Mercer

Stopping the race to the bottom

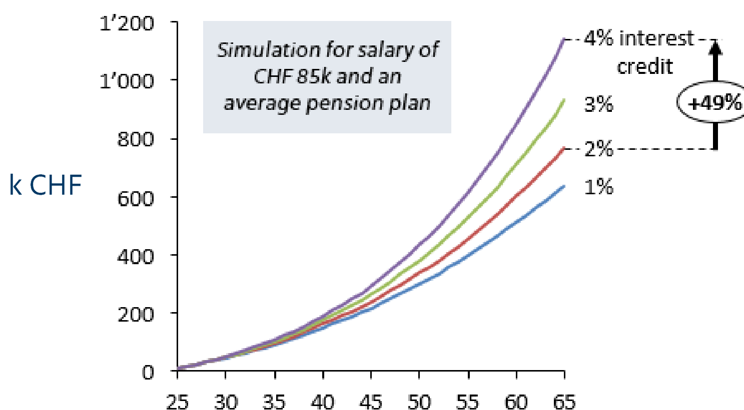
The investment side of pensions is often neglected – but 2% less in returns can result in about 50% less retirement benefits.

The Swiss pension system is a great achievement and has, for the most part, stood the test of time. But parts of it have become a bit worn with age. Especially in the second pillar, a number of external and internal factors, such as the difficult market environment, the demographic development, investment inefficiencies and cross-financing from actives to pensioners, have driven down the expected future pension benefits quite significantly over the last years. The Swiss system only ranks 11th in the 2021 Mercer CFA Institute Global Pension Index. In 2015, Switzerland still ranked 4th. If the pension reform deadlock continues, Switzerland is likely to lose further ranks.

While the decrease in benefits is bad enough for all future pensioners, women are particularly affected due to their – on average – higher likelihood of working part time and average lower salaries leading to lower contributions, resulting in a 85% median pension gap in Switzerland[1].

Now, a Swiss pension fund might argue that many of these issues are beyond their control. And this is certainly true e.g. in the case of overdue pension reforms that should target the demographic issues and BVG conversion rates, or the fact that Swiss government bonds have had negative yields for a while now.

However, looking at the investment side also shows where pension funds can make a real difference. More than one third (37.1%) of the average pension is financed out of investment returns[2]. Our calculations show that an increase from 2% to 4% in interest credit for a salary of CHF 85k in an average pension plan can result in a 49% increase in expected pension benefits in retirement.

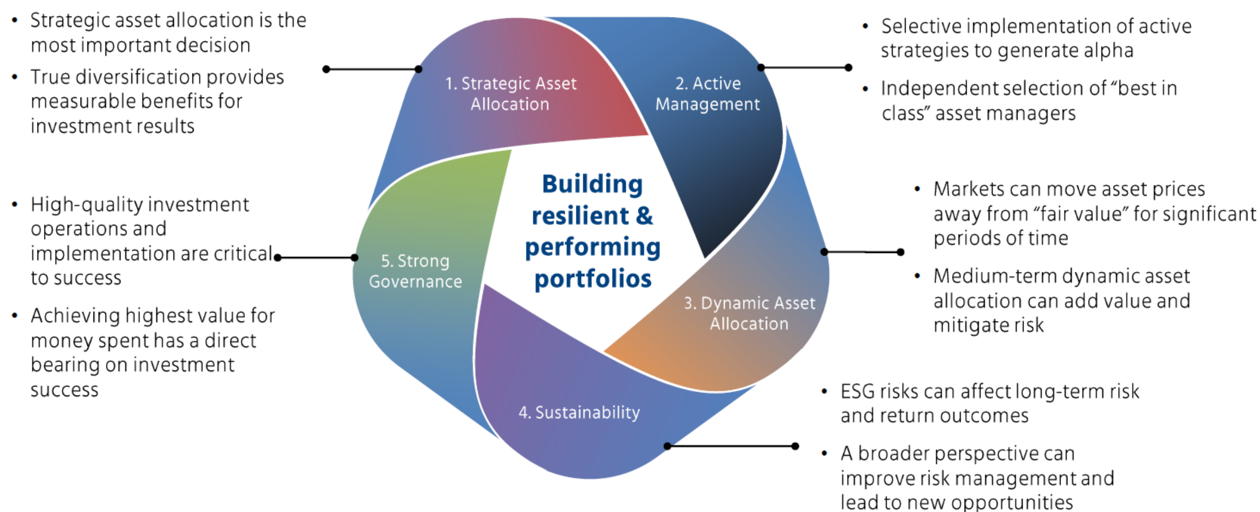


[1] Bundesamt für Statistik
[2] Swisscanto Pensionskassenstudie 2020

A business of Marsh McLennan

How to get investments right

We believe that there are five principle areas that should be targeted by Swiss pension funds in order to increase investment returns and thus, by extension, increase the expected outcomes for their pensioners.

