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PROJECT M · Issue 1/2013

Multiplying investment and retirement knowledge

PROJECT M

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Theoretical replacement rates look set to decline across the European Union over the next four decades.

#14 MIND THE GAP

As pressure to reform pension systems grows, to avoid an income gap for future retirees, policy makers must answer the question, how much is enough?

MICRO

Rare Scotch whiskey is proving popular as an alternative mode of investment.

MACRO

A matter of lifestyle: Why do monks and nuns all live longer than men in the general population?

META

Turning a remote Icelandic lighthouse into what may be the world's most remote art gallery.

Allianz

MAKING OF THE COVER

Each PROJECT M cover is created by a special software program that transforms complex raw data, images and figures into aesthetic clusters by means of special rules and parameters. For this issue, the program was fed the text from the article "Mind the gap" as well as data showing the predicted change in public pension expenditure 2010-50 and the change in net theoretical replacement rate (TRR) over the same period for a range of European countries. The change in pension expenditure is represented by the font size – the larger the font, the greater the predicted jump in spending as a percentage of a country's GDP. Countries with a negative change in TRR contain a stronger red color. Despite most governments being predicted to spend more on pensions, replacement rates in many countries look set to decline.
(Artwork/Generative Design: Projekttriangle Design Studio, www.projekttriangle.com)

CHANGES BETWEEN 2010–2050 IN PUBLIC PENSION EXPENDITURE AND PENSION ADEQUACY INDICATORS IN P.P.

as % of GDP	CHANGE IN PUBLIC PENS. EXPENDITURE	CHANGE IN NET TRR
CZECH REP.	1.93	-27.47
ITALY	0.36	-20.40
LUXEMBOURG	8.96	-16.88
SWEDEN	0.28	-7.30
NETHERLANDS	3.58	-4.02
UNITED KINGDOM	0.51	-2.06
AUSTRIA	2.34	3.70
GERMANY	2.18	4.57

Source: *Pension Adequacy in the European Union 2010-2050*, Council of the European Union

BRIGITTE MIKSA
Head of International Pensions

HOW MUCH IS ENOUGH?

About halfway into his re-inauguration speech, President Barack Obama stated that "we reject the belief that America must choose between caring for the generation that built this country and investing in the generation that will build its future."

It is an admirable sentiment and it will be an impressive maneuver if he pulls it off to the satisfaction of all. For the last two decades, in efforts to ensure the sustainability of pension systems, governments in developed countries have trimmed, cut and redefined rules relating to old-age provision. While it seems they have saved the system from spiraling and ultimately ruinous costs, it means individuals, such as you and I, can expect to receive less – perhaps significantly less – when we retire.

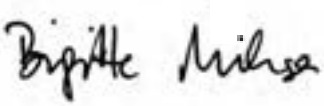
The logic of the reforms was directed towards individuals preparing for retirement by saving privately so as to have enough income to live on in retirement. The question is, what is the amount that is enough for us to live on in our old age? That is, will our retirement income be "adequate?" The answer is unclear, simply because when you get down to it, the notion of adequacy is a slippery one.

As described in this PROJECT M, organizations such as the OECD, EBRI in the United States and the European Commission are attempting with various degrees of success to define adequacy. However, we as individuals need to face the fact that while what we will receive may be enough to survive on, it is likely to fall well short of a comfortable retirement.

Mind the Gap! There is no question that we will need to fill in that missing retirement income ourselves. Governments must assist by creating the conditions, incentives and tax breaks that enable people to save to provide a significant portion of their own retirement income in the end. But exactly what and how much each of us needs to do is unknown, tangled up in the messy debate about pension adequacy.

It is likely in the future that President Obama – or one of his successors – may still have to choose. Not starkly between one generation and another, but by policies that could seem inadequate to the expectation of both, but ultimately also to the benefit of both.

Yours sincerely



Brigitte Miksa, xxxxxxx 2013

FOCUS
(Issues in depth)

ADEQUACY

THOUGHT LEADERS IN THIS ISSUE

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MICRO
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MACRO
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META
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Filling a gap: English artist Ben Wilson has found his own unique style by using small pieces of chewing gum as canvasses for his miniature paintings.

MIND THE GAP

Pressure on pension systems is forcing governments to rethink their pension policies. To avoid an income gap for future retirees, policy makers must address sustainability and find useful definitions of adequacy.

By Renate Finke

At first glance, "adequacy" seems a simple word, one whose definition can be readily understood. *Merriam-Webster* describes it as "sufficient for a specific requirement." But don't be mistaken, this seemingly harmless word is becoming loaded with complex meanings even as experts discover how ill prepared we are to actually define it. And, as they struggle to determine its parameters, chart the components of personal income and wealth, and measure the social standards that could contribute to an understanding of adequacy, the word itself is assuming the potential to become one of the most explosive in pension politics.

Expressed another way, adequacy is the question: "How much is enough?" Ask that in the context of pensions and you immediately touch upon a topic sensitive to millions of current and future retirees: "How much will I receive in my retirement benefits?" Unfortunately, and there is no other way to couch this, most of us whether retired or retiring in the future will experience a significant gap between what we could reasonably expect to receive based on past experience and what we will actually receive in the hand.

Anger at pension reforms has spilled out onto the streets in Paris, Athens and even Beijing, and unless politicians tread warily, we will undoubtedly see it elsewhere. However, if politicians bow to popular pressure – and all voters are potential members of the retiree lobby group – the danger is that they will defer decisions that could ultimately save the retirement system.

How did this situation arise? German chancellor Otto von Bismarck can be considered the godfather of European social security. In 1889, he introduced an old age provision system as a means to buy social peace. It was primarily meant to be an insurance in case of invalidity and only a subsidy for old age. But as the legal retirement age was 70, double the then average life expectancy of 35 for men, hardly anyone received a pension. Most contributors failed to reach the age to receive benefits, but if they did they found the amount paid out only just above starvation level.

FROM SUSTAINABILITY TO ADEQUACY

Retirement age is by now a standard 65 years in most western countries. More significantly, life expectancy has risen from 48 for people born in 1950 to 69 for those born today. In more developed countries life expectancy has gone up from 66 to 78 (UN, 2010). This means a growing portion of the population in developed nations is now living up to 30 years longer than the retirement age.

Unlike Bismarck's time, the scales have tipped in favor of retirees. What was designed as a way to alleviate old-age poverty has morphed into a guarantee under state (first pillar) pay-as you-go schemes. Such PAYG schemes are based on intergenerational solidarity, with today's workers paying the retirement of the previous generation.

However, with the aging of society and the retirement age "fixed" at 65, we face the prospects of ever fewer workers left to pay obligations. Over the last two decades, governments have undertaken a wave of reforms to try and rebalance the scales. While improving the sustainability of the system, these reforms have often left tomorrow's retirees with a lower replacement level from first pillar pensions than today's retirees.

In many countries, the result is a gaping hole in workers' retirement provisions. Among European Union (EU) savers eligible for retirement between 2011 and 2051, the annual pension gap is €1.9 trillion ($2.5 trillion), UK insurer Aviva estimated in *Mind the Gap* (2010). The largest shortfalls were observed in the United Kingdom and Germany. British and German workers would have to increase their yearly savings by €12,300 ($16,180) and €11,600 ($15,260) annually to close the gap.

In the United States, the Employee Benefit Research Institute (EBRI), which developed a national measure of adequacy in 2003, estimates that Baby Boomers (individuals born 1948-1964) and Generation Xers (born 1965-1974) are lacking $4.3 trillion (*Retirement Income Adequacy for Boomers and Gen Xers*, 2012). Workers born between 1948 and 1954 would have to save an additional $22,000 per individual for married households, rising to $34,000 for single males and $65,000 for single females, EBRI says. To compensate for decreasing pension levels, governments provide incentives to foster funded occupational and private pension plans. A process of balancing out the different pension pillars more evenly will continue with the first pillar moving from PAYG to funded systems, while in the second pillar (occupational) the trend from defined benefit (DB) to defined contribution (DC) schemes will continue.

Yet, policymakers and regulators still need to define the equilibrium between sustainability and adequacy. The question of how today's workforce can achieve a retirement income adequate to maintain a reasonable standard of living is still open. If not correctly handled, it could mean future retirees experience an income gap or even fall into old-age poverty – the very scourge the pension system was originally designed to prevent.

In emerging Asia, the challenge is different. Countries there began establishing formal pension systems on the multi-pillar approach after rapid industrialization, economic growth and urbanization. Yet, the introduction of formalized systems for old age provision has a slightly different focus than reforms in developed countries. Adequacy means increasing the coverage of formal pension systems and including large numbers of informal workers.

The Asian Development Bank notes that coverage of the labor force ranges between 13 % in Vietnam to 58 % in Singapore. They suggest measuring adequacy with both replacement rate and coverage (ADB; *Enhancing Social Protection in Asia and the Pacific*; 2010).

DIFFERENT PERCEPTIONS OF ADEQUACY

So what is an adequate retirement income? While *Merriam-Webster*'s offers a straightforward definition of adequacy, interpretations placed upon the word differ widely. In the context of pensions, adequacy is often defined by reference to a social standard, such as the poverty line, as Pensions Europe chairwoman Joanne Segars points out (see page 15). Or it can be expressed as a percentage of pre-retirement income or as a benchmark to maintain standard of living.

As to the poverty line there are several approaches: an absolute poverty line is used in the US; a relative standard and a subjective standard. In Europe a relative poverty line is defined at 60% of the national median equivalized disposable income, although some countries even set the level at 50%.

Another approach to define adequacy is replacement rates, that is, understanding retirement income as a percentage of pre-retirement income. But even this term is not clear-cut. The problem is how the notion of replacement rate splices together with the concept of pre-retirement income. ☞

Less is more: Ben Wilson at work turning chewing gum in the streets into spontaneous pieces of miniature art.

In continental Europe, where the first pillar aimed to maintain a standard of living, the replacement rate focused on the first pillar. But as systems are reformed and the three pillars become complementary, more sources of retirement income have to be taken into account. Some approaches go further and include income generated from non-retirement savings accounts – but what the actual replacement rate may be is still open for interpretation. One flaw in the concept is that it can be tweaked by governments so that it considers income levels at retirement, but disregards income development over the entire retirement phase. This raises the issue of indexing of retirement income. Depending how indexing is handled, an income shortfall can arise and have particularly devastating effects as the savers' life expectancy and inflation increases (see article on "Retirement Repression" on page 24). As a general rule of thumb, experts often consider a replacement rate of 70% of pre-retirement income as adequate. This is based on the idea that retirees require less income than non-retirees as the costs for raising children or buying real estate are already covered. However, other researchers define adequacy at a higher level. For instance, the OECD (*Resources During Retirement*, 1998) has shown that the replacement rates in Germany, France, Italy, the Netherlands and Switzerland, when all pillars are considered, add up to approximately 80% of pre-retirement income. This was slightly lower in the United Kingdom. Considering the different pension systems, these results suggest strong substitution occurs among the three pillars. While this definition probably holds for most average earners, target replacement rates should probably be higher for low-income groups and the income mix derived from each of the three pillars defined differently.

Obviously, results depend on pre-retirement income and using replacement rates as a benchmark may be misleading in countries where workers choose or are forced to reduce their workload prior to retirement. In these cases, the targeted replacement rate may understate the standard of living to which retirees are accustomed.

THE COST OF MAINTAINING LIVING STANDARDS

The European Commission was one of the first organizations to raise the issue of pension adequacy in a 2010 green paper. In a subsequent report, *Pension Adequacy in the European Union 2010-2050* (2012), it states that adequate pension systems should enable "individuals to maintain, to a reasonable degree, their living standard" (see pages 19-20).

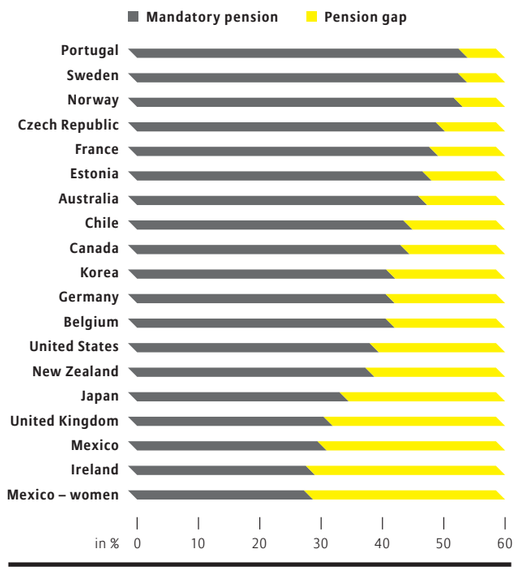
The Commission's approach obscures one of the key challenges: defining an adequate retirement income at entry age and maintaining it over time. Following the Commission's approach, an individual's expenditure before and after retirement as well as the expected income stream should be considered. A comparison between both should yield the degree of adequacy. Yet, this leaves out longevity risks, investment risks and uninsured health care risks. And while there are reasons why retirees' overall expenditure is lower than non-retirees, costs such as health care or leisure may be higher. Consequently, necessary expense levels are partly determined by health-care coverage, services, subsidies or in-kind benefits provided by governments. The European Commission points out in its report that "a full assessment of the adequacy of pensions will therefore require taking into account the access to free or subsidized resources of economic value, including subsidized owner-occupier housing." This perspective underlines the many dimensions governments have to consider in designing a system to maintain an adequate standard of living for the elderly. And even if one can agree on a definition of adequacy, there is still the open question as to how to achieve such an income with the greatest possible certainty.

This question has become even more critical after the recent financial crisis and increasingly volatility of financial markets. Particularly difficult will be to define adequacy in terms of various socio-economic groups and for women, whose life course often involves long absences from the workforce.

While social protection has undoubtedly improved since Bismarck's times, identifying and closing the pension gap will remain on ongoing challenge.

THE PENSION GAP

Gross replacement rate for average earner from mandatory pension schemes and difference from OECD average replacement rate



Source: OECD pension models; *OECD Earnings Distribution Database*.

While the need for reform is clear, the human impact is not easy to accept.

THE ITALIAN LESSON

The point at which academic theory meets political reality could be seen in the tears in Elsa Fornero's eyes. The IMF believes the reforms she implemented have made Italy's pension system one of the world's strongest.

As an economics professor at the University of Turin, Elsa Fornero wrote much about the need for urgent pension reform. When Mario Monti tapped her on the shoulder to join his technocratic cabinet as Italy's Minister of Labor, Social Policies and Equal Opportunities, she recognized an unprecedented opportunity to put theory into practice.

» DOING RESEARCH ON A SPECIFIC SUBJECT AND UNDERTAKING A REFORM THAT IMPACTS PEOPLE'S LIVES ARE TWO COMPLETELY DIFFERENT THINGS. «
ELSA FORNERO

But as she announced pension reforms as part of the Monti government's $26 billion austerity package, the human impact became all too real. On national television, she stumbled on the word "sacrifice" and was too overcome to continue. Prime Minister Monti intervened to finish the announcement.

"I would like to convey the distance between doing research on a specific subject and undertaking a reform that impacts people's lives," Fornero says, recalling that moment. "They are two completely different things."

Speaking at the 2012 World Pension Summit in Amsterdam in November on the anniversary of her appointment to cabinet, Fornero outlined the challenges she faced in effecting swift, profound reforms of the public pension system, while the country existed in what she describes "a state of emergency." The government's mandate was clear and ambitious: "To rescue Italy," Fornero explains, "(we had) to significantly reduce the likelihood of even a partial default on public debt and restore the country's international credibility."

Working in a tense situation made reform easier in one way – she was able to be "rapid and sharp." On 4 December 2011, 20 days after assuming office, the government held a meeting to pass reforms as sweeping as they were necessary. However, they were not as they have often been described, "radical," but rather based on the significant acceleration of the phasing in of previous reforms.

PAST FAILURES

In 1995, under Lamberto Dini's leadership, Italy established a notional defined contribution (NDC) pension system. The country was aware that the relative generosity of its existing defined benefit (DB) system was unsustainable, particularly when coupled with a high – and still climbing – old-age dependency ratio.

In 1994, Italy had 25 people aged 65+ for every 100 of working age. By 2010, this number had climbed to 31. And by 2050, it is expected that there will be one person 65+ for every two of working age (*United Nations, World Population Prospects*, 2010).

Facing such a dramatic demographic change, successive governments failed to take the "Dini reform" far enough and applied the DC system only to new workforce entrants, before hitting the snooze button. The rest of the workforce would transition over a 30-year period. "Of course, reforms are necessary, but let's not be too severe," was the mood of the country. The hard stuff could come later. ☞

By the time Fornero arrived, there was no later. Along with other changes (see right), she axed the transition period, making her reforms "the most significant transfer of burden from the young generation towards the older ones," she says. "The exact opposite of what's been done for decades in Italy."

