sale and realization of the investment) can be through an IPO, supporting capital market development.
Overview of Namibia’s pension system:

- **Old Age Pension**
  - National Pension Act, 1992
  - 100% of population over 60 (citizens and permanent residents)
  - Tax funded
  - US$90/month
  - Administered by Ministry of Labour and Social Welfare

- **National Pension Fund (proposed)**
  - Social Security Act, 1994
  - Working population
  - Compulsory
  - Funding TBD
  - Administered by SSC

- **Pension Funds**
  - Pension Funds Act, 1956
  - Voluntary
  - Contributory (DB/DC)
  - Usually set up by employers
  - Regulated by NAMFISA

- **Parliament/Office Bearers Pension Fund**

100% of Population

100% working of Population

Voluntary or occupational
Case study - Namibia

Pension assets versus GDP:

- **2010**: Pension Fund Assets - N$ 60 billion, GDP - N$ 80 billion
- **2011**: Pension Fund Assets - N$ 65 billion, GDP - N$ 85 billion
- **2012**: Pension Fund Assets - N$ 80 billion, GDP - N$ 100 billion
- **2013**: Pension Fund Assets - N$ 100 billion, GDP - N$ 110 billion
- **2014**: Pension Fund Assets - N$ 120 billion, GDP - N$ 130 billion

**Designing the Right Governance for Investing in Alternative Assets**

- ADRIANUS VUGS
Case study - Namibia

- **Increased political pressure for domestic investment:**
  - *Prominence of pension assets* – due to the size of pension fund assets to GDP, and reporting thereon, there is increased pressure to make pension fund assets “work for the domestic economy”; and
  - *Rationalizing the argument for domestic investment* – it is difficult to attract foreign investment if local assets are invested in other jurisdictions.

- **First attempt – GIPF Capital Investment Portfolio:**
  - *Approximately N$600 million invested in alternative assets* – the Government Institution Pension Fund directly invested (i.e. with little or no intermediation) N$600 million in various companies in Namibia; and
  - *Approximately N$2.5 billion opportunity cost* – almost all investments did not perform and the N$600 million had to be written off, the current opportunity cost is approximately N$2.5 billion.
Case study - Namibia

- **Identified problems:**
  - Lack of understanding of alternative assets;
  - Lack of due-diligence and process;
  - Lack of active management;
  - Poor governance; and
  - Perception of “friendship” investment and corruption.

- **Policy response:**
  - Develop a system to address the identified problems;
  - Formalize and regulate the alternative asset market; and
  - Where possible address problems of illiquidity and valuation.
Case study - Namibia

Second attempt - Regulation 29 (Unlisted Investment Regulations for Pension Funds)

- **Pension Funds**
  - Requirement for 1.75% to 5% in Unlisted Investments;
  - Subscription agreement;

- **Unlisted Investment Manager**
  - Board of Directors
  - Investment Professional
  - Co-investment requirement (1%)

- **Special Purpose Vehicle (Investment Vehicle)**
  - Regulated by NAMFISA
  - Board of Trustees/Directors
  - Trust/Company
  - Investment Plan
  - Reporting to NAMFISA

- **Capital draw down**

- **Unlisted Investment 1**
- **Unlisted Investment 2**
- **Unlisted Investment 3**
- **Unlisted Investment X**

DESIGNING THE RIGHT GOVERNANCE FOR INVESTING IN ALTERNATIVE ASSETS
Case study - Namibia

- **Result of Regulation 29:**
  - 19 Unlisted Investment Managers registered;
  - 16 Special Purpose Vehicles registered;
  - Capital committed (estimated) between N$2-3 billion;
  - Some drawdowns; and
  - To early to determine success of otherwise, however, issues related to governance, due-diligence and process, active management and perception of corruption seem to be largely addressed.

- **Further work:**
  - Listing of SPVs to enhance liquidity and price discovery;
  - Investment in infrastructure; and
  - Participation in Public Private Partnerships.
QUESTIONS/DISCUSSION?

Designing the right governance for investing in alternative assets

Presenter: Adrianus Vugs BSc, MBA, FIA