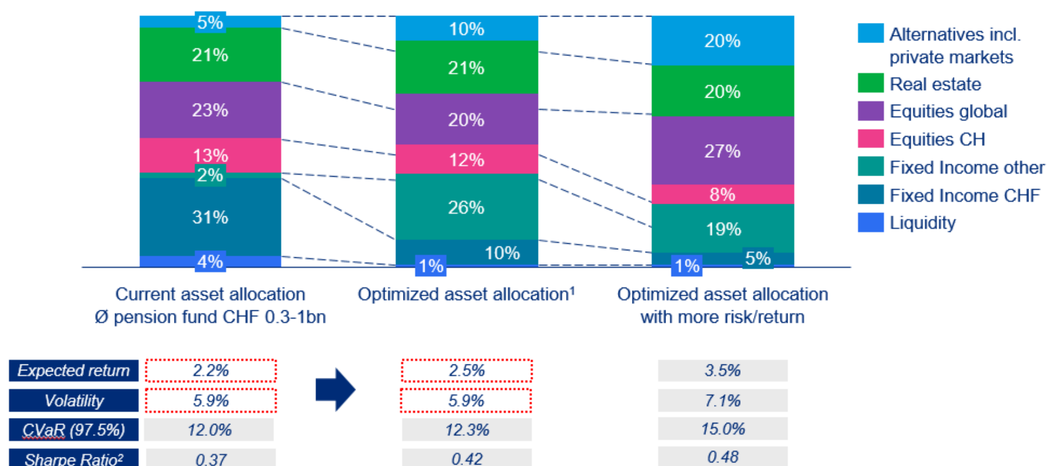


1. Strategic Asset Allocation (SAA)

The strategic asset allocation (SAA) is the most important decision and forms the basis of the investment efforts and outcomes of the pension fund. True diversification is key, with a focus on risk factor diversification rather than a pure diversification by asset classes, which can result in unwanted concentration of certain risks. The degree of required factor diversification can vary depending on risk tolerance and the expected development of the pension fund.

Equity risk is typically the dominating portfolio risk, due to the relatively high volatility compared to other risk factors. However, risk needs to be understood as a multi-dimensional concept and every investment strategy should be reviewed based on scenario and factor analyses.

Strategic asset allocation is also a way to realize potential for higher investment efficiency. The average Swiss pension fund shows a significant home bias, with more than 30% of the portfolio concentrated in CHF Fixed Income, and 13% in Swiss equities. An optimized, balanced portfolio would aim for broader diversification while decreasing home bias and capturing multi-asset factors including Emerging Markets and Small Cap. In addition, harvesting illiquidity premia through private market investments should be strongly considered as a strategic choice.



	Current asset allocation	Optimized asset allocation	Optimized asset allocation with more risk/return
Expected return	2.2%	2.5%	3.5%
Volatility	5.9%	5.9%	7.1%
CVaR (97.5%)	12.0%	12.3%	15.0%
Sharpe Ratio[2]	0.37	0.42	0.48

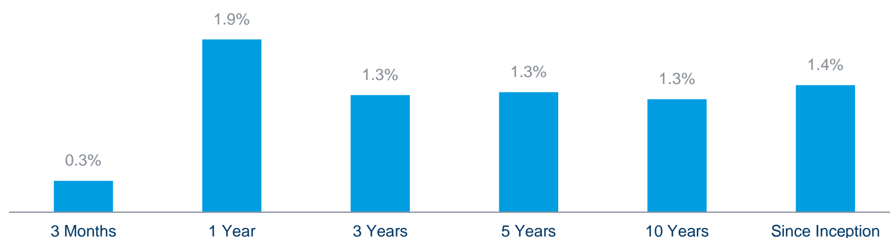
1. A sample portfolio: appropriate investment risk, liquidity requirements, investment strategy etc. should be determined as part of an ALM study; CVaR Simulation: Time Horizon 1 Year
2. Sharpe ratio is here calculated as expected return over volatility
Sources: UBS Pensionskassen Index, Mercer analysis

2. Active Management

If applied properly and selectively, active management can be a key source of added value, and making use of a manager's skill to outperform markets can lead to higher return expectations. Additionally, some attractive markets such as non-listed Swiss real estate are only investable through an active investment style by their very nature.

