Generating ideas out of adversity

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In his 2001 review of UK institutional investing, Paul Myners wrote: "I regard our strong funded pensions system as a key national asset." However, some fault lines have since been exposed and the Sykes Committee remit to design a better investment system could not have come at a better time.

Last year, I felt very low about the problems of the pensions industry, but things now seem a little brighter - there is more evidence of corporate leadership in the pensions world.

Companies running pension funds have had a massive range of adverse circumstances to deal with. The Maxwell scandal left a huge legacy: a pension fund framework managed largely by trustees representing those with fixed promises.

This framework insufficiently reflected the views of companies, whose investment risk-taking and variable expense are an essential part of the deal. I have always appreciated company people who articulate to the trustees a clear view about their tolerance for pension fund risk. This year I am seeing much more of that.

The other problem has been the influence of successive governments - the football equivalent of the FA playing a shocker. Long-term planning has been difficult and, as a consequence, we have built up layer upon layer of complexity. The natural response of company boards has been to bring in the defined contribution model.

One of the brighter signs is the recognition given to alternative benefit designs which capture some of the positives of DC without its compelling negative - transferring risk to employees.

Companies should recognise that, while many of the current benefit designs have not moved with the times, there are many forms of defined benefit scheme that can deliver flexibility, efficiency and transparency.

Ideally, DC is an excellent place for "topping-up" benefits - rather than being the principal provision.

One of the problems of the industry comes from its interconnectivity. Change the benefits and the investment policy needs to move.

The key changes that need to be made to oil the pension cogs of the future include rethinking asset allocation and a return to more genuine forms of long-term investment, with benefit designs that can accommodate them.

What is involved here? In the past we have evolved asset allocation on largely scientific grounds based on each scheme's liabilities and funding position. But now many "softer" factors must be taken into account - most important, the employer's risk tolerance and its support for the fund. The form of governance is a consideration here too.

This also affects the frequency of the fund's investment policy review, which has been typically set every three years by trustees with help from advisers. There is now a need to take account of fast-changing conditions.

The discipline of risk budgeting can make a powerful contribution - as can using value-at-risk measures. This will allow the company to make a comparison with money at risk in other business ventures, as well as resonating with the way shareholders now look at pension fund risk.

The critical point is that both short and long-term measures need to be considered.

Alongside a fresh look at asset allocation, we need the commitment of the fund management industry to longer-term goals. This requires a lighter touch as far as benchmarks are concerned - success should be defined as meeting long-term real growth targets and de- emphasising short-term index comparisons.

The design of a better investment system should be more of a directional shift than a complete about-turn. But it would be extremely positive to see: Longer holding periods in equity portfolios, with correspondingly lower transaction costs. More engagement of investment managers and pension fund owners in exercising positive influences on their equity holdings. Less turnover in manager appointments - I see the "10-year mandate" as the way forward. But this should co-exist with more intensive shorter-term investment styles where benchmarks remain the central monitoring discipline.

I believe the Sykes Committee can make a difference in effecting this shift.

What part will consultants play in this new landscape? I think there is considerably higher potential for us to add value to benefit design and investment policy at this critical moment.

While it appears a paradox, stronger corporate leadership is critical to delivering this value within the pension investment system.

The pension fund world in the UK has been built on robust foundations but, like any long-term investor, it is still vulnerable to the dreaded double-one throw of the dice that investment markets have given to us in the last three years.

While there are some survival issues for our financial institutions, the wake-up call is bringing a refreshing new wave of thinking. I am optimistic. We must develop better process out of new thinking, and encourage new leadership and a higher degree of co-operation among all players. *To submit evidence: evidence@tomorrowscompany.com*