Nevertheless, the projected expenditure savings were met with a blunt response from cabinet colleagues: It's not enough for the financial markets!

To reduce the country's short-term expenditure, a simultaneous increase in retirement age was necessary and the minimum age was lifted for both sexes. It was, Fornero says: "The single factor most effective in convincing the financial markets that Italy was serious about reform. That Italians were accepting sacrifices."

» IT WAS ALMOST IMPOSSIBLE TO CONVEY THE MESSAGE THAT THIS ... IS FOR US ITALIANS. «
ELSA FORNERO

The sacrifices Italians are making extend to pension adequacy. This is no small concern in a country where 52% of the population lives on a retirement pension of €1,000 ($1,290) or less per month and where purchasing power dropped 3.8% in 2011.

The elimination of inflation indexing for all but the lowest pensions removed the old system's implicit higher return for the wealthier. And by continuing to work, Italians also keep contributing to their funds, while simultaneously reducing the period those funds are required for.

Where this system breaks down is for those with poor or discontinuous working careers. And in a country where youth unemployment is currently hovering around 35%, this could have serious long-term implications.

The system is also lop-sided with an over-reliance on the first pension pillar. But with the government currently hamstrung by an inability to reduce the pay-as-you-earn tax rate, it has little scope to encourage workers to divert money into private pension funds. Budgetary constraints also rule out providing tax incentives for the pension fund industry.

As Fornero sees it, the problem is macroeconomic and tied to the labor market, whose reform is also in her charge. "People have a lot of uncertainty, but not a lot of earnings," she says, "so they don't think in terms of a future private pension that complements the public one."

The World Bank and the IMF consider the reforms now make Italy's pension system one of the world's strongest, providing a good example to other countries facing reform. According to the IMF, over the next three years the reforms will lead to a reduction in pension expenditure of €22.2 billion ($29 billion) (*IMF Country Report* #1, Italy 2012).

CONVINCING PEOPLE

Yet, for Fornero, these plaudits are sour as well as sweet. She laments the indelicacy with which the changes were handled and the insufficient time to explain their necessity.

"I don't think I was successful enough in communicating the reform to the Italian people," she says. "Maybe the young perceived it was in their interest, in the sense of reducing the burden on their shoulders. But, in general, it was almost impossible to convey the message that this is not just for the financial markets ... this is for us Italians."

She also wanted a smoother transition to the retirement age increase and wryly notes that had it been possible, she might enjoy more popularity in her own country. Time wasn't the only enemy – financial literacy also played a part. "If people don't have the basic concepts, they get the wrong idea and it's very difficult to convince them that reform is in their interest."

To those countries watching, Fornero's message is clear. "The Italian lesson is this: If you have problems, but are not in an emergency, then act before you are ... If you do, you can be more effective in terms of communication and ability to convince the public."

FORNERO'S REFORMS

As of 1 January 2012, benefits accruing to all Italian workers are calculated using a DC formula. Over the medium-to-long term, government pensions will be paid on a DB-DC blend.

Italy's seniority pension was abolished. By crediting years worked against the retirement age, it enabled funded retirement as early as 56 after 40 years of contribution. No inducement to continue working existed, since by not claiming benefits from minimum retirement age, pension wealth was effectively lost. The retirement ages (now 66 for men, 62 for women) will be aligned over the next five years.

For a video interview with Elsa Fornero at the Berlin Demographic Forum, please see: **projectm-online.com/xxxx-xxxxxx-xxxxxx**

JOANNE SEGARS

CHAIR OF PENSIONSEUROPE AND CHIEF EXECUTIVE OF THE BRITISH NATIONAL ASSOCIATION OF PENSION FUNDS

PensionsEurope clearly supports the European Commission's struggle for adequate pensions, yet its chair Joanne Segars stresses the affordability of pensions for sponsors and members alike.

IF	THEN
IF adequacy is the new buzzword, what are we talking about? How do you define adequate pensions?	**THEN** it is a really complex concept, particularly across countries. In the United Kingdom, state pensions provide 45% of average earnings. Yet, one person's adequacy may be another's inadequacy.
IF adequacy is more than just poverty protection, how can it be assessed?	**THEN** that depends on how much people can afford to save. Workers with low earnings will likely need a 100% replacement rate, while the rate for wealthier workers can be lower. Defining the baseline through a state pension will make it easier for people to establish their needs.
IF the European Commission strives for adequacy, what is your response?	**THEN** clearly we support that. However, our concern is that the Commission's approach, particularly with regards to Solvency II-style rules for pensions, may incur high costs for employers as well as employees and even the closure of pension schemes.
IF humans are inert and fundamentally short-term, how can we make retirement saving relevant for tomorrow's retirees?	**THEN** I point to auto-enrollment. Money diverted from your paycheck into a pension scheme you are unlikely to miss. Retirement saving needs to be as automatic as paying your mobile phone bill. To help achieve that, the industry has to speak in clearer, less technical language.
IF that is the case, how long do you expect this transformation to take?	**THEN**, frankly, I don't know. But that should not keep us from educating today's 20-year-olds.
IF you consider female careers with breaks for child-rearing and so on, what is your recommendation?	**THEN**, while easier said than done, women have to change their mindset to strive for financial independency not only at working age, but also in retirement. Regardless of gender my advice is: if you have the opportunity to join a pension scheme, then join it.

To hear Joanne Segars explain her understanding of adequacy, go to:
projectm-online.com/xxxxxxxxxxxxxxxxxxxxxxxxxxxx

CONFERENCE CALL: ADEQUACY

The question of adequacy is gaining relevance as policy makers focus on redesigning social systems. The notion of adequacy itself, however, lends itself to debate. In this conference call, Jack VanDerhei of the EBRI, Pablo Antolín-Nicolás of the OECD and Renate Finke of Allianz discuss how to treat this illusive concept.

WASHINGTON D.C. USA

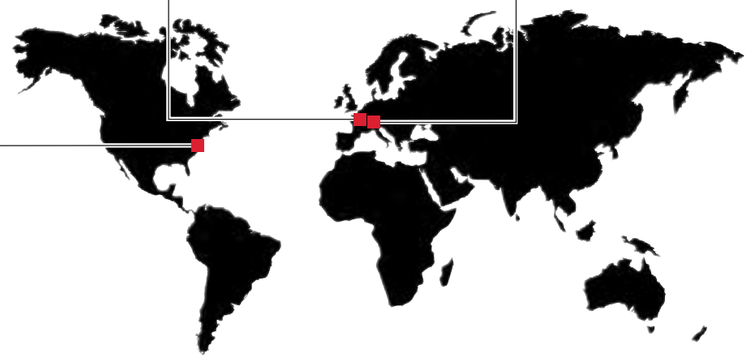
Jack VanDerhei
Research director, Employee Benefit Research Institute (EBRI)
EBRI is a private, nonprofit, nonpartisan organization committed to original public policy research and education on economic security and employee benefits. Jack is also the director of both the EBRI Defined Contribution and Participant Behavior Research Program and the EBRI Retirement Security Research Program. He has been with EBRI since 1988 and is their "go-to man" on matters relating to adequacy.

PARIS France

Pablo Antolín-Nicolás
Principal economist, Private Pension Unit, Financial Affairs Division, Organisation for Economic Cooperation and Development (OECD)
As the principal economist at the OECD's Private Pension Unit, Pablo Antolín is currently involved in several projects about pensions and adequacy. Together with colleague Juan Yermo, Antolín is currently conducting extensive research for an OECD report on adequacy, set to be published by the end of 2013. Antolín has a PhD in Economics from the University of Oxford.

MUNICH Germany

Renate Finke
Senior economist, International Pensions, Allianz Asset Management
International Pensions conducts research on trends in the global retirement market and on developments in pension systems and markets. Renate's focus is the quantitative analysis of market development and growth potential, particularly the sustainability and adequacy of retirement systems. Before joining Allianz in 2009, she worked for the Dresdner Bank in Frankfurt/Main.



Finke: Adequacy is a topic that has gained in importance after recent pension reforms. These aimed to regain sustainability in the first pillar and often fostered funded pensions. The idea was right, but the financial crisis has brought new challenges. Now, we must address the topic again and rethink the approach.

Antolín: The question is whether pay-as-you-go (PAYG) public pensions are sustainable. If we are going to pay less in pensions, are we going to increase the private pensions component? And, if we are going to do this, by how much? This "how much" needs to be defined as a target retirement income individuals should aim to achieve. The next step in defining adequacy is to see how much people have and to see how big is the gap. This is the analysis we are undertaking at the OECD.

Finke: Jack, discussion has been quite intense in Europe. Is it similar in the US?

VanDerhei: Yes, very intense. Within the last two years, EBRI has testified at three Senate hearings and a Ways and Means hearing on this issue.

Antolín: What definition of adequacy do you or EBRI work from?

VanDerhei: For me, adequacy can be defined as anything from being able to replicate some stated percentage of pre-retirement income, to retaining one's pre-retirement standard of living, to having enough to cover basic expenses plus uninsured medical costs in retirement. For public policy analysis, EBRI defines adequate retirement income as having enough financial resources to cover basic expenses plus uninsured medical costs in retirement at least X% of the time. X can take several values. We start at 50% in large part because that is what an individual implicitly assumes if he or she uses average longevity, average rate of return assumptions, average retiree expenditures, etc., when using some of the more rudimentary retirement planning models. However, since most individuals would not be comfortable coming up short half the time, we also provide projections with 75-90% probabilities of success.

Finke: Has there been a tendency to focus on sustainability and to miss adequacy?

Antolín: I don't think so. Most countries that have undertaken reforms have introduced incentives to join occupational DC pension plans or have implemented such plans, like the *Riester Rente* in Germany. So, there has been a recognition that making PAYG systems sustainable requires increasing savings in other sources to finance retirement.

Finke: Pablo, in a way that is correct, but in a number of countries this was done on a voluntary basis and people were hesitant to take up the schemes, although, as in Germany, the results were directly integrated into calculations showing the benefits the "standard retiree" could achieve. But in a transition from where people did not have to think much about pensions to a system where additional saving is necessary, this can lead to a huge gap. People are realizing they have to adjust their behaviour and policy makers should monitor this more closely.

On a slightly different topic, it's commonly said that a 70% replacement rate is sufficient for retirement needs. I know that is an average and it depends on many parameters whether it is appropriate, but, Pablo, I was wondering if you feel that was roughly correct?

Antolín: This is difficult. Is it 70%, or better said two-thirds, of your final salary? I don't think this is a correct measure. There are problems with replacement rates depending on whether the person was in full or part-time employment before retiring. Also, replacement rates are fixed in time. As you go forward in retirement, even though your pension benefit compared to your final salary is still constant, your position in the income scale might change. It then becomes important whether your benefits are inflation indexed or not, or indexed to incomes. The point is that just looking at final salary can be misleading.

But then there is another complication. It is not the same for a person at the lower end of the income scale as for an individual at the upper end. An individual at the lower end of the scale may need more benefits to substitute past salaries than a person at the higher end. One can say that someone with a lower income needs 100%, a middle income two-thirds and a higher income 50%. A general question is, do you think we should consider other sources to finance retirement when we take into account whether income is adequate or not? ☞

» AVOIDING POVERTY IS THE PRIMARY GOAL AND THAT IS A RIGHT TARGET. BUT THAT DOESN'T MEAN THAT IT IS AN ADEQUATE RETIREMENT INCOME. «
PABLO ANTOLÍN-NICOLÁS

Finke: Yes, we should, as the reform process was precisely set in this direction. If governments foster additional pension schemes and focus on complementary savings, we should include them in the analysis, otherwise governments may as well redirect subsidies to other, possibly more productive, investments.

VanDerhei: Yes. In our analysis, we include Social Security – both status quo and several reform scenarios, defined benefit and / or defined contribution plans, IRAs (regular, Roth and rollover) and net housing equity. We also include non-tax-advantaged savings in some scenarios and any salary that may be earned beyond the age of 65.

Finke: It has been suggested that to motivate people to develop adequate savings, there has to be some kind of "spectre." Is avoiding poverty the right approach?

VanDerhei: No, I think that is too limited. I believe it is important that we define adequacy because as a question it comes down to will you have "enough" financial resources available to sustain yourself throughout your post-working life? It would be helpful to those attempting to rely on definitions of adequacy, if the individuals and organizations making claims about their results would be clearer about the assumptions they make in defining their inputs, and the projected outcomes.

At EBRI we developed a Retirement Security Projection Model with a stochastic decumulation model in addition to an accumulation model to simulate adequacy. Any other approach means generally relying on a target based on deterministic assumptions and a likelihood of failure that most people would likely find unacceptable.

Antolín: Avoiding poverty is one goal, but pensions have traditionally had three. One is avoiding poverty, the second is redistribution, and the third, which is the most important part from our point of view, is saving for retirement Obviously, PAYG systems try to fulfil the role of avoiding poverty and some redistribution – as well as pushing people to save for retirement. The funded concentrate more on saving for retirement. So, yes, avoiding poverty is the primary goal, and that is a right target. But that doesn't mean that this is an adequate retirement income. If everyone is at the poverty level, then fine – people have enough to eat and live, but they haven't saved to maintain their living standard.

One way to get a handle on adequacy is a general measure by different socioeconomic characteristics – income, gender – and then look at the consumption patterns. Unfortunately, focusing only on consumption patterns has the problem that some retirees don't consume more because they don't have more money. So, is consumption based on actual desire or on constrained income?

Finke: I agree. Targeting "avoiding poverty" is really the lowest approach as it leaves out schemes which are earnings-related. If people save for retirement from wage contributions, the aim should be more than poverty prevention – especially compared to people who do not have a comparable working career or no working career at all. To avoid poverty, governments have instituted welfare programs – and that should be the basis. Earnings related retirement schemes should reach further and aim at higher levels.

In all, defining adequacy is not an easy task. There is a wide variety of definitions and approaches and personal perceptions. Governments need to clearly define what is adequate because they design, redesign and adjust pension systems as they set the framework and give incentives for people to reach the targets.

Antolín: Adequacy is complicated. The answer will be different for different income groups, and it will be different for genders and various economic statuses. At the OECD we understand that governments and policy makers want just one number, but one number is wrong. Low-income people may need more income as a share of his or her final salary than high-income people.

VanDerhei: I beg to disagree. I think it is a simple concept, just extremely difficult to model accurately. If you mean that it can be subject to many different definitions, depending upon the definer's point of reference, then it will have wide variations.

Finke: Thanks to you both for your time. Without doubt, this is far from the last word on the subject.

» IF PEOPLE SAVE FOR RETIREMENT FROM WAGE CONTRIBUTIONS, THE AIM SHOULD BE MORE THAN POVERTY PREVENTION. «
RENATE FINKE

Millions of young Europeans are not in work, education, or training

THE SEARCH FOR SUSTAINABILITY

A report on pension adequacy in the EU reveals some harsh truths about the way ahead and deserves more attention from the media.

When Nicolas Sarkozy, former president of France, raised the pension age in 2010, he was met by massive public strikes and street protests. For the international press, for whom the Gallic temperament and *Tricolore* always present a colorful photo opportunity, it was a bonanza.

A similar situation played out in Greece last November, when hundreds of thousands of workers staged a 48-hour strike to protest the latest round of wage and pension cuts. It was part of a series of sometimes violent demonstrations staged since Greece fell into crisis in 2009, which aimed at alleviating the deep international lender-prescribed cuts that have helped inflict misery on the country.

Whether it is in scandal sheets such as *The Sun* in Britain or Germany's *Bild-Zeitung*, or buried in more highbrow publications such as *The Economist*, *Time* or *Le Monde*, pensions make good copy: cuts can be played from the political angle as hard news; you can emphasize emotions through suffering retirees or the palpable anger in demonstrations; or you can focus on the ponderous thoughts or urgent prescriptions of business leaders, academics or government commissions.

All this makes the reaction to the European Commission's report on pension adequacy last May all the more curious. The most vexed question at the heart of the wave of pension reforms that has swept the developed world in the last two decades is, as the OECD described in its *Pensions at a Glance 2011*, the dilemma between balancing the *affordability* of pension systems with the *adequacy* of pension benefits.

The report, *Pension Adequacy in the European Union 2010-2050*, represents one of the most considered studies conducted into the most personal questions surrounding pension reforms as it relates to individuals: "How much will I see in my pocket when I retire?" and "Will it be enough?"

LESS POSITIVE, MORE UNCERTAIN

It could be its density (194 pages of tables and charts), the fact that it avoids defining what "adequacy" means or that the concept does not lend itself as readily to depiction as a protestor hurling a Molotov cocktail in downtown Athens, but the media reaction to the report was one of indifference.