Mercer's research shows that top-rated managers across all asset classes have been able to provide an average outperformance versus benchmark of 1.4% p.a. since inception[1]. Looking at single markets and segments, e.g. US small cap, we see some good potential to generate alpha which is mainly driven by market inefficiency. The less efficient a market is, the greater the opportunity for skilled managers to create outperformance.

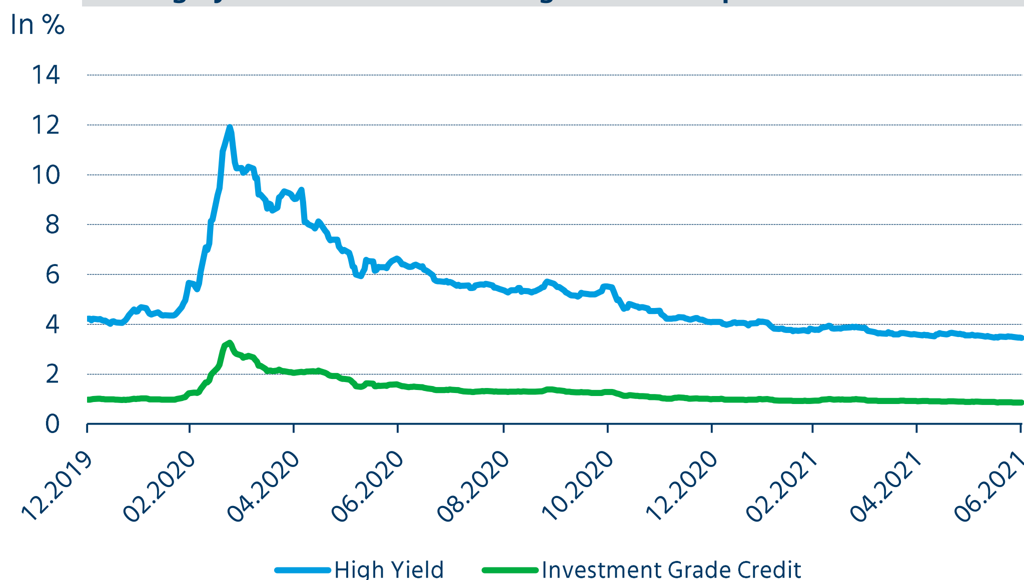
All asset classes: Value added of A-rated managers per June 30, 2021



3. Dynamic Asset Allocation (DAA)

When managing a pension fund portfolio, dynamic asset allocation (DAA) provides opportunity to benefit from market movements away from fair asset prices. If applied in a consistent manner, it might not only drive returns but could also mitigate risk. A very good example was the extraordinary spike in high yield credit spreads during COVID-related market turbulences in early 2020. Based on the belief that it would only last for a short period, some market participants were able to capture the opportunity by buying high yield bonds which significantly contribute to portfolio returns with a lower downside risk compared to equities.

High yield versus investment grade credit spreads* since 2020



[1] Performance is gross of investment management fees and certain other expenses. Past performance is no guarantee of future results. Please see Important Notices for further information on Value Added Disclosures and Manager rating methodology.
* Global High Yield & Investment Grade Credit Option Adjusted Spread; Source: Bloomberg

For Swiss pension funds, especially in the smaller and medium sized segment, we often see two major challenges in the implementation of dynamic asset allocation:

1. First, they need to have the resources to monitor capital markets, identify relevant investment ideas and, most importantly, need to have the expertise to identify relevant investment solutions in which they want to invest.

2. Second, they must have implemented investment processes that allow for such short-term investment decisions. If it takes two months for the whole process from idea generation to implementation, the opportunity will often be gone.

These factors should also be considered within a pension fund's governance framework that keeps pace with increased complexity.

4. Sustainability

Sustainability factors are gaining increasing attention, and for good reason: A responsible investment approach, which considers Environmental, Social and Governance (ESG) factors, is likely to add value to an investment portfolio through earning sustainable returns, accessing new opportunities and a lower risk profile.

Mercer has been committed to sustainable, responsible and impactful investing since 2004 when we established a Sustainable Investment (SI) team within our Wealth business. This team has 23 full-time professionals around the globe and we have had experience in advising on a variety of ESG issues over the years as the timeline below shows:

Mercer uses a 4 step process to guide our Sustainability Framework for our clients, this is presented below:

We undertake a variety of sustainable investment workstreams for our clients, and below are some examples of how we implement the Sustainability Framework:

- **Integration**: Include ESG factors in investment decisions, with climate change transition and physical risk factors managed within the strategic asset allocation approach.

- **Stewardship**: Exercise active ownership / stewardship through voting and engagement with underlying companies and by engaging with policymakers.