This is a shame because it is a solid effort at examining the questions surrounding pension adequacy in ☞

Europe. Among its many harsh truths, the report notes that, while "great advances in the sustainability of public pensions have been achieved," this has "to a significant extent been achieved through reductions in future adequacy." What the report says about future adequacy is that specifically outcomes "are less positive and more uncertain."

If the function of a pension is to provide an income in retirement that allows citizens to enjoy living standards close to the general population, then the 27 EU Member States can be generally said to have done a good job to date. On average, they spend 11.3% of annual GDP (from 6% in the Netherlands to 15% in Italy) on public pensions and currently 120 million people in Europe, 24% of the population, are beneficiaries.

MAKING UP THE SHORTFALL

However, as László Andor, commissioner for employment, social affairs and inclusion, noted in March 2011: "The number of people in retirement is now rising steeply. Until a couple of years ago, around a million people reached retirement age across the EU each year. Fuelled by aging baby-boomers, the pace is now two million and will remain constant over the two next decades."

Given that rising longevity and lower fertility rates will result in a steep increase in the demographic old-age dependency ratio, it was essential that pension systems be reformed. But, in striving to ensure sustainability, states are placing ever greater responsibility on individuals.

Analysis of reforms by the EU 27 countries shows that 17 could see a decrease in the net replacement rate of pensions of at least five percentage points by 2050 compared to 2010. Of these, 11 will experience drops of more than 15 percentage points. Greece and Poland could experience drops of over 30 percentage points though most of the reductions seem based on a change in statutory pensionable age.

To make up the shortfall, the report states clearly that, if today's workers want pension entitlements at levels of adequacy similar to those pensioners currently enjoy, "they will have to change their working and savings behavior."

The most obvious change involves working longer. Calculations show delaying retirement by two years (retiring at 67 years after a 42-year career instead of 65 after 40 years) will in most European countries provide higher pension entitlements in the future of more than 10 percentage points for the average earner.

Statutory pension ages are rising in many countries to match rising longevity. If benefits change to encourage later retirement, rather than people leaving the workforce before the official retirement date, this too could have an influence.

Certainly, for citizens of some countries, such changes could make up the gap. Portugal and the Netherlands, for example, could bridge the loss in benefits by working longer, but given the harshness of cuts, there is no way the Greeks will be able to make up for the loss of benefits by working only two years longer.

However, a longer working life assumes work is available. In 2011, Europe had 14 million people aged 15 to 29 who were neither in employment, education or training. The highest rates were among southern and eastern European countries. In Greece and Bulgaria, almost a quarter of all under-30s fell into this category; Italy and Spain had just over 20%. Apart from scarring youngsters for life, large unemployment breaks result in a loss of pension entitlements and leads to drops in replacement rates. In general, the longer the break, the bigger the drop – and this will hold true in years to come.

In the near future, countries will focus on eliminating incentives to take early retirement and to encourage people to work longer so as to close the gap between the normal and effective pensionable ages, but there is no certainty there will be employment for older workers. The employment rate of older workers remains low and once unemployed, they tend to experience longer periods of unemployment.

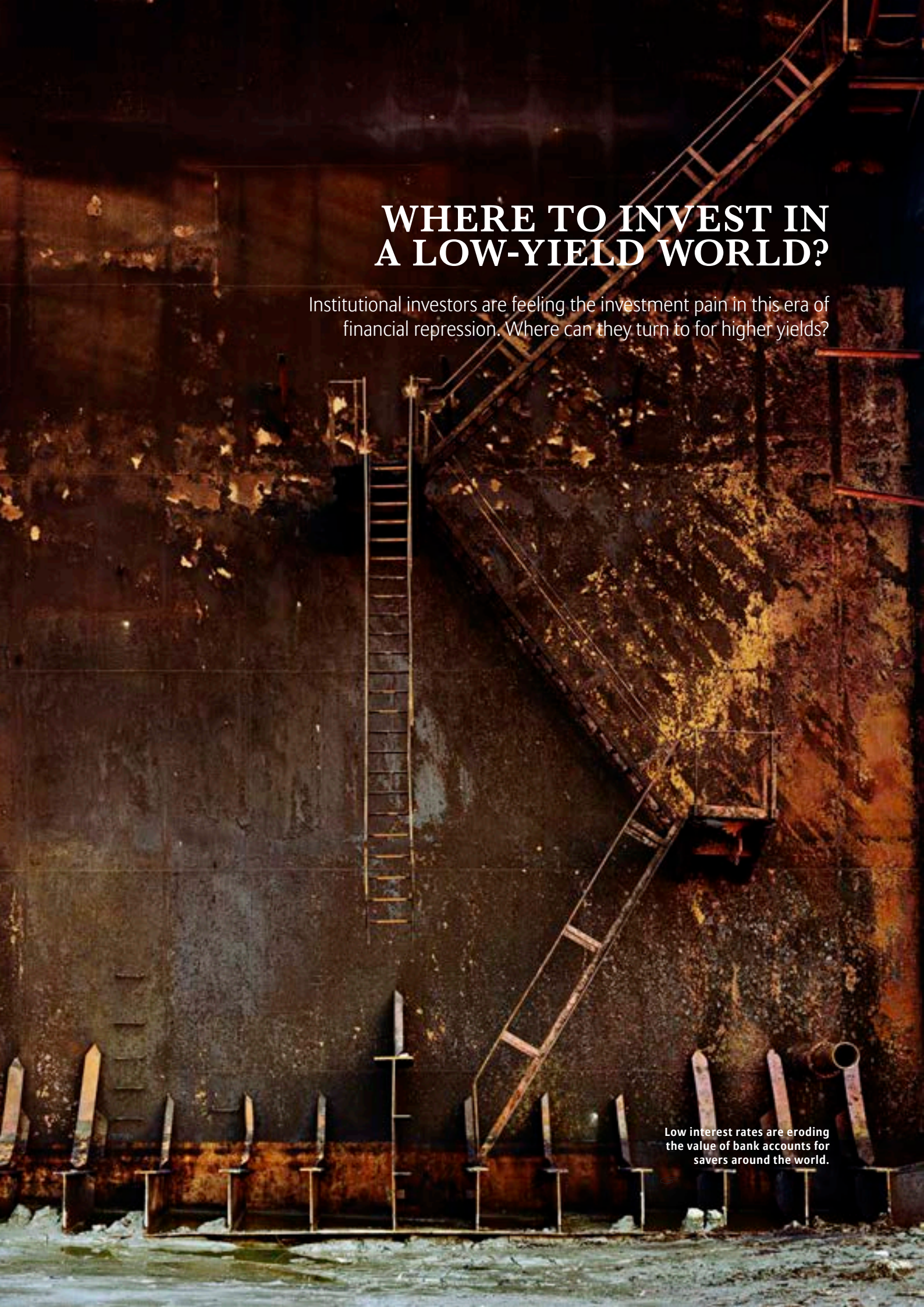
TRICKY TRANSITION

Another harsh truth stated in the report is that, even if people extend their careers, only in a few countries will this allow people to fully make up for the large drops in total net replacement rates. To ensure the adequacy of pensions, today's workers will have to save more. In some countries, this could entail greater contributions to public plans while in others, people will have to save more through occupational and private schemes (for example, see Italy's case on page 12).

Is this feasible? By the admission of the Commission, public pensions will continue to play a major role in maintaining the income security of Europe's elderly by 2050. The question in each country is how successful will government efforts be in encouraging complementary occupational and individual retirement plans? As roughly one fifth of people aged 65 or older have pension incomes just near the poverty-risk threshold, relatively small increases or decreases in pensions can have a major impact on the poverty rates of the elderly. While the current pension rules may be untenable, the successful transition to an alternative pension system will depend on the skills and abilities of each nation's politicians to walk the tightrope between sustainability and adequacy, so it is unlikely sensational headlines will stop.

WHERE TO INVEST IN A LOW-YIELD WORLD?

Institutional investors are feeling the investment pain in this era of financial repression. Where can they turn to for higher yields?



Low interest rates are eroding the value of bank accounts for savers around the world.

The specter haunting investors is financial repression, a deliberate policy by governments to keep interest rates artificially lower than inflation. Needing to service gargantuan levels of public debt, significant amounts of it stemming from private sector bailouts during the financial crisis, governments have passed the burden onto savers.

By pushing nominal yields below inflation and channeling the resulting cheap money towards themselves, governments aim to inflate their debt away over the years.

The problem with financial repression is that, unlike many past specters invoked to scare the public, this one is real and causing havoc for investors. As Andreas Utermann noted in the last edition of PROJECT M ("Taxation by Stealth") financial repression represents a redistribution of wealth from the prudent to the indebted.

Savers around the world can now watch as painfully low interest rates corrode the value of their bank accounts. Governments are also using various tactics to encourage captive audiences, such as banks, pension funds and insurance companies, to buy their debt.

DILUTING YIELDS

For example, in Germany, life insurers are obliged to invest in safe assets. In the last five years, the yield on bonds outstanding, the benchmark for a safe investment, has dropped from four to one percent. This lowered performance hits people who may have a participating payout annuity where benefits depend on investment performance.

The net return on capital investments of German life insurers has dropped from an average 7.5% throughout the 1990s to 4% in the past few years. In the United Kingdom, where the Bank of England embarked on a £375 billion ($601 billion) money printing policy in 2009, annuity rates have plunged to their lowest level since records began.

The story is also grim for pension funds. With falling yields, especially at the long end of the curve, the present value of future liabilities has risen steadily, possibly leading to funding shortfalls. This applies especially to pension funds who are required to value their liabilities on a mark-to-marked basis such as in the Netherlands. There, 260 of the country's 317 pension funds, representing 95% of all plan members, failed to meet the minimum funding requirement (De Nederlandsche Bank). This could translate to benefit cuts in the near future. In France, the compulsory pension scheme Agirc-Arrco was confronted with a funding deficit of €119.2 billion ($153.75 billion) by 2030, before the social partners agreed on benefit cuts.

In real, inflation-adjusted terms, high-quality sovereign bonds have become too expensive for the long-term, concludes Franck Dixmier, CIO of fixed income Europe at Allianz Global Investors. "Total return expectations are extremely low and could even be negative for bonds, such as US Treasuries or German Bunds," he says.

As a consequence, investors in search of higher returns need to seek outside the high-quality sovereign bond market. Yet, investors are also strongly risk averse, having been savaged by the financial crisis and been burnt on write-downs of debt to Greece. So, with no hint that financial repression is likely to end any time in the next few years, Dixmier believes investor interest in corporate bonds, as well as in emerging market bonds, is likely to continue.

"We know from statements of the European Central Bank and from what the overnight interest rates on a forward basis are telling us that markets are absolutely buying the scenario of a low yield climate for a long time."

» WE KNOW THAT MARKETS ARE ABSOLUTELY BUYING THE SCENARIO OF A LOW YIELD CLIMATE FOR A LONG TIME. «
FRANCK DIXMIER

YIELDING ELSEWHERE

An alternative for institutional players is infrastructure or loan markets. These could provide alternatives for institutional players as the investment durations match well to the long-term requirements.

"One significant trend is that, as banks are deleveraging, they are seeking partners to co-operate in investments and to co-finance corporates." Yields can vary, but opportunities abound, Dixmier says.

One potential area likely to cause shudders among institutional investors who have grown gun-shy is sovereign debt. While Dixmier, who has 21 years of experience in fixed income markets, can understand the mindset given the losses involved with Greece, he believes a special case can be made for Spain and Italy.

"Italy and Spain, both under market pressure, are experiencing different situations: Italy is suffering from a liquidity crisis, while Spain is facing a true problem of solvency. In a context where we now have credible support schemes in the Eurozone, our view is more constructive and we are building additional exposure in our portfolios; in Italy, despite some political uncertainties, our scenario in the medium term is a normalization of yields."

Dixmier argues sovereign debt yields in troubled peripheral countries of the euro zone have fallen sharply since June 2012. Partly this has been inspired by creditable commitments to the European Fiscal Compact, an accord on euro-zone budget discipline.

Subject to strict conditions, the ECB has also committed to buying without limit short-term government bonds of countries applying for assistance. This is a "game changer" in his view, empowering the ECB with a similar powerful tool to that used by other central banks. A move to form a euro-zone banking union, based on a June declaration "to break the vicious circle between banks and sovereigns," has also played a role in allaying market fears.

BENEFITS TO CONVERTIBLES

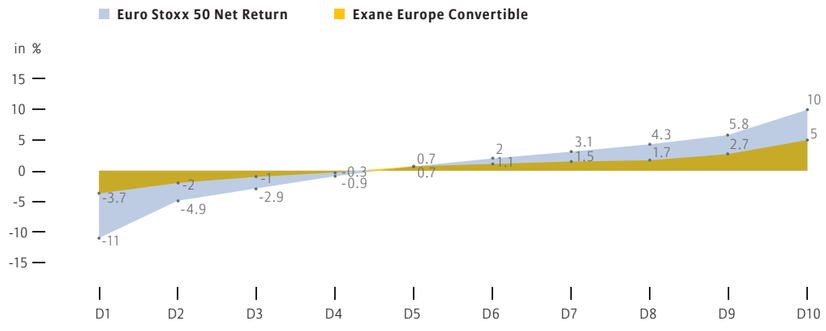
While convertible bonds are a niche market, they present a compelling case for some institutional investors. Given current yields, investors could be exposed to substantial losses with even modest increases in bond yields. Convertible bonds, a hybrid security with both debt- and equity-like features that can be exchanged for a predetermined amount of equity in a company, can provide a measure of protection.

Analysis run by Dixmier's team on the Euro Stoxx50 since 1996 (see chart) showed investors in convertibles during a time of positive markets had participated in half of the performance of the equity market during that time. While investors are also exposed to losses, they are only exposed to a third of the losses of the equity market under adverse conditions.

"It's a third of the losses opposed to half of the gains, which should make them attractive," he concludes.

CONVERTIBLES: AN ATTRACTIVE CONVEXITY

Average monthly performances by decile since 31 December 1996. Convertible bonds have benefited from most equity market rallies, while proving their defensive characteristics during market downturns.



Source: Europerformance, Allianz Global Investors; data as at 29 February 2012

Governments and retirees feel the heat as pension benefits threaten to melt away.

RETIREMENT REPRESSION

The adequacy of a pension income is not set in stone at the end of a working life. As lifespans increase, people are spending more time in retirement. The question facing each retiree is then, "Will the benefits I receive be adequate over the entire retirement?"

To provide a satisfactory benefit for citizens, countries such as the United States as well as most in the European Union (EU) have linked pension benefits to the rising cost of living. Now, facing severe fiscal constraints, countries are cutting social security spending. The measures include altering or abolishing the index link, as has happened in Portugal, Greece, Italy and Lithuania.

This stripping of the pension-index link can be likened to financial repression, market mechanisms used by governments to reduce debts (see "Taxation by stealth," PROJECT M #12). The problem with "retirement repression" is that it may bring fiscal relief, but could come at significant social cost. People retiring today could wake up in 10 years' time and realize that benefits no longer cover the costs of living – and it is too late to do anything about it.

RENEGING ON PROMISES

Indexing serves as insurance to protect retirees from changing economic circumstances. If no adjustment exists, even at low inflation rates, retirees can face a tremendous decline in living standards. For example, the average life-expectancies of 65-year-old citizens of the European Union (EU-27) amounts to 20.7 years for women and 17.2 for men. An annual increase in consumer prices of 3% without indexing, means a real purchasing-power loss of 46% for women and 39% for men through the average retirement.

From a budget viewpoint, eliminating pension indexation works like compound interest in reverse. It enables the state to lower pension obligations over time, leading to lower retirement spending. In Italy, scrapping indexation has resulted in a reduction in 2012 of €3.2 billion ($4.19 billion). In 2014, according to the *IMF Country Report No. 12/167, July 2012*, the annual saved amount is projectedto be € 10.5 billion ($13.7 billion). Such measures help governments gain control of spiraling pension obligations. That is why it was part of many pension reform programs to regain fiscal sustainability. It also shares the burden between generations. Not all costs are saddled on the shoulders of the young, Today's retirees also share part of the load, which is why some countries, such as Germany, have applied even more severe measures to pensions, including "sustainability-factors."

Shifting the indexation rule can also threaten the adequacy of a pension. The choice of the index benchmark is crucial to sustaining adequate retirement income. A peg towards prices protects retirees against the loss of purchasing power as benefits change with the costs of living. Indexation to wages results in benefit changes in terms of living standards. This protects the retirees' relative income level.

In general, wage inflation is assumed to be higher and pension systems that link pensions to earnings are seen as more generous. Most EU countries have shifted their policy to price indexation or at least to a combination of wages and prices. By pegging retiree benefits to the consumer price index (CPI), the relative income of retirees lowers over time, increasing their risk of poverty and social exclusion.

According to *Pension Adequacy in the European Union 2010-2050* (see page 27), the theoretical replacement rate of retirees who will have spent 10 years in retirement in 22 member states will fall by at least 5% and in some cases by more than 10%. Poland is the most extreme example with a benefit drop of 15%.

The effect is most dramatic if the minimum pension is pegged only to consumer prices. John Piggott, director of the ARC Centre of Excellence in Population Ageing Research (CEPAR) from the University of New South Wales in Australia, noted in a recent interview with PROJECT M.

"First-pillar pensions declined dramatically in the UK and that was because it was price-indexed and not wage- ☞

indexed. You could see that coming a long time ago. This runs counter to any notion of long-term guarantees of adequacy in the sense of providing people with enough to get by."

INADEQUACY TRAP

Wage indexation of pension benefits can provide a rising absolute level of retirement income. However, in some situations, it can also be an inadequacy trap. In peripheral European countries with wage-indexed and partly wage-indexed benefits, the current debt crisis and the pressure it places on unit labor costs could lead to declining living standards for retirees as overall living standards decline.

Other political measures also threaten the adequacy of wage-indexed pensions. Several countries that rely on wage indexation, notably Germany and Sweden, where there was intense discussion about the financial sustainability of the pension system and the burden sharing between generations, have introduced "sustainability measures" that ensure pension indexation lags behind wages.

Between 2001 and 2011, state pensions adjustments in western Germany were consistently below annual inflation. The link between consumer prices and state pensions was decoupled with the introduction of the "Riester-" and "Sustainability"-factors. According to Deutsche Rentenversicherung statistics, in the past 10 years, German retirees saw real purchasing power decline by 8% as measured against official CPI. So, both wage and partly wage-indexed retirement system can be prone to retirement repression. Yet, although inadequate in the longer term, a consistent indexation – whether against CPI or wages – is fairer than no indexation at all.

Unless indexed, benefits can become inadequate to sustain retirees above the poverty line. In Italy, as only the minimum pension is now indexed to prices, more and more pensioners will be pushed down to a benefit level that amounts to social allowance. The government is betting that changes to second and third-pillar pension provisions (occupational and private provision) will make up the shortfall, but is struggling to create robust systems and tax incentives to do this.

HONEST COMMUNICATION

There is a compelling, critical fiscal need for countries to temper their "pension promise." However, to do so without adequately informing citizens or equipping them to make up the shortfall could result in significant social unrest in years to come. Instead of furtively cutting benefits in the future, there are measures that can promote financial sustainability and adequate retirement income today.

To sustain adequacy throughout retirement, the initial pension payment could be lowered and coupled with adequate indexing rules. If this basic mechanism for the adequacy of retirement income is explained to citizens while they're still working, they can react by working longer and saving more. Lowering initial benefits would reveal the effect of the austerity measure immediately and begin to promote a more financially sustainable pension system.

Currently, 25-50% of people retire before the statutory retirement age. As each additional year worked yields a pension bonus of 2-6% of retirement income, lower initial benefit payments could incentivize people to work longer. This would promote the financial sustainability of the pension system by increasing the size of the labor force, which means more people contribute longer to the state pension while decreasing the number of people receiving a state pension as well as the length of time they receive it.

EUROPEAN APPROACHES TO INDEXING (PUBLIC OLD-AGE PENSIONS)

INDEX BENCHMARK	COUNTRIES
Wage growth	Denmark (nominal income)
Wage growth & sustainability factor	Germany (nominal income – sustainability factor), Sweden (nominal income – sustainability factor)
Prices and wages	Bulgaria (50% CPI+50% nominal income, as of 2013), Czech Republic (CPI+1/3 real income), Estonia (80% social tax +20% CPI), Cyprus (progressive nominal income + CPI), Hungary (min. 100% CPI), Poland (80% CPI+20% real income), Finland (80% CPI+20% nominal income-sustainability factor), Slovakia (50% CPI+50 nominal income), Malta (30% CPI+70% nominal income), Romania (50% CPI+50% real income, 2030: 100% CPI)
Prices	Belgium (+living standard adjustment), France, Latvia, United Kingdom, Luxemburg (if CPI > 2.5% + re-examination)
Discretionary	Greece (starting 2015: min 50% CPI+50%GDP or 100% CPI), Lithuania (2013: real income, 2014: CPI), Ireland (real income), Austria (CPI), Italy (none), Slovenia (nominal income), Spain (CPI), Portugal (CPI + GDP)

Source: *The 2012 Ageing Report*, European Commission

FROM THE LABS

The effects of an aging population will have an impact on both national budgets and social systems across the 27 EU Member States.

PENSIONERS IN THE EU

120 MILLION

Pensions represent by far the largest element in social protection systems, affecting the primary incomes of more people than any other part. The total number of pensioners in EU Member States presently totals around 120 million, or a quarter of the population.

LEGISLATED PENSIONABLE AGES

RETIREMENT AGES IN THE EU

The actual legislated pensionable age in the EU varies from Member State to Member State. The lowest pensionable age for men is currently in France, where males can retire from the labour market at 60. For women, Romania has the lowest legislated pensionable age across the 27 EU Member States, at 59.

MEN		WOMEN	
Belgium	65	65	Belgium
Italy	65	60	Italy
Latvia	62	62	Latvia
France	60	60	France
UK	65	60	UK
Romania	64	59	Romania

AVOIDING POVERTY

A fifth of people aged 65 or over in the EU today have pension incomes just below or just above the poverty risk threshold. The EU aims at reducing the number by 20 million by 2020.

20%

2060

DEMOGRAPHIC CHANGE

The old-age-dependency ratio in the EU is projected to surpass 50% by 2060, almost doubling the current ratio of around 26%. To learn more about the impact of changing demographics on public pension systems, watch a video at **projectm-online.com/leading-thoughts/half-empty-half-full**

REPLACEMENT RATES

REDUCED BENEFITS

The number of EU Member States projected to experience decreases in net replacement rates between 2010 and 2050. Analysis of theoretical replacement ratio scenarios demonstrates that as an effect of pension reforms, net replacement rates are projected to decrease by at least 5.5 percentage points in 17 Member States between 2010 and 2050. In 11 of them drops are projected to exceed more than 15 percentage points for a worker with average earnings retiring at 65 after a 40-year career.

PENSIONS AND PUBLIC EXPENDITURE

Public pensions make up a growing part of public expenditure in the European Union, currently taking up 11.3% of GDP on average across the EU 27. The number is projected to reach 12.8% on average by 2060.

11.3%

Source: *Pension Adequacy in the European Union*, Council of the European Union, Brussels, June 2012.

THE ART OF SPENDING

A look at the Eurostat figures reveals surprising things about the spending habits of European retirees and draws into question the method used to calculate the cost of living for the elderly.

in %

RETIREE SPENDING (OF TOTAL CONSUMPTION)

	HIGHEST	AVERAGE
Alcoholic beverages	**3.5** Ireland	**1.4**
Clothing	**4.9** Spain	**3.1**
Shoes	**2.4** Macedonia	**1**
Cars	**10** Norway	**3.2**
Transportation	**17.2** Norway	**8.6**
Books & newspapers	**2.3** Finland	**1.3**
Restaurants & hotels	**8.9** Portugal	**3.62**
Recreation & culture	**12.1** UK, Austria	**6.8**
Personal care	**3.2** France	**2.1**

Retirees in Macedonia seem obsessed with shoes. The elderly in the home of sandal-wearing Alexander the Great spend double the European average on footwear. Retirees in Spain are clearly the continent's chicest, outlaying the largest percentage on clothing, while retired Irish, ever willing to confirm a stereotype, devote a quarter of their nutrition expenditure to alcohol.

A glimpse at the figures from Eurostat,* the statistics office of the European Commission, offers a fascinating and sometimes bizarre picture of national spending patterns, as well as the interests of statisticians. According to the figures, no European of the 60+ generation travels by rickshaw, though why this is even included in a European survey is puzzling.

Source: Eurostat

Norway is an interesting case. Retirees there spend double the average European outlay on cars. This is most likely a reflection of the nation's tough tax code, which targets cars and other luxury goods, rather than an indication that Norwegian retirees are status-conscious petrol-heads.

According to the figures, elderly Finns spend the most on books and newspapers, the French on personal care, including hairdressers and beauty products, and the Portuguese a staggering 9% of total expenditure on restaurants and hotels. While some countries also provide categories for prostitution and narcotics, it appears no retirees are, or at least willing to admit to, paying for these.

Within the European Union, 19 countries peg old-age pensions in some form to the development of consumer prices. Of these, Lithuania, France, Spain and Austria rely solely on price indexation to adjust future pension payments.

Yet, is the official consumer price index (CPI) really the right basis for pension increases? From the data, it appears that the consumption pattern of retirees is more exposed to inflation, so a policy linked to indexation may be failing to protect retirees from actual rises in the costs of living as they experience them.

HEALTH AND HOMES

How could this be? The official CPI itself is the consumer expenditure bundle of goods and services for the average household. If spending patterns among one age group differ significantly, indexation may not protect that group from spiralling costs in particular expenditures.

According to Eurostat, the consumption expenditure of people 60+ deviates to some extent from those of the average household. The most pronounced differences can be found in health and housing expenditures. On average, elderly households in the EU spend approximately 2 percentage points (pp) more of their total expenditures on health care and 5.5pp more on housing. As inflation of housing prices rose 40% faster and medical costs twice as fast as the overall CPI in EU countries from 1996-2011, the actual loss of purchasing power for the older population might be higher than the official CPI suggests.

Data from the United States provide some support for the claim that retirees face a bigger loss in real purchasing power than the average household. There, the experimental CPI for the elderly (CPI-E), introduced in 1982, tries to capture the consumption expenditure of the population aged 62 and over. As part of the approach, it places a higher weighting on healthcare and housing.

From December 1982 to December 2011, the CPI-E rose an average of 3.1% annually. Over the same period, the official consumer prices only increased by 2.9% on average. So, when indexed to prices, headline CPI might be an unsuited measure to account for real changes in the costs of living that retirees face.

BACK TO BENEFITS

All of this indicates that the benchmark chosen for the pension peg is important to sustain payment adequacy in the long term. And, as the Eurostat figures indicate, the benchmark may also have to be weighted differently between countries.

For example, the most pronounced differences in consumption expenditure on housing and health care occur in the eastern countries of the European Union. Slovakians over 60 years of age spend roughly 40% of their expenditure on housing, 9.4 percentage points more than the national household average.

Elderly Romanians' spending on health care is disproportionally high. With a share of 10.3%, they have the highest exposure to medical expenditure, which is 6.5pp above the mean national consumption. But major differences are also apparent within the Euro zone. Finland's older population, for example, spends 8.4pp more on housing than the average Finnish household.

Linking pension payments to national CPI may be an inadequate way to assess the real cost of living that retirees face. This could be providing a false impression of the adequacy of pension benefits and, ultimately, may even undermine the adequacy of those benefits.

PRICE INDEXING LOW INFLATION/ DEFLATION:

In the United Kingdom in 1999, low inflation meant the annual pension increase was a measly 75 pence per week. This "derisory" pension increase caused social uproar, leading to extra benefits such as free TV licenses. In Poland in 2002, a legislative change (inflation adjustment after cumulative changes reach 5%) saw pensions rise by a minuscule 0.5%. In protest, many Polish retirees sent the additional money in cash back to the social-insurance agency, causing immense logistical problems.

Source: *OECD Pensions, Purchasing-Power Risk, Inflation and Indexation*, 2009

Compare retiree expenditure on goods and services across the EU and to the national averages at: **projectm-online.com**

*Eurostat data refer to EU countries plus Norway, Croatia, Macedonia and Turkey.

India may have a young population, but the elderly still number more than 80 million.

COMPLETELY INADEQUATE

India's state pension system is at once sorely lacking and hugely expensive. Fortunately, there is still time for the big changes needed for the good of the country's long-term financial security.

A dozen eggs will set you back as little as 45¢ (25 rupees) in villages throughout India, while a 1.5 liter bottle of water costs 32¢, slightly less than a loaf of bread. However, a kilogram of apples or chicken breasts is expensive, coming in at around $2.70.

What sounds like bargain prices to westerners must be measured against the reality of life. In India, despite GDP growth averaging 6.5% a year since 1991, 42% of the population still live on less than $1.25 a day and the social safety net is sparsely and often inefficiently meshed.

For the elderly, the Indira Gandhi National Old Age Pension Scheme (NOAPS) provides a measure of relief. People aged 65 years or more and belonging to households living below the poverty line are entitled to 300 Rs ($5.50) a month, as well as two or four kilograms of rice depending on their nutritional intake. Twice a year, for the *Deepavali* and *Pongal* festivals, men receive one free *dhoti* and women a free *saree*.

The way the poverty line is defined, however, prevents many other needy people from accessing pension benefits," says Arnav Pandya, a researcher and consultant on pensions in India. "In fact, even the 17 million beneficiaries have major problems receiving their monthly payments," he explains. "What tends to happen is that payments get 'bunched,' so several months arrive together."

In a letter to Prime Minister Manmohan Singh in May 2012, the rural development minister, Jairam Ramesh, requested the NOAPS be reviewed. "I have always held the view that the amount of pension we are giving is an insult to the dignity of the individual," the minister wrote.

Apart from urging a review of the pension, Ramesh wanted payments restructured so pensioners would receive benefits in their bank accounts on an assured date every month. Last October, the government raised the rate to 300 Rs, with the 35 state and union territories governments expected to provide a similar amount.

THE AGE-OLD CONUNDRUM

"The total is still inadequate, but it is better than nothing," says Hira Sadhak, an advisor to Pricewaterhouse Coopers and former chief executive officer of LIC Pension Fund. In fact, he adds, NOAPS manages to be both inadequate for recipients and incredibly expensive for the nation.

This is reflected in the Allianz *Pension Sustainability Index* of countries with the most sustainable pension systems. India is next to last among the 44 countries studied. One reason for the rating is that, while both pension coverage and the replacement rate (the percentage of a worker's pre-retirement income received as a pension) are extremely low, the fiscal burden of the pension system is as high as in many western European countries. This is a significant factor in the high overall debt level of India, which is 70% of GDP.

According to the Ministry of Statistics, the elderly (aged 60 years or above) accounted for only 7.4% of the population in 2001. While India is "young" with a median age of 25 (*UN 2010 World Population Prospects*: in comparison, the US median age is 36.9 and Italy 43.2) with one-sixth of humanity living in the country, the elderly number over 80 million people, a figure that exceeds the entire population of all but 16 countries.

The proportion of the elderly is set to rise to 12.4% of the population by 2026 against a background of rapid transformation in household structures. Traditionally, ☞

Learning to plan for the future: rapid social change leaves India at a crossroads.

India's elderly are supported by an extended family, but the economic transformation undergone since the end of the license raj in 1991, the Byzantine regulation and permit system that formed the basis of India's planned economy, is having profound social consequences.

The extended household is changing to a nuclear one, and the elderly can no longer depend on transfers from their children. Other changes, such as the migration from the country to the city, are also leaving many older people in rural areas without any familial support. Left to fend for themselves, many elderly are in poor physical condition and unable to collect water from wells or hand pumps, let alone earn a living.

» THERE ARE INDICATIONS THAT AWARENESS OF THE NEED FOR OLD-AGE INCOME IS CHANGING. «
HIRA SADHAK

This situation has pushed the government into assuming an ever greater role in assisting the destitute elderly, and there are calls for a universal, non-means-related, non-contributory pension scheme as a right, such as at a 48-hour *dharna* by 5,000 elderly people last May. A *dharna* is a fast held outside an offender's door in order to shame them into complying with a demand for justice, such as paying their bills.

Yet, with a public debt of over 70% of GDP, and NOAPS supporting less than a tenth of India's current elderly, others question the cost of continuing and extending the current system. N.R. Bhanumurthy, a professor at the National Institute of Public Finance and Policy, has written that a move to extend the system would entail a huge fiscal burden that would see public debt levels soar and may produce macroeconomic instability.

Unfortunately, neither occupational nor private pension savings provide a solid base on which to build for retirement. Today, the modern Indian pension system is a rickety three-pillar structure that is both complex and totally inadequate for the needs of most of the population.

While it consists of targeted plans for high-wage earners, civil servants, the formal sector, and Indians living and working abroad, less than 12-20% of India's 493 million active workforce are actually covered.

Introduced in January 2004, the New Pension System is a defined contribution plan for civil servants who entered government employment after that date. In 2009, the New Pension System was extended in an ambitious bid to draw in India's massive informal sector working above the poverty line – one of the largest in the world – into the retirement system. Yet, the positive impact of this won't be felt for another 30-35 years.