- **Thematic Investment**: Allocate to sustainability themes or impact investments for new opportunities – for example renewable energy, water and social housing.

- **Screening**: Screen out sectors or companies deemed to be irresponsible or not acceptable to profit from.

5. Investment Governance

Pension funds should be governed like a corporation. As such, you would also expect that different business areas, like the investments business, are given strategic objectives that can be translated into measurable targets. If you steer the pension fund like a business, you will also need to decide how you can most efficiently operate it and make clear decisions as to which tasks should be kept in-house and where it would be more efficient to delegate them.

For a small and mid-sized pension fund, it may be very costly to build up a fully-fledged investment organization, and it might be much more efficient to engage a professional partner who can support the Board of Trustees in the design and implementation of their investment strategy. If you select an implementation partner, you can typically benefit from an investment platform that helps independently selecting and implementing best-rated managers at competitive costs and having robust risk management processes in place.

A state of the art investment governance allows the Board of Trustees to free up time no longer needed for the day-to-day business and to focus on the most important strategic questions. For example: Are our pension benefits attractive and sustainable for our employees?

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About Mercer

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Measurement of value added through manager research recommendations as of June 30, 2021.

Mercer's Investment business has developed and implemented a methodology for measuring the value added through their manager research recommendations. This methodology and the results of the analysis, for periods to June 30, 2021, are presented below.

Measurement methodology

For most investment strategies that we research, we arrive at a rating on a four-tier scale in which the possible ratings are A, B+, B and C. When we formulate short lists of candidates for clients to consider in manager searches, these are generally drawn from the list of strategies rated A within the relevant product category. We first began maintaining formal ratings on this basis in 1995, replacing less formal methods in place, and have extended this to cover all product categories that we actively research, over the period since.

Our methodology for measuring the performance of our ratings entails calculating the average performance of the strategies that we rated A within each product category each quarter, based on the ratings as they stood at the end of the previous quarter. Therefore, there is no element of hindsight in the analysis. We then compound these quarterly results together to calculate performance over longer periods. Finally, we subtract the return for an appropriate and widely accepted benchmark index for the product category concerned to calculate value added. We also calculate a risk-adjusted measure of the value added known as the information ratio.

In essence, this methodology tracks the performance of a hypothetical Mercer client that is assumed to split its money evenly between all of the strategies rated A by Mercer within the product category concerned. This hypothetical client is assumed to have reviewed its manager lineup at the end of each quarter, based on the Mercer ratings as they stood at that point in time. A typical client would not invest in all strategies in all of the categories, as some may not be relevant to a particular client for a variety of reasons. Therefore, the actual added value of strategies selected by a client would vary from the results depicted here.

Three types of strategy are excluded from the analysis. Firstly, we exclude strategies that are sub-advised by other investment managers, to avoid double-counting. Secondly, where a manager offers two variants of what is essentially just one strategy, we only include one of these in the analysis (we used to use the one with the longer track record but in 2011 we assigned the decision on which track record to use to the researcher responsible for the strategy), once again to avoid double counting. Thirdly, if a strategy's track record relates to a benchmark that is materially different to the benchmark used in the analysis for the product category concerned, it will be excluded from the analysis to avoid distortions that could arise solely as a result of the non-standard benchmark.

Where a manager offers equity strategies in a typical long only format and a variant which includes the ability to short, we only include the long-only version.

For some product categories, where the use of custom benchmarks is prevalent, there is no single widely accepted benchmark that can be used as a basis for this analysis. We therefore use a slightly different methodology for these categories. In these cases, we carry out the analysis by first calculating value added each quarter for each track record relative to its custom benchmark, then calculating the average of these value added figures each quarter, and then compounding the quarterly value added figures to calculate value added over longer periods.

We have carried out these calculations for most of the product categories where we both maintain ratings and for which we have reliable performance data (currently 69 categories), going back in each case to when we first had a reasonable spread of ratings for the product category concerned.

Some important caveats
All of the value added figures have been calculated by Mercer, but are based upon performance data provided to Mercer by the investment managers concerned. Mercer generally does not independently verify the performance information provided by investment managers.

The methodology described above does not allow for transaction costs that an investor would have incurred if it had actually changed its panel of investment managers every quarter in line with changes to the list of products rated A by Mercer within the product category concerned. In practice, the turnover of managers incurred by such an investor would have averaged about 15% per annum (the actual averages since inception for each product category are shown in the final section of the results). We have not attempted to estimate the transaction costs that would have been incurred as this would require assumptions on a number of factors, including the investor's cash flow position and how the changes had been implemented.

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