With 42% of children malnourished or underweight, low literacy rates and increasing inequality amongst a host of problems besetting this still developing nation, pensions may not seem to be India's most pressing concern. Yet, Hira Sadhak says it's a system that needs to be organized now for the economic security of the country in the long term.

"Financial literacy in India is the lowest in the Asia-Pacific region, yet there are indications that awareness of the need for old-age income is changing," he says. "According to a 2007 study, nearly 69% of households in India save for old-age financial security." The government needs to promote and further encourage their efforts, he says.

The NPS is an offshoot of this growing awareness, but it is only slowly gaining traction. Savings are also encouraged through tax incentives on long-term investments, such as pension and life insurance. There is also pent-up demand for increased participation by the private sector, through mutual funds, for example. Sadhak believes these could enter the market in a substantial way in the near future.

According to the United Nations, India's total fertility rate has more than halved in 60 years, estimated at 2.54 births per woman in 2010. This figure is set to decline further to 1.87 by 2050, while the number of elderly will begin to rise. Unlike many other Asian countries, India has time to adjust to an aging population, but it is not an issue that can be defered indefinitely.

FURTHER READING

Caught in a daily struggle to survive, India's unorganized workers can hardly afford to save for retirement and the subcontinent is faced with implementing a sustainable pension system. For more details, download the working paper *What's happening in India?* at **www.projectm-online.com/research**

SHARING THE LOAD

Encouraging governments to issue longevity bonds may sound hazardous, but by supporting a longevity capital market, they could share the risk of rising life expectancy for their own benefit and that of investors.

By Bernhard Brunner, director, risklab

People are living longer, but they are killing defined benefit (DB) pension plans. Every time life expectancy rises by a year, another 3-5% is added to liabilities in DB pension plans. In OECD countries, this equates to an estimated €500 billion ($652 billion) of additional pension assets to maintain current funding levels.*

In the scramble to mitigate such a severe risk, many OECD countries with developed DB plans are experiencing a strong shift to defined contribution (DC) ones. But this simply moves longevity risk away from institutions to the individual. And it's this individual, if left with an inadequate annuity payout in retirement, who will be looking to the state for social security top-ups and health care.

Governments, therefore, literally cannot afford to singlehandedly carry the dragging weight that rising life expectancy is having on retirement systems.

DEALING WITH LONGEVITY RISK

One potential answer lies in sharing longevity risk by helping pension funds and annuity providers to offload it into the capital markets through longevity swaps. This could promote sustainability in the private DB pension sector as well as help investors looking for alternative, uncorrelated asset classes.

Unlike buy-out solutions, a longevity swap allows a pension plan to keep control of all its assets. And unlike both a buy-out and its buy-in cousin, it involves a pure longevity risk transfer separate from interest rate or inflation risk.

At present, the longevity capital market is a small one. Most over-the-counter (OTC) swaps may look like capital transactions with ☞

*Further information: risklab report – *Longevity Risk within Pension Systems (A Background Paper to the OECD Policy Report*, 2011)

the involvement of an investment bank, but the risk is just passed on to a re-insurer with the bank acting as a middleman. In their current form, these will in any case be limited in number due to restricted insurer capacity.

Attempts to hedge risk with the markets have mostly been made directly. However, the demands of pension funds and investors in relation to maturities and the underlying population have proved too difficult to align. In addition to missing standardization and transparency in longevity deals, this is why so few transactions – the vast majority of which have taken place in the United Kingdom – have actually been completed.

It's hard to see the whole picture. Are government longevity bonds the answer to evenly distributing the risks from increased longevity?

An injection of liquidity is therefore imperative. This is where governments can come in. By issuing standardized longevity bonds index-based on the country's own population, governments would make prices publicly available. These would then be used as reference points for other transactions and assist the growth of a longevity derivatives market, solving the problem of transparency that is also holding the market back in current over-the-counter deals.

Encouraged by government intervention, other parties could use the bonds to hedge longevity risk. The best-placed party to do this is a reinsurer. Reinsurers provide a vital link between pension funds and annuity providers, who prefer instruments with maturities of more than 30 years, and investors who are interested in asset classes with maturities of about a third of that time period. Reinsurers could then pool and select portfolio-specific longevity risk taken from a variety of pension plans and annuity providers, and transfer it to the capital markets.

Government longevity bonds would also help investment banks link highly customized swap arrangements, which have an underlying index to a very specific population, to a standard index. This would help make them more attractive to investors.

The best type of government-issued longevity bond would be a deferred version. Coupon payments from this bond depend on the survival rate of a given population, such as a cohort aged 65 in 2013, and are deferred so that payments start when the cohort reaches a pre-determined age. This provides more longevity exposure with less capital investment.

Annual bond issues set at a face value of €5-10 billion ($7-13 billion) with maturities of only 10-15 years could be a massive boost for the longevity market. Governments could then gradually reduce their size in the market and, once investors flow in and increase liquidity, eventually exit it.

OVERCOMING OBSTACLES

Apart from solving the problems of liquidity and transparency, government-issued longevity bonds could also help remove two other obstacles: standardization and education.

Aside from the United Kingdom, most of the rest of the developed DB market uses standard mortality tables that still largely ignore the positive trend in life expectancy.

This puts them at a large variance when they look to hedge longevity risk because investment banks will have more realistic trends built into their calculations. As a result, hedging can look extremely expensive from a pension plan perspective.

If government longevity bonds were to exist, then there would be an accurate national longevity index that pension plans would be able to use, bringing valuations between parties closer. And the growing liquid market and the subsequent raised awareness of longevity hedging would take care of the education side of things.

One difficulty exists in a lack of uniform accounting rules. In Germany, for example, local regulations make longevity hedges unattractive for German insurance companies. Tackling this is necessary in order to ensure the creation of a truly global longevity market.

FALSE STARTS

Attempts to issue longevity bonds have been made in the past. In Chile, an effort by the World Bank Group and local regulators to issue bonds in 2008 and 2009 to support the pension system were thwarted by reservations held by domestic insurance companies. Interest has also been shown in countries such as Canada, Israel and Mexico; so the appetite is there.

Skeptics may recall that a similar situation existed with inflation hedging until governments began offering inflation-linked bonds, which was the starting point for inflation as a tradable instrument.

Taking on more longevity risk may sound like a perverse course of action. But a brave government could be well-rewarded for its courage, both by the risk premium earned from issuing longevity bonds and by taking some of that risk off their shoulders in the longer-term.

» TAKING ON MORE LONGEVITY RISK MAY SOUND LIKE A PERVERSE COURSE OF ACTION. BUT A BRAVE GOVERNMENT COULD BE WELL-REWARDED FOR ITS COURAGE. «
BERNHARD BRUNNER

DEFINING ADEQUACY

Adequacy is not a question of how much is enough, but rather how much is enough for whom, says Pablo Antolín-Nicolás, principal economist at the OECD's Private Pension Unit.

Enough in Austria: Toy cars, cranes, and planes.

Pablo Antolín pauses slightly and carefully measures his words before answering. "My personal view is that, politicians love to use the term adequacy," he says. "But when it comes to defining what is adequate, it's not that easy."

Antolín, the principal economist at the OECD's Private Pension Unit, is perhaps more comfortable thinking about policy issues than dealing with the press, but happily describes his work, vividly and with a surprising deal of professional passion. Currently he is seeking an answer to the very existential question of how much, exactly, is enough?

This may sound a somewhat abstract pursuit, but it has direct relevance to your wallet. Consider that the average pensionable age in OECD countries is set to reach 65 for both sexes by 2050, an increase of about 1.5 years for men and 2.5 years for women. But life expectancy is rising even faster, meaning that in all but five OECD countries time spent in retirement will continue to grow over the next decades (OECD *Pensions at a Glance*, 2011).

The forecast is forcing governments to reform pension policies to balance sustainability of pension systems with adequate income levels for future retirees. This begs the inevitable question; what is adequacy? Or in other words: how much, exactly, is enough?

Antolín is seeking an answer. Together with colleague Juan Yermo, he is conducting a study into pension adequacy, backed by the European Commission. It's a monumental task, he reveals, and not necessarily one that will provide the straightforward answers that governments sometimes look for.

Defining adequacy, he says, is not a question of how much is enough, but rather, how much is enough for whom.

"We understand that in the end, governments and policy makers want to have just one number, but one number is wrong," he says, again after some thought. "It's quite complicated, but the answer will be different for different income groups, and it will be different for the different genders and economic statuses."

REAL PEOPLE, REAL NUMBERS

Launched in January 2012 as a pilot project, Antolín and Yermo's Retirement Saving Adequacy study* is not searching for a single figure, but instead attempting to reach a more useful, flexible set of definitions of the illusive concept of pension adequacy.

The outcome of the two-year project will be policy advice for governments and guidelines on how to target specific population subgroups to secure that future retirees will have enough funds available to sustain an adequate living. The project is noteworthy because it aims for real insight into not only the different countries' pension systems, but also socioeconomic groups and cohorts that make up the social fabric of those systems, Antolín explains.

"Up to now, many of the studies completed at the OECD and other institutions are about replacement rates of hypothetical individuals joining the labor market today and contributing for 45 years. We wanted to see what happens when you move on and look at actual individuals."

To do this, the project will look at the resources actual individuals between 35 and 65 might have to finance their retirement at the time of leaving the labor market. Information is collected from household surveys and administrative data sets. This is then analyzed with the help of national experts by incorporating parameters like employment status, participation in private pension plans, interest rates, rates on return on investment, productivity and inflation.

A RELATIVE NOTION OF ADEQUACY

The next step is to define what the researchers call a country's "specific reference income." The reference income will serve as a pointer for researchers to generate a percentage number of future retirees likely to achieve adequate levels of retirement income. That is, how many retirees will have enough funds available once they retire.

The exercise, however, goes far beyond a simple calculus. Defining a country's reference income is both complex and complicated, Antolín points out. Several factors must be considered, and the researchers are forced to take into consideration a host of potential hurdles.

"The big challenge is to define the reference income. What you call 'adequate.' There is a lot to discuss about this, it is the difficult part of it all."

In Bangladesh: Three-wheeler, cricket bat, football, wheel and slingshot.

*The *OECD Retirement Saving Adequacy* study will work with a deadline for an initial report on the United States, Germany, Chile, the Netherlands, the UK, France, and Italy by the end of 2013. The study will continue after that and extend to other OECD countries.

In Argentina: Dolls, bicycle, play phones and plastic toys.

In South Africa: Toy cars and play wheel.

It is commonly said that 66% or roughly two-thirds of one's final salary income is assumed as enough or adequate as a pension replacement rate. This, however, is an incorrect measure, Antolín says. An absolute amount or percentage replacement rate does not cover the full scope of needs different retirees may have, and to use it as a measurement for adequacy therefore becomes problematic. Replacement rates can only be treated in terms of adequacy if they are understood in relative terms, he explains.

"Saying that everybody needs 70% or 66% or two-thirds is not correct. One could argue that a low-income person needs 100%, a middle-income person two-thirds, and a higher-income person needs 50%. Usually higher-income people have other sources to tap into to finance retirement."

"If you tell me a high-income person gets a pension benefit of $5,000 a month, and that in terms of replacement rate is only 50% of his or hers last salary, it seems low in terms of replacement rates. But in absolute amounts it's not bad." Similarly, retirement income adequacy may vary from country to country. "An American might need more retirement income than a German, because he will have to finance all his health care expenses, while in Germany this will be covered by the state. Having €1,000 a month in Germany, in Spain, in the US or in Australia is not the same. It depends on the specifics of the countries."

"CONTRIBUTE, AND CONTRIBUTE FOR A LONG TIME"

One year into the study, there are nonetheless a few general findings and preliminary lessons to be learned, Antolín reveals.

"Some of the indicators that have come out of the preliminary analysis are, firstly, that status of the labor market is very important. People need to be working, having jobs, in order to build up savings. Retiring later is essential. You need to diversify the sources to finance retirement. You need a pay-as-you-go public system, and you need a funded system and to have the two complement each other. But the main message is that if you want to achieve a target retirement income with a higher likelihood, you need to contribute, and contribute for a long time."

The preliminary findings resonate with earlier messages from the OECD, which have stressed the importance of later retirement and extending the coverage of private savings (OECD *Pensions Outlook*, 2012).

Still, there is some controversy linked to the project. As Antolín lets down his guard for a short moment, he invites a rare view into some of the arguments that must be going on behind closed doors.

The topic is controversial and does lead to intense discussions, he admits. It is a sensitive matter "because at the end of the day you have to say that a certain percentage of the people in a country are not achieving their target," he says.

"We are also discussing the assumptions, we are discussing scenarios and the reference income. There are strong policy issues because, depending on what you choose, some countries will look better or worse."

This makes Antolín's work potentially provocative, too. With a grin, the researcher comments that he hopes not all the controversies will be smoothened out in the backrooms of halls of power.

"I hope not," he says. "It's an important issue that needs to be discussed, even in public if necessary."

PABLO ANTOLÍN-NICOLÁS

Pablo Antolín is the principal economist at the Private Pension Unit of the OECD Financial Affairs Division. Previously, he worked at the IMF and at the OECD Economic Department. He has published journal articles on aging issues as well as labour market issues. Pablo has a PhD in Economics from the University of Oxford and an undergraduate degree in Economics from the University of Alicante.

RETURN OF THE BULL

Not all of investing's cherished truths have disappeared. Stocks for the long run remain a reliable source of adequate pensions, argues Jeremy Siegel.

By Jeremy Siegel

Five years after one of the most disastrous financial crises in economic history, investors are still shell-shocked. How else can we explain bondholders accepting negative real bond yields with stock valuations so promising.

We know there is a human tendency to overreact and I believe the pendulum has swung too far back. Investors and the financial industry have become overcautious. At the height of the crisis, when housing prices were 30% to 40% higher than today, banks were willing to lend 100% on a non-documented loan. Today, with real estate prices at rock-bottom, financial institutions request endless verification. This is part of the reason why the US economy continues to see a slow recovery.

In a market commentary last year, "bond king" Bill Gross went as far as declaring equities near dead. I think he is wrong. Going forward, stocks can continue to generate real returns between 6-7% a year for two reasons: first, the valuation of stocks is currently at or below its long-term average. This is the most powerful indicator that stocks will appreciate.

But productivity growth will also be restored or even exceed its long-term average, reaching perhaps 3% or more per annum over the next five to 10 years. Thanks to the communications revolution, collaboration has become possible on a scale previously inconceivable and this should spark productivity growth. There is no reason to be a productivity growth pessimist on the United States and many other developed markets as quite a few people have become.

Consequently, I believe a significant share of plan sponsors' portfolios should remain invested in equities to generate sustainable and adequate pensions. Stocks remain a promising long-term investment, contrary – with all due respect – to Mr Gross' commentary last August (see PROJECT M #12, "River of no return?"). As long as price-earnings ratios do not rise to unsustainable levels, one should remain bullish on stocks.

30 REMARKABLE YEARS

Now, some may discount this as the old "mega-bull" Siegel, but you have to be fair: while I, like many others, did not foresee the bear market of 2008 and 2009, I have not always been bullish on stocks. There have been times when I recommended the purchase of bonds and I came out with a very bearish opinion piece in the *Wall Street Journal* in March 2000 when the growth prospects of new technology were widely overrated.

I agree that the last 30 years have been remarkable for bonds. Yet, we are unlikely to see a 16.5% return for a 10-year treasury bond any time soon, as we did in 1981. Bonds can be very risky and my research has shown that US Treasury bond returns were negative after inflation for a full 35-year period after World War II. There has never been a 20-year, much less a 35-year period in stock market history in which real returns on stocks were negative.

While stocks do have greater volatility in the short run, they generate sound returns for a long-term retirement saving plan. Stocks also had extraordinary returns over the past 30 years, close to their normal return as the 200 years of data I've examined show. Looking back, the high returns on bonds over the last 30 years were an anomaly.

Naturally, my outlook is based on a number of premises. While developed markets had to make significant adjustments in response to the Great Recession, I expect China and other emerging markets to continue to grow at rates of 5-7% per annum. This is growth that firms in developed markets can capitalize on. In 2012, an estimated 45% of profits of the S&P 500 firms came from foreign sales and I expect that to increase over time. These are great opportunities for firms and – by extension – for investors.

There is a concern among investors that the aging of the developed world will cause baby boomers to sell stocks to finance their retirements, bringing about a long and painful bear market. But I am convinced the strong growth of the emerging markets will generate enough appetite for stocks to keep prices high. Many Western companies, particularly multinationals, will come to be owned by Asian investors by 2050. Brand names like Procter & Gamble or Louis Vuitton may remain, but most of their investors may come from Asia.

If capital and trade flows remain open, investing in stocks should remain the preferred saving strategy.

» WE KNOW THERE IS A HUMAN TENDENCY TO OVERREACT.«

JEREMY SIEGEL

Jeremy J. Siegel is the Russell E. Palmer Professor of Finance at the noted University of Pennsylvania Wharton School and a senior investment strategy advisor to WisdomTree Investments. The fifth edition of his 1994 classic *Stocks for the long run* is scheduled to be published this year.

THE RISK OF OVERREACTING TO RISK

Now is a good time to stop and reflect on our new relationship with risk, writes managing director of Greenwich Associates, Goran Hagegard.

By Goran Hagegard

Across the United States, pension plans have been slowly but surely reassessing – and then lowering – their return expectations. A reasonable maneuver given today's political and economic realities. It's a good time to stop and reflect on our expectations and take a look at how our new relationship with risk is impacting us and our plans for the future.

After all, risk isn't just a financial or economic topic, it's one that can be deeply personal and emotional, and affects our behavior in a very fundamental way.

The financial crisis of 2008 was a big event, bigger than anything seen in our lifetimes with the possible exception of those who were alive during the Great Depression. Nothing else has compared in terms of magnitude and impact. Hardly anyone, especially in the financial sector, escaped without some professional or personal pain – and in this case, more personal than ever before. If we didn't get hurt ourselves, we knew someone who was severely hurt. It's been a painful journey; one that left a lot of people scared.

OVERREACTING TO RISK

So as a result of this deeply rooted pain, people began to appreciate risk in a very different way. There's more fear and behaviors change; this translates into various outcomes for the economy. One is that, in general, investors are shying away from risk and corporations don't dare to invest as much as they once did.

And if we look at the bigger picture, we have an economy in which many parts of the world are still mightily struggling. However, if you look at corporate profits, particularly in the United States, the profits are actually quite healthy. The economy's chugging along, but corporations are still fearful and reluctant to invest or hire new people, which means you don't get strong growth – although there is still growth.

At the same time, there are more people than ever before focusing on and identifying risks, both the known and unknown. We're identifying if not all, then most of those risks people would have previously swept under the carpet. There's a much higher awareness and much more conservative and cautious approach to risk by corporate managers. It means slower growth, but nevertheless it is steady growth. All of this might lead one to ask: Are we now, in fact, overreacting to risk?

If so, the risk of overreacting to risk is that corporate and public pension plans may be in a lesser position to produce sufficient income for future generations of retirees.

To understand the scope of that issue, let's pause to look at what the research data tells us. At Greenwich Associates, we conduct research with institutional investors in all the major regions in the world and we are seeing similar trends in all regions with the possible exception of Asia. As an example from the United States, in our 2012 research, we saw the actuarial earnings rate – meaning the assumed rate at which pension plans expect their overall portfolio to appreciate – take a continued downward path. The traditional 8% has come down to 7.3% in 2012 for corporate pension plans and to 7.5% for public pension plans.

In the United States, the behaviors of corporate plans and public plans are different because they are primarily driven by the corporate's exposure to mark-to-market ☞

GORAN HAGEGARD
Managing director, Investment Management at Greenwich Associates, and founder and CEO of management and technology consulting company Adacra, Hagegard holds an MBA with high distinction from Harvard Business School.

Investment behavior tends to move in cycles, says Hagegard. In time, we forget the pain of the past and become too optimistic.

accounting and their tie to a sponsoring corporation. These companies are pushed by regulatory requirements towards "liability-aware," or lower-risk investing, with a heavy preference towards fixed income.

So we must consider the impact of the financial crisis and the resulting fear on one hand, and then on the other consider the situation retirement plans are currently in. Both corporate and public plans suffer from severe underfunding; in 2012, the funding rates were at about 81% for corporate plans and 77% for public.

It's a seemingly unsolvable equation because if a company makes a strong move towards fixed income in a liability-driven approach, it essentially "locks in" losses – and that means the sponsoring institution must add capital to the fund to make up the difference. Many corporate plans have decided to simply bite the bullet and do exactly this; Ford Motor Company is a good example.

A CHALLENGING PATH

But public plans can't expect to get any additional capital from taxpayers who are, at least in the United States, hesitant to give money to pension plans in the current political and economic climate.

With this difficult scenario as a backdrop, and in the current low interest environment, investors are faced with a critical challenge to generate enough returns to meet their actuarial assumptions while continuing attempts to de-risk. Greenwich Associates research shows how this has led investors to accelerate their allocations out of US equities and into alternative investments.

Investors frequently see alternatives as a way of not only creating more diversification, but also as a path to generating higher returns. It is not obvious to us that investors' plans to generate higher returns at lower risks will be uniformly successful. Similarly, within traditional asset classes, we see product demand being steered towards higher-return products.

Although many pension plans would like to move more into fixed income, the low yields and future prospects for interest rate increases make this path challenging. Research also seems to indicate that many pension funds are putting some essentially permanent changes in place. For example, many are implementing what is known as dynamic de-risking, meaning they establish a number of trigger points tied to their funding ratio that changes the asset allocation when certain milestones are met.

REACT, FORGET, REPEAT

This is the framework needed to move towards de-risking and it means that, initially, the plan may increase its equity exposure and risk in order to fix the funding ratio, but it also helps acclimatize to the idea of further locking in the funding ratio and immunizing the portfolio over the longer term.

Are measures like these an overreaction? Is de-risking in fact a risk itself? It's hard to say. My belief is that the world post-crisis has certainly been permanently changed, but maybe not as radically as some would believe or even would fear. Behaviors tend to move in cycles: we react and often overreact to a crisis. In time, we tend to forget or at least discount the pain of the past and become too optimistic. Then another crisis comes along and we react again. What is important to remember is to not let yesterday's misfortune prevent tomorrow's success.

» ALL OF THIS MIGHT LEAD ONE TO ASK: ARE WE NOW, IN FACT, OVERREACTING TO RISK? «
GORAN HAGEGARD

CAVEAT EMPTOR

Mark Rothko's *Orange, Red, Yellow* set a price record for contemporary art in 2012 when it sold for $86.9 million. The international art market is running hot, but, as with any investment, there are risks.

From transport and special storage to forgery; the art world is fraught with potential issues for investors.

It was Kandinsky who first raised Oliver Class' suspicion. The documentation concerning the origins of 30 Russian avant-garde paintings looked good, but when the Swiss art expert went on to evaluate the collection at the request of a prospective client seeking to insure the works for 28 million Swiss francs ($30 million), he became uneasy.

The collection was kept in a toll-free storage hold in Zurich and, like the Kandinsky, the works were incredibly detailed as if copied millimeter by millimeter rather than showing the ingenious grand stroke of a master painter. "They looked like they had been drawn by the same hand," recalls Class.

Class immediately thought of Wolfgang Beltracchi, the notorious German forger who specialized in paintings from the first half of the 20th century by masters like Fernand Leger, Max Pechstein and Max Ernst.

As a child, Beltracchi learned his craft by assisting his father, a restorer, when the older man struggled with details. Beltracchi's work was so good that the self-proclaimed "world's only expert on Max Ernst," the German Walter Spies, was fooled by the talented forger as were many collectors, dealers and museum curators.

The noose around Beltracchi's neck, however, soon tightened. In 1995, the auction house Lempertz in Cologne, Germany, learned that a painting by Hans Purrmann offered for sale by the forger's accomplices was identified as a fake by the administrators of the artist's archive.

Nonetheless, the same auctioneers sold a forged Heinrich Campendonk, *Rotes Bild mit Pferden* (1914), in 2006 from the same source for over $2 million. Somewhat belatedly, the buyer demanded proof of provenance from Lempertz. It was only after the documents failed to arrive that the painting was tested and titanium white was found, a pigment not available at the purported date of origin.

Beltracchi was finally arrested in 2010 and admitted to forging works of more than 50 unspecified, but renowned artists. Only 14 works were subject to the court case. Unfortunately, Beltracchi, who is now serving a six-year sentence, refused an interview for this article so Class may never know if the dubious Swiss collection (which he refused to insure) came from the flamboyant forger's atelier.

NO GUARANTEES

Worldwide, hundreds of billions of dollars are spent annually in an art market that is again running hot. The auction house Christie's alone sold artworks for $3.5 billion in the first six months of 2012, an increase of 11% over the same period in 2011. According to company records, private sales increased by a stunning 53%. Buyers came from 124 countries and 19% were new clients.

The most important segment for the auction house was post-war and contemporary art, which grew by 31% to $921.8 million dollars in sales. Impressionist and modern art followed with sales of $676.7 million, a 4% increase over the first six months of 2011.

Certainly, sellers of contraband, forgers and money launderers exist, but they are far from the only investment risk that collectors face in the market. While expensive masterpieces like the record-breaking Rothko boost sales results, prices for lesser works and traditional antique objects have been languishing for years.

Corinna Thierolf, chief curator at the Pinakothek der Moderne in Munich, says buyers should choose a market niche wisely and build a network of experts among artists, dealers and museum curators. "Sometimes you see collections in which millions (of euro) are wasted on second and third-quality art," she comments.

Thierolf urges collectors and investors to train their eye by visiting galleries, ateliers, academies and museums. Even browsing online catalogues of auction houses can help build a sound collection centering on one artist, one era or a focus which is entirely new and different.

"The documented provenance of the art work should always be conclusive," Thierolf advises, even though, she adds, "in some cases, there is no 100% guarantee."

THE ART OF KNOWING ART

An art insurer, such as Allianz, Axa or smaller specialists like Markel Museums in the United States can lend a hand or an eye and offer sound advice to collectors. Together with the owner, the expert establishes a value for each work of art. The ensuing document serves as the basis for damage claims, establishes a sales price and may be used as security against bank loans. As market prices can increase, the exercise must be repeated from time to time.

Art historians such as Class, who works for Allianz Suisse, can also point out problems that demand restoration and help find the right artisan for the job. Storing artwork demands thought, too. Drawings on paper and photographs, for instance, are especially sensitive to light and keep their original color better in the drawer than on the wall.

Experts can also assist with advice on alarm systems or even the selection of the all-important frames that Heinz Berggruen, an avid collector and dealer, once said sometimes took him years to source.

FROM BAZOOKAS TO MATISSE

With an insurance premium secured, overflowing bathtubs, Christmas trees on fire, masked men with big bags or party guests bumping into a 3,000-year-old Chinese terracotta horse no longer need lead to heart attacks.

Fortunately, such incidences are rare. Private collections are mainly well-guarded secrets. Hidden away in parks and on hillsides, there are museums no one has ever heard of housing spectacular paintings, says Class.

Such buyers only make headlines when they open their collections to the public, such as the Miami-based Rubell family, whose collection now forms the basis of a world-renowned museum.

This is how it should be. "Artworks of significance demand public exposure," says Thierolf. After all, art is about communication. But that is also where the headache for the insurer starts. Public exhibitions, museums, auction houses and galleries are vulnerable to damage by humans in more than one respect, as shown in the 2012 heist of seven masterpieces (valued at more than $100 million) from an exhibition in Rotterdam. The paintings have been entered into the ART LOSS REGISTER, an international database of stolen art works, which alerts important institutions as well as the FBI and Scotland Yard.

One such investigation reminiscent of American heist film *The Thomas Crowne Affair*, led Class to Magdeburg, Germany, after a Renoir, a Matisse and other paintings were stolen from the auction house Koller in Zurich in the early 1990s.

The Magdeburg police had been baffled when, after listening in to conversations by arms-smugglers from Poland, the gang suddenly switched topics from bazookas to Matisse. Class, who arrived in the town after a tip from a private detective, solved the riddle. An undercover policeman pretended to be a willing buyer, arrests were made and Class went home with the Matisse.

Yet, the private detective was not finished there. He told Class that the Renoir and the other missing works were in Serbia in the circle of then President Slobodan Milosevic.

A story appeared in the Swiss newspaper *BLICK* and was picked up by media around the world, including in Serbia. The stunt did the trick: the paintings were returned voluntarily, but the case disproved the belief that renowned stolen masterpieces cannot ever be sold.

TOO GOOD TO BE TRUE

In his memoire *Hauptweg und Nebenwege* (1996), the late dealer and avid collector Heinz Berggruen, part of whose major collection can be viewed in museums worldwide, advises buyers to beware if the seller claims that:

- The piece has been owned by the same family for generations
- Forty years ago, when the art work was acquired, the artist was unknown und nobody would have dreamt of forging his paintings
- Prominent experts have certified the work as genuine (promptly forgetting to mention that the certificates may also be forged).
- The painting was part of a famous collection (even if true, famous collectors may also occasionally have fallen for a copy).

Source: Heinz Berggruen, "Hauptweg und Nebenwege", Fischer Verlag, 1996.

THE SPIRIT OF INVESTMENT

Passion and patience can see whisky provide an attractive payoff. Knowing how to pick the right bottles, however, is crucial.

In 2010, this 64-year-old Macallan Scotch whisky contained in a handmade Lalique Perdue crystal decanter sold at an auction for a record sum of $460,000. Buyers of rare whiskies are often young professionals from emerging markets looking for an alternative investment opportunity.

Andy Simpson believes his love affair with whisky began when he was just six months old. His father, as was common in Glasgow, would rub single malt Scotch whisky onto the gums of his baby to ease its teething pain.

When Simpson turned 16, father and son began exchanging bottles of Scotch at every celebration in an effort to sample as many whiskies as possible. As he grew older and his passion developed, Simpson began gathering data to help determine the future value of his whisky collection. From this interest, Whisky Highland was born, a consultancy that works with distilleries, corporations, banks, large estates and solicitors to assess the value of single malt Scotch whisky.

"I always wanted to help consumers make an educated decision about which whiskies could potentially increase in value," says Simpson. "I'm now akin to an analyst, but I look for value in sealed bottles of single malt Scotch."

GOLDEN DROPS

Whisky is the most-traded spirit in the world. The Scotch Whisky Association, an industry organization protecting Scottish whisky, reports that exports from Scotland rose by 23% in 2011 alone, making it a £4.23 billion ($6.65 billion) market. While whisky is not a traditional investment, the spirit has surged in popularity in recent years. In 2010, a record was set at an auction when a Maccallan 64-year-old contained in a Lalique Cire Perdue crystal decanter sold for $460,000. Last September, a Dalmore 62 – one of just 12 bottles of its kind – was sold to a Chinese businessman at a duty free shop at Changi Airport, Singapore, for £125,000 ($196,400).

As prices have climbed, some collectors have seen up to 400% gains on their bottles. Simpson says the 45 bottles he collected last year have already risen 130%. In comparison, gold reached record prices at over $1,900 per ounce in 2011, a 41% gain from the previous year.

"I think the global financial crisis has actually pushed the value of whisky up," says Simpson. "As people have become disillusioned with traditional investments, they've looked for other options. One of those is Scotch because there are potentially big rewards."

GROWING DEMAND

David Robertson, rare whisky director at Dalmore, a 173-year-old distillery on the northern shores of the Firth of Cromarty deep in the Scottish Highlands, says the market for rare whisky is booming.

"If you go back 10 years, to sell a bottle for £10,000-30,000 ($15,700-47,200) was almost inconceivable," says Robertson, who learned the trade from his father, a manager at the Brackla distillery. "There are a number of iconic collector and investor distilleries now showing tremendous gains in value."

The Killyloch distillery leads in the average price fetched at auction between 2008 and 2012, going for just over £700 a bottle ($1,099). Scotch from Ben Wyvis sells at around £680 ($860) and a Dalmore will go for £450 ($700). Across the board, the top 1,000 bottles have performed well. As a word of caution though, the bottom 10 bottles have lost 70% of their value in the same time period.

Whisky has always been a big seller in the United States and western Europe, but demand has intensified in eastern Europe, Latin America and Asia, particularly in China and Taiwan. As the market expands, investors are actually buying less whisky, but paying substantially more for good bottles, which is driving prices up.

"Certainly, more young professionals are considering rare whisky as an alternative asset. We're often approached (at Dalmore) by investors saying, 'Look, I've got money to invest. Can you recommend what I should buy for £100,000-300,000.' That's only really happened in the last 12 months," Robertson explains.

Demand is currently so high that distilleries are increasing production to levels never before seen. "There is such a global thirst for Scotch that distilleries are unable to lie down significant volumes of casks to age for any period of time," says Simpson. "Stocks of old whisky are dwindling rapidly and much of it has been used already."

One of the main risks to whisky investments comes from the market itself. As the number of buyers and auctions grows, the massive increase in supply could cause a fall in whisky values. Yet, a potential boom-bust cycle has not deterred investors. However, those hoping to turn a profit should be aware that investing in whisky requires patience. Bottles may produce rapid gains, but generally investors realize significant profits only after storing bottles for 10-20 years.

» I THINK THE GLOBAL FINANCIAL CRISIS HAS ACTUALLY PUSHED THE VALUE OF WHISKY UP. «
ANDY SIMPSON

"It is worrying because there is a lot of inexperience out there and some people see whisky as a quick-win investment, which it really isn't," says Simpson, who worked in the corporate banking sector for two decades before starting Whisky Highland. "Whenever I speak to people, I say there is potential for significant short-term gains, but you have to be good – very good – and you have to buy the right bottles."

FOR PAYOFF OR PLEASURE

The dry, powerful taste of whisky is traditionally associated with older drinkers, mostly men. With the current boom being driven by a younger, cashed-up crowd, this prompts the question: Is this current interest in whisky just a fad?

"Will future generations be a market for scarce bottles?" Robertson ponders. "Well, we can't go back in time and create a 25-year-old whisky to put on the market today. So, for such classic drinks, I think there will always be a tight supply. This is why I believe many people will always find it an attractive investment."

Simpson suggests potential investors stick to iconic distilleries. The top 20 include Macallan, Balvenie and Glenfiddich as well as Dalmore. The value of such brands tends to increase because they are not mass-produced and because "they are phenomenally good drinking whiskies."

"That's important because, if the market ever crashes, at least you've got something you're going to enjoy drinking."

IGNORANCE IS GENETIC BLISS

In the interest of spreading our genes, we delude ourselves to better deceive others, says eminent biologist Robert Trivers.

Financial media headlines are screaming bloody murder and trust in the financial industry is wavering. Indeed, the industry's battered record is plummeting from behavior that ranges from merely worthy of public debate to the morally questionable.

United States bank JPMorgan is struggling to rebuild its reputation after a trader nicknamed "the London whale" for his outsized derivative positions incurred losses of more than $5 billion. The US branch of British bank HSBC looked the other way as its affiliates circumvented anti-money laundering laws or provided accounts to overseas banks with links to terrorist financing.

With a collective intention to deceive, the manipulation of the benchmark London Interbank Offered Rate, or Libor, is of a markedly different character. It is the type of behavior that inspired Bank of England governor Mervyn King to issue a scathing critique of the UK banking industry in June 2012, demanding "real change in the culture of the industry."

Unsurprisingly, criticism of the financial industry has gathered momentum since the 2008 financial crisis; however, the problem at hand is complex. Although the housing bubble and excessive credit played a key role in the crisis, the US Financial Crisis Inquiry Commission points to a long history of shortfalls when describing the meltdown's underlying causes.

"While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble – fueled by low interest rates, easy and available credit, scant regulation and toxic mortgages – which was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008," the commission concludes in its January 2011 report.

Rather than blaming a single crook's wicked play, actors in the financial world – from regulators to academia to service providers – might have to factor in the likelihood of misperception inherent in their views. "Self-deception underlies various aspects of the behavior of investors and of prices in capital markets," writes Harvard Business School professor Joshua D. Coval in *Self-Deception and Deception in Capital Markets*. If so, the question is: Why does self-deception exist in the first place?

» THE KEY TO DEFINING SELF-DECEPTION IS THAT TRUE INFORMATION IS PREFERENTIALLY EXCLUDED FROM CONSCIOUSNESS. «
ROBERT TRIVERS

IMPROVING DECEPTION

True to form, eminent biologist Robert Trivers has a clear answer. "There is strong selection in nature to not only deceive, but also to spot deception and the cues that come with it. That makes the case for deceiving unconsciously," he tells PROJECT M when interviewed on occasion of the launch of his 2011 book *The Folly of Fools. The Logic of Deceit and Self-Deception in Human Life* (published as *Deceit and Self-Deception: Fooling Yourself the Better to Fool Others* in the United Kingdom).

"When we lie unconsciously, cues of conscious deception such as cognitive load, nervousness or – to avoid the former – control vanish. In short, self-deception makes deceit more effective. And since we are all in the business of inflating ourselves to look and even be better than we actually are, this contributes enormously to an individual's greater reproductive, or rather genetic success," Trivers goes on to explain. ☞

Self-deception has evolved in order to better fool others, says Trivers in his criticism of the finance industry.

Of all candidates, Trivers, who *Time* magazine once listed as one of the 20th century's 100 greatest thinkers and scientists, lends himself least to writing a blank check to the financial industry. In fact, *The Folly of Fools*, intended to outline a science of self-deception, offers a blasting critique of economics as a field. While admitting that he knows nothing about it, Trivers claims, "Economics acts like a science and it quacks like one … but it is not yet a science."

ECONOMISTS MISS THE POINT

Calling the economic concept of utility a shell game, Trivers, who is known for his theory of reciprocal altruism developed in the 1970s, criticizes the field for ignoring the biological definition of utility; namely "the individual's inclusive fitness; that is, the number of its surviving offspring plus effects (positive and negative) on the reproductive success of relatives." While this more comprehensive definition may not always make a difference, by ignoring it, economists miss out on a whole series of linkages, Trivers says.

"If only thirty years ago, economists had built a theory of economic utility on a theory of biological self-interest," he explains, "we might have been spared some of the extravagances of economic thought regarding, for example, built-in anti-deception mechanisms kicking in to protect us from the harmful effects of unrestrained economic egotism by those already at the top."

While Trivers enjoys being blunt and is hardly timid in his use of language to make a point – neither in his book nor in the interview for this magazine – his logic of deceit and self-deception feeding into each other as a unitary subject is relevant to the financial industry among others. "Take bubbles, for instance. There's a real process of group self-deception going on here that manifests itself in the notion that things can keep going up, up, up. But brother, you people don't see what is going to happen."

Trivers' central claim is that self-deception evolves in the interest of deceiving others on all levels – from gene to cell to social group – aided by the reality that the conscious mind is often an observer after the fact, with the unconscious mind becoming the facilitator of self-deception. "The key to defining self-deception is that true information is preferentially excluded from consciousness," Trivers writes. False information, or reality, he goes on to argue, is stored in the unconscious to better hide it from others.

The *Folly of Fools* is an entertaining read, thanks to Trivers' conversational tone. Yet, the question remains: how can the theory of self-deception be made useful? Francis Mechner, retired professor of psychology at Columbia University, has his doubts. "Since the times of Sigmund Freud, psychology has more or less stopped thinking in terms of the unconscious. To me, the value of this book lies in the richness of examples Trivers lists."

Who's fooling who?

BEYOND PROFITS

Inspired as much by Mahatma Gandhi as capitalist principles, the Bajaj Group is a company with a vision that goes beyond profits, says Sanjiv Bajaj, the youngest son of famed entrepreneur Rahul Bajaj.

Rahul Bajaj with his wife, Ruparani. Rahul took over the family business from his father Jamnalal Bajaj in 1965 and has since passed it on to his own son, Sanjiv.

Why did the Bajaj Group, which was really known as a scooter company, decide to go into financial services?
The interesting answer to that is that we didn't. When the government opened up the insurance market to the private sector in the late 1990s, a number of foreign insurers were interested. However, as regulation restricted them to owning 26% of an Indian company, they needed a local partner. A number of foreign companies approached Bajaj for a partnership. It was my father who dealt with them, but he maintained that we should focus on what we did well already and build our existing businesses to world-class companies: motorcycles, auto-rickshaws, electrical appliances and steel. Insurance was not something that we should shoot for.

So what changed your minds?
We realized that insurance could be an interesting way to develop a financial services business. We had a small finance company that gave loans against our own motorcycles, that was our limited presence in financial services. What triggered the Bajaj Allianz cooperation was the tremendous comfort that we had with Allianz when they approached us.

We believe in running our operations with the highest level of integrity and transparency. We also like to build businesses based on long-term sustainability and profit. Allianz were keen to find a partner in India who thought in the same conservative long-term manner as them. We believed that it was a good opportunity. It took a lot of convincing to get us involved in the partnership, but I am glad that we did that, though to be honest, I don't think any of us expected the business to grow to be as successful as it is today.

The philosophical underpinnings of the Bajaj Group are quite unique. I refer to Jamanalal, your great grandfather, and his belief that inherited wealth is a sacred trust to be used for the benefit of the people, as well as his close association with Mahatma Gandhi.
That is absolutely correct. The values that exist across our businesses are based on those he got from Gandhiji. Of course, as the business develops, you do what you need to do to continue to build it. But we are very clear we will never compromise on ethics or transparency.

» PROFIT IS THE MEANS, BUT NEVER THE END GOAL. YOUR END GOAL HAS TO BE TO DO SOMETHING BETTER THAN SOMEONE ELSE. «
SANJIV BAJAJ

On that point, in 2011 India dropped 11 places on the Transparency International Corruption Index. Is corruption in India getting worse?
Previously corruption existed when the government was handing out big contracts. In some areas there was an unholy axis between business and government, but once you received your license you built a business based on your own capabilities. Over the last ten years it has become far unhealthier with some businesses proactively paying certain politicians for specific favors. This blew up dramatically, amongst other examples, during the ☞

More than a business: Sanjiv Bajaj believes the Bajaj Group has a social and ethical responsibilty in his native India.

Commonwealth Games preparations. This is affecting business sentiment in India and has contributed to the economic slowdown. I honestly wouldn't mind if the economy slowed down for a couple of years in order to clean this out. I believe India has such great promise that you can't afford for a few corrupt people – business people, politicians or bureaucrats – to hold the country to ransom. An honest person must be able to work in this country and it's getting increasingly difficult to do so.

Is the Indian economy really performing as badly as is being currently reported?
We were growing at 9%, but are now at 5%. Optimists say that almost anywhere else in the world today one would be exceedingly happy with 5%, but they forget our inflation rate is 8%. If you look at our per capita income, we are at less than $2,000 per person per year. If we can grow at 9%, but are only growing at 5% we are missing the opportunity to bring 15 to 16 million people out of poverty over the next five years.

We have a large, young and increasingly literate population that will have huge demands and also the ability to fulfill them. Our economy could be firing on all cylinders in terms of both producing jobs and consumption based largely upon our own internal needs. This huge domestic strength is evident if you look back to 2008/2009 when the West slowed down. Our GDP growth rate dropped, but only to 8.5%. That we now languish at 5% is frustrating because we are solely responsible for driving ourselves down to that lower number.

» THE OPPORTUNITY FOR INDIA IS ALMOST LIMITLESS. «
SANJIV BAJAJ

Your great grandfather was a famed philanthropist and an important member of Gandhi's inner circle. Your father, Rahul, is a legendary entrepreneur who built Bajaj into one of the world's leading automotive companies. What was it like growing up in the shadow of giants?
We grew up going to a school five minutes away from home. My classmates' parents were employed in middle management by Bajaj, or were drivers, or employees in various companies. It was an unassuming environment, so much so that it took us quite a while to realize what it meant to be a "Bajaj." This was due to my mother. She was a teacher before she got married and came from a middle class, but very cultured and well-educated family. She insisted on a simple environment that helped us keep a level head, and this still helps us today.

What core values of your great grandfather are still evident in the business?
A high level of ethics. Transparency. Long-term value creation. Customer service and a focus on employees. In my great grandfather's writings, he talks about Mahatma Gandhi telling him to build businesses for public good. I recall we once had a renowned speaker at our companies and we asked him what is the role of a profitable business? He said, for a company, people are the purpose. People can be customers or employees, but people are the purpose. Profit is the means, but never the end goal. Your end goal has to be to do something better than someone else, only then will your products sell, only then will your best employees stay with you to build a better future, but you need to be profitable to do that.

While you were ticking off points on your finger, I think you missed the philanthropic aspect. The Bajaj family has a lot of charitable trusts.
Yes, but we are quiet on that front as they are not part of the business. We know we have a social responsibility, but we just don't give our money away to good causes. We try to execute in the right manner. That is why we have a dedicated team involved in our social activities, whether it is education, health care, or building self-independence and sustainability in over one hundred villages. This includes teaching women how to do small jobs such that they can make enough money to manage their houses, or ensuring basic things like education and health are available for their families. There are many things we are involved with, but, unfortunately, with half our population surviving on less than $1 a day, whatever we do is nowhere near enough.

Many western companies headed by CEOs of the Gordon Gecko school would say that really the corporate social responsibility stuff is just PR. How would you respond?
When I did my MBA at the Harvard Business School, we were drilled by some to say that the role of an enterprise is only to make money. You make the money, you share it with your shareholders and they do what they want with it. Getting into social work is not the role of the company,

I think it's more obvious today that for any enterprise to be seen as successful, stakeholders expect it to be responsible. And responsibility is not just to your shareholders, it's to customers, employees, society and the environment. It's not just a question of quarterly or yearly profits, but impact on the long-term future. Today, you do have to take a larger view of society, but where you draw the line is for each business to decide.

You are still on the board at Bajaj Auto, so we can look forward to the Bajaj Group releasing environmentally friendly three-wheelers?
We already have. We were the first to launch, almost ten years ago, three-wheel rickshaws running on alternate fuels. At the Taj Mahal, for example, the elderly and disabled people can use rickshaws from us running on electricity. We have a number of other technologies that we are working on to make our vehicles more fuel efficient and less polluting. The motorcycles we make today have 100cc engines, and are amongst the most fuel efficient in the world. They typically give 85 kilometers per liter of petrol. It's cheaper to use them than to use public transport.

Where do you hope Bajaj Allianz, Bajaj FinServ and India will be in ten years?
The opportunity for India is almost limitless. If a country like China could grow at 8-9% plus per year for 25 years there is no reason why India cannot do that. Some 70% of our population is under 30 and we are a very literate, tolerant and capable society. I also believe India, because of its non-aligned, non-aggressive foreign policies, could play a responsible role in the global sphere.

Specifically, I think financial services in India should grow at 2-2.5 times the GDP growth rate, which means that over the next ten to 20 years we are talking about 20% growth rates. That is a very large opportunity and the challenge for us is to continue to build profitable and responsible businesses that we can be proud of.

IS SOLVENCY II SUITABLE FOR IORPS?

Solvency II-like regulations could be applied to European occupational pensions, but is it really the best approach?

By Martina Bätzel, Bernhard Holwegler

Early last year, the European Commission released the *Adequate, Safe and Sustainable Pensions* whitepaper. The topic has been on the agenda of the Commission for some time. One of the crucial questions concerns the design of the regulatory and supervisory framework that supports the delivery of secure and adequate retirement incomes throughout Europe.

Occupational pensions, the second pension pillar standing aside social security pensions (first pillar) and private pensions (third pillar), are regulated via the directive on the activities and supervision of institutions for occupational retirement provision. This is known more practically as the IORP Directive.

» WHAT IS NECESSARY IS A THOROUGH EXPLORATION OF THE EFFECTS OF A NEW SOLVENCY REGIME FOR IORPS BEFORE IT IS IMPLEMENTED. «
MARTINA BÄTZEL, BERNHARD HOLWEGLER

A proposed revision of the directive has sparked intense and sometimes heated discussion as to what an adequate regulatory framework for occupational pensions should look like. The Commission's approach is to use the revised regulatory framework for the European insurance sector (known as Solvency II) as a starting point.

Solvency II is a consistent risk-based approach to regulation and supervision. The framework comprises three areas (also called pillars). These are risk quantification, that is rules for calculating technical provisions, and minimum and solvency capital requirements; risk management and governance, including principles of supervision and supervisory powers; and risk disclosure, that is transparency, supervisory reporting and public disclosure. A similar risk-based regulatory framework exists for banking and is known as Basel II or, respectively, Basel III.

The idea of a risk-based approach to the IORP revision is widely accepted as this would provide a consistent regulatory framework to the financial industry in Europe as a whole, encompassing banks, insurance companies and institutions for occupational retirement provision. This was one of the rationales for the implementation of IORP I, as the current IORP Directive is often called.

But the devil is in the detail. Stakeholders of occupational pensions have pointed out that their industry has characteristics that make occupational pensions unique – not just a special form of insurance business.

QUESTIONABLE ARGUMENTS

First, there are more than 180,000 IORPs in Europe (compared to 5,000 insurance companies) and many are small entities set up by a single employer/sponsor. These IORPs are often not-for-profit institutions under the governance of employers and/or the social partners.

Second, IORPs can usually rely on backing and funding from one or several employers/sponsors. As part of this, there are often additional security mechanisms in existence, protecting beneficiaries in the case of insolvency of the plan sponsor.

Third, IORPs are not only regulated by supervisory authorities, but in many countries labor, tax and social security laws constrain their behavior. Against this background, the level-playing-field argument, which states IORPs compete with insurance companies and should be subjected to identical regulation is at least questionable.

Of the three pillars forming Solvency II, the transfer of pillar 2 (risk management and governance) and pillar 3 (risk disclosure) to IORPs is largely accepted by stakeholders. This is provided that the principles of proportionality and materiality are reflected in the regulatory framework and supervisory practice. However, the quantitative requirements of Solvency II (pillar 1) have evoked heated discussion.

ATTENTION TO DETAIL

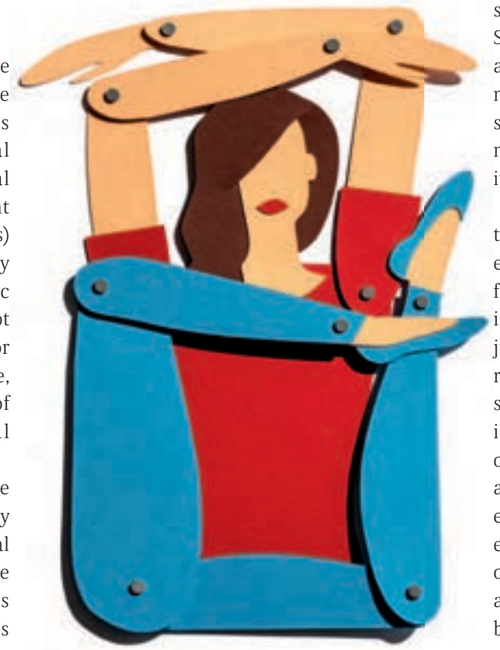
Objectors argue that the application of Solvency II-like quantitative requirements could result in additional burdens (via solvency capital requirements, which might finally be imposed on sponsors) for IORPs. This is particularly true if the specific characteristics of IORPs are not comprehensively accounted for – and how could they be, considering the variety of vehicles and national frameworks?

If, on the other hand, the application of new solvency rules did not result in additional capital requirements, then the security level for beneficiaries would remain unchanged. This could result if, for example, the regulations take into account sponsor support or insolvency protection schemes. In such a situation, the new solvency rules would then be an extra bureaucratic burden without any additional benefit.

Advocates of Solvency II for IORPs argue that new solvency rules could lead IORPs to change the allocation of security assets, switching to less risky assets to keep their solvency capital requirement low and thereby raising security for the beneficiaries (or sponsors). However, less risk usually equals less return, so the Commission should keep in mind that the aim of European policy is not just safe pensions, but adequate retirement incomes as well.

In addition, stakeholders point out that the duration of liabilities of IORPs is significantly longer than that of insurance companies. Therefore the impact of the volatility of assets – and the demand for solvency capital – is not comparable to insurance companies.

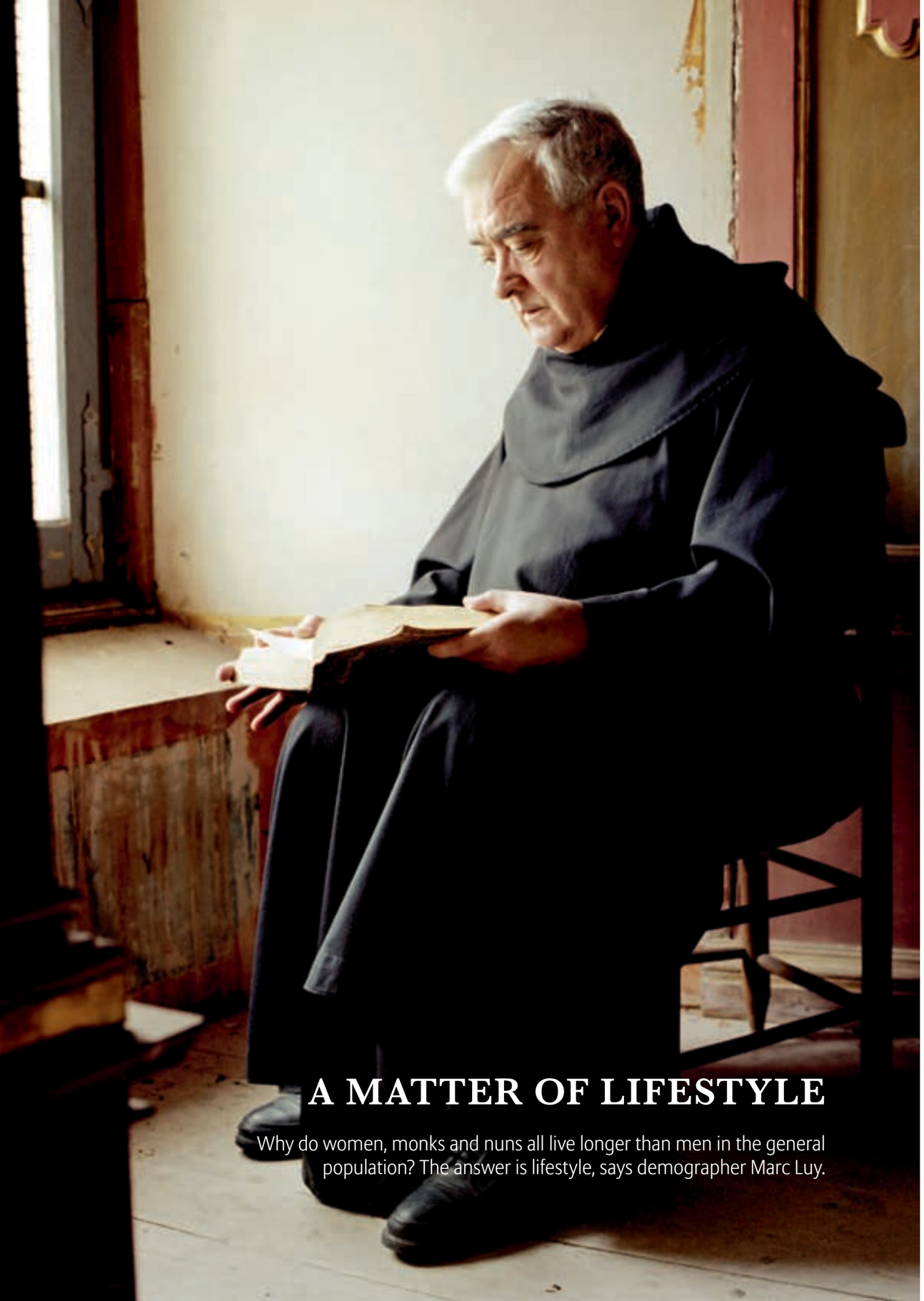
In order to take into account the particularities of IORPs, it is proposed to establish a holistic balance sheet. On this balance sheet, any risk-mitigating mechanisms of IORPs should be recognized and measured as additional assets, which would then reduce solvency capital requirements. Stakeholders again argue that any difference in the business model should be reflected in the supervisory framework itself, not only in recognition of single items in the balance sheet.



An uncomfortable fit: Are Solvency II-like regulations really suited to the occupational pension sector?

What is necessary is a thorough exploration of the effects of a new solvency regime for IORPs before it is implemented. This should not just focus on the effects of regulations on the balance sheet of a single IORP, but take into account the system of occupational pension provision as a whole. It should also assess effects on the willingness of employers to provide occupational pensions as well as on benefit levels for the beneficiaries. Last, it should examine the effect of regulation-induced parallel behavior of all IORPs on the stability of financial markets (pro-cyclicality of regulation).

There is no need for undue haste, especially given that there have been multiple Quantitative Impact Studies (QIS 1–5) and repeated postponements of the implementation of the complete Solvency II framework for the insurance sector. In the same manner, the Commission should take time for a thorough investigation and evaluation of an adequate regulation for occupational pensions.



A MATTER OF LIFESTYLE

Why do women, monks and nuns all live longer than men in the general population? The answer is lifestyle, says demographer Marc Luy.

» IT'S NOT THAT WOMEN LIVE LONGER. IT'S ABOUT MEN DYING EARLIER. «
MARC LUY

Women outlive men in all but six countries and these are among the most impoverished and destitute on earth, according to the United Nations Development Programme. Yet, the shorter male life span is no reason to pity men.

"It is not that women live longer. It's about men dying earlier," explains Marc Luy, a soft-spoken researcher from the Vienna Institute of Demography and author of the "Cloister Study."

The debate about gender life-expectancy dates to the mid-18th century when the female edge in longevity first became known. Since then, arguments about the reasons have fallen into two broad camps. The causes for male excess mortality were assumed to be either biological or environmental. Luy's study of nuns and monks living in cloisters shows that lifestyle and environment seem to influence life expectancies of men and women stronger than biological factors.

Luy has not been the first demographer to look at cloistered populations. French mathematician Antoine Deparcieux published his "Essay on the Probabilities of the Duration of Human Life" based on data from religious communities as early as 1746.

Father Francis C. Madigan studied monks' and nuns' data in the United States between 1900 and 1954. He concluded that biological factors are more important to life expectancy than socio-cultural and economic factors. While the cloister study suggests the opposite, Luy stresses the importance of biological factors. Prenatal losses and infant mortality cannot be attributed to behavior.

"A SPECTACULAR RESULT"

The 42-year-old head of a research group on health and mortality has been fascinated with this issue since his student days. At university, he learned that women in post-war Germany live up to six years longer than men. The gap is even greater in the United States, England and Wales. This puzzled him and the phenomenon became his master's thesis.

"I was trying to conceive of an experiment to study the causes for earlier male mortality when thanks to my mother, who taught at a monastery's boarding school, I realized such experiments have been conducted for thousands of years – in cloisters," he recalls.

"There, populations of monks and nuns live under similar conditions, so they provide a near-perfect sample to try to understand the biological versus environmental factors in life expectancy."

For his cloister study, Luy collected data on 11,624 monks and nuns from twelve monasteries in southern Germany, covering a period of more than four centuries up until 1995. Among the sources was the "profession book" which lists all members, their life stories as well as cause of death.

In "Causes of Male Excess Mortality: Insights from Cloistered Populations"* and subsequent publications, Luy clearly shows that monks and women experienced similar increases in life expectancy until the 1970s (see graph). At the time, a typical 25-year old woman and similar aged nun could look forward to 51 more years of life. In comparison, a 25-year old male could only expect 45-46 more years on average. However, monks could expect up to 50 years, five more than the general male population. "That was a spectacular result," Luy says of his findings. "It shows gender specific differences in life expectancy can be reduced from six years to one or less when lifestyles are harmonized. In the end, biological factors seem to account for no more than a year in life expectancy between men and women."

THE BENEFITS OF CLOISTER LIFE

In short, the study shows life expectancy is not so much influenced by sex but by lifestyle. Men simply bear the consequences of their more risky lifestyle, but many of these factors can be influenced if men desire to live longer.

"While not all components of a long and healthy life can be controlled by the individual, much of our life expectancy is affected by man-made circumstances. These include social, political, economic, demographic and behavioral factors such as a stressful work environment or smoking," sums up Luy. ☞

* published in *Population and Development Review 29*(4), December 2003

When he presented his findings, monks often attributed their long lives to a regular daily routine.“ Many also pointed to a smooth transition into old age,” Luy comments. Ongoing responsibilities were often considered beneficial by elder monks.

Abbot president Jeremias Schroeder agrees. “In St. Ottilien, a brother’s 65th birthday, traditionally the official retirement entry age in many countries, is celebrated like any other birthday.” The Benedictine community of 100 brothers, nestled into the rolling hills of Bavaria, is one of the monasteries that provided data for Luy’s study.

“Retaining a degree of responsibility in old age is visibly beneficial to the elderly members of our monastery. It often leads to healthier and more active aging,” Schroeder says. St. Ottilien has no retirement phase in the worldly sense of the word. Instead, a change of tasks is discussed between the brother and the archabbot.

The fact that non-working monks continue to be included in the community likely adds to their wellbeing. While they pay into the German state pension system, benefits go directly to the monastery and the individual member is fed and clothed regardless of how much he works. The monastery also maintains a care unit for those too weak to take care of themselves.

“We have no private property,” says Schroeder. "Elder brothers contribute to the community to the best of their abilities and if that decreases in old age, so be it. As a collective, we care for each other from the time of entry until the end.”

NARROWING THE GAP

Curiously, official data shows that the gender mortality gap appears to be closing since the early 1980s. It is not so much that men are narrowing the gap, but that women in the general population are adopting the more harmful male way of life.

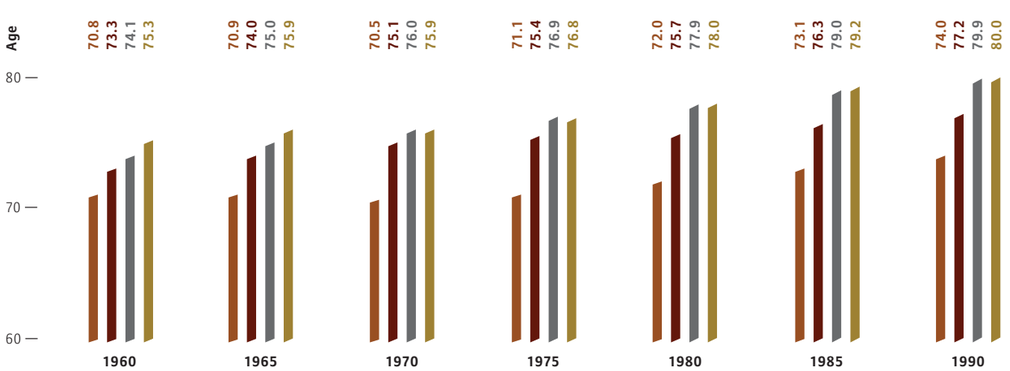
“More women have been entering the workforce, experiencing the stress that can come with professional jobs and taking up the habits men use to cope, such as drinking and smoking more. This is reflected in the data and the effects can be clearly seen in the trends.”

The cloister study is now extended to health. “We know that it is not biological factors that primarily influence longevity.” To find the key to aging healthily, Luy now works to understand the factors influencing the years spent in good or bad health.

For more information, see an interactive version of the graph at: **projectm-online.com/xxxxxxxx**

WHAT DETERMINES LONGEVITY – GENETICS OR LIFESTYLE?

Life expectancy at age 25 for women, men, monks and nuns.



Source: *Deutsch-Österreichische Klösterstudie*, Vienna Institute of Demography

A quiet lifestyle free from stress and unhealthy habits allows monks to outlive men in the general population.

Ólafur Jónasson (r) provides shelter and inspiration in the wild.

LIGHT ON A LONELY SEA

Distance is no tyranny for Ólafur Jónasson as he seeks to create an artistic haven in the Icelandic wilderness. On the contrary – this isolated and wild place attracts artists, writers and musicians seeking solitude and inspiration.

NAME
Ólafur Jónasson
PROFESSION
Freelance stage designer
TRUE CALLING
Innkeeper of Icelandic art

What is surely the world's most remote art gallery is located in a small lighthouse on the windswept northwestern tip of Iceland. Known as Galtarviti, it can only be reached by boat or a four-hour hike across a mountain range that locals say is the home of elves and trolls. Built in 1956 as a beacon for ships braving their way around the headlands, Galtarviti has become popular with artists seeking solitude.

Ólafur Jónasson, a 45-year-old freelance stage designer, purchased the caretaker cottages and the surrounding land, including the two brooding mountains that separate it from the outside world, 12 years ago – for the price of an old car. He then began turning it into a cultural destination. Against the odds, he is succeeding.

A wilder, more barren wilderness is hard to imagine; the raw, natural beauty has inspired several writers who have dwelled in residency. A growing body of music has been composed there too. Múm, an internationally famed Icelandic band, featured the lighthouse in a video after recording at Galtarviti's basic studio. In collaboration with the Kling & Bang gallery from Reykjavík, 30 Icelandic artists also paid recent tribute to Galtarviti in an exhibition called *Echo of the North*, staged inside the lighthouse itself. Most recently, artist Hrafnkell Sigurðsson held an on-site exhibition for the 2012 summer solstice.

TALES AND LEGENDS

During winter, Jónasson works in the capital Reykjavík, but in summer, home is the lighthouse cottages. "Galtarviti is a telephone- and Internet-free zone," he joyfully informs guests. Not only is communication with the outside world not possible, it isn't even desired.

For Jónasson, it is a pleasure to act as guide. Without exertion he clambers across the stony landscape. It is said that during one dark Icelandic winter, he even carried the small harmonium that stands in the guesthouse alone over the mountains. This is perhaps a tall story, but as in earlier times, before mobile networks, people sit around late into the night at Galtarviti exchanging stories that are fast becoming local legends.

RECOGNITION FOR PROJECT M PRINT AND ONLINE IN 2011/2012/2013

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ASTRID AWARDS: Bronze (Custom Publications: Financial Services)
BEST OF CORPORATE PUBLISHING: Silver (Financial Services); Silver (Special Award: International Communication); Silver (Digital Communications); Silver (Best Digital Solution B2B)
GALAXY AWARDS: Gold (Website, Online Media); Honors (Financial Services); Best of Website Grand Award (Online Media)
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