Pensions With Purpose
Meeting the Retirement Challenge

Featuring the findings of the State Street 2015 Asset Owners Survey
This Is State Street

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*Assets under management include approximately $22 billion as of December 31, 2015, for which State Street Global Markets, LLC, an affiliate of SSGA, serves as the distribution agent.

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Research at a Glance

This report is based on a State Street survey of 400 senior executives in the pension fund industry conducted by Longitude Research in October and November 2015. Respondents to the global survey included representatives of public and private pension or retirement systems, and superannuation funds across 20 countries. The quantitative research was supplemented by in-depth interviews with 43 pension industry experts from 13 countries.

- Predominantly board and C-level respondents
- 29 percent Defined Benefit (DB)-only, 20 percent Defined Contribution (DC)-only, 51 percent have both DB and DC schemes
- Insights from pension fund board members, in-house and external investment managers, private and public funds, consultants, academics, and State Street experts [see our Executive Q&A Library]
- Identifies five areas where pension funds should act:
  - Own the Outcome
  - Own the Strategy
  - Own the Risks
  - Own the Efficiency
  - Own the Talent

Please note all sources are based on the above State Street survey unless otherwise indicated.
Respondents by Region

* The base is all respondents whose funds have some defined benefit (DB) component.  
Source: State Street Asset Owners Survey 2015

Range of Total Assets Overseen

<table>
<thead>
<tr>
<th>Range of Total Assets</th>
<th>Percentage</th>
</tr>
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<tbody>
<tr>
<td>$10 billion or more</td>
<td>22%</td>
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<tr>
<td>$5 billion-$9.9 billion</td>
<td>28%</td>
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<tr>
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<tr>
<td>$500 million-$999 million</td>
<td>6%</td>
</tr>
<tr>
<td>Less than $500 million</td>
<td>2%</td>
</tr>
</tbody>
</table>

Institution Type

- Private pension or retirement system: 68%
- Public pension or retirement system: 25%
- Superannuation fund: 7%
Executive Summary
The global pension industry faces some significant challenges in its mission to deliver optimal retirement outcomes for plan participants. Pension funds should rethink their strategies in the face of historically low interest rates, demographic shifts, persistent market volatility and funding pressures.

To succeed in this environment, pension funds need to establish “mission clarity” — by defining a sustainable strategy that will deliver an acceptable level of retirement income for their members. Leading pension funds are taking greater ownership of member outcomes. They are becoming more transparent and professional in managing risk and reporting performance. They are growing more sophisticated in how they manage a greater range of alternative assets and investment strategies. And they are redesigning their governance frameworks, for a more challenging future environment. There’s no universal one-size-fits-all approach. The size of the fund, its available resources and the scale of its liabilities will play a part in determining the best course for success. However, our latest research identifies five areas where all pension funds should act if they are to take control of their future.

92% will upgrade at least one of their governance aspects in 2016

35% are planning to pool assets and liabilities within the next three years
Pensions with Purpose
Faced with aging populations and uncertain markets, the most innovative pension funds are proceeding with a confidence that comes from clear ownership of the challenges ahead.

Own the Outcome
Governance is getting an upgrade as pension funds get fit for purpose

Own the Strategy
Pension funds search for a new model to meet changing retirement needs

Own the Risks
Funds pursuing higher returns are upgrading their risk-management capabilities

Own the Efficiency
Pension funds consolidate to reduce costs, boost efficiency and improve oversight

Own the Talent
Pension funds must stand on their own two feet — balancing a mix of in-house and outsourced capabilities

Own the Outcome
Strong governance is key to pension funds executing on their strategies and realizing the outcomes required by members. The vast majority will need to adapt their existing governance models — at least in part — if they are to fulfill their objectives. According to our research, 92 percent of funds will upgrade at least one of their governance aspects in 2016.

Own the Strategy
Pension funds are searching for a new model to meet changing retirement needs. External pressures such as demographic shifts and low interest rates are driving transformation in the industry. Alternative investment asset classes are gaining mainstream appeal and more funds are embracing environmental, social and governance (ESG) investing. In addition, more than half of the funds in our survey expect their institution to introduce a defined contribution scheme or hybrid model in the next three years.
Own the Risks
The industry faces stark choices around risk. Our survey indicates that more than one-third (36 percent) of pension funds are ready to take on additional risk to boost investment returns, while 45 percent are actively looking for ways to decrease the overall risk within their investment portfolios. Both options require a more sophisticated understanding of diverse risks, including longevity risk, liquidity risk and operational risk. The shift into alternatives will also put pressure on pension funds to improve risk management across these less familiar asset classes.

Own the Efficiency
Some pension funds are pooling assets or consolidating schemes to save cost, improve visibility on risk and enhance overall performance. More than one-third (35 percent) in our survey are planning to pool assets and liabilities within the next three years. Gains may be made through sharing information and ideas, while new partnerships can grant access to previously unattainable investment opportunities.

Own the Talent
Pension funds are ramping up internal investment and risk teams as well as bringing aspects of their investment management in-house. Almost half of pension fund professionals surveyed expect to expand both their internal investment and internal risk teams over the next three years. They will be more discerning in their use of consultants and asset managers too. They will look for external advisors to add value in new areas.
#1
Own the Outcome
Pension funds are upgrading their governance in response to mounting external pressures.

They need more reliable, accurate ways of tracking risk and performance as market volatility persists into 2016. Meanwhile, the aging global population, in combination with historically low interest rates, is pushing pension funds into a broader range of asset classes in search of higher investment returns.

Strong governance will be integral to delivering transparency across complex, multi-asset portfolios — for the benefit of in-house teams, for scheme members, and for regulators that continue to scrutinize the industry.

Improved governance structures will also be important in providing the agility needed to seize new investment opportunities, while ensuring that risk tolerance levels are not exceeded. "We see good governance as the means by

Overhauling Governance Models

Is your institution planning to take any of the following actions to support its governance over the next year?*

- Adjust the balance of responsibilities between board and management: 50%
- Adjust the balance of responsibilities between board and management: 50%
- Increase training and education opportunities for board members: 45%
- Change the process for recruiting new board members: 44%
- Increase transparency to members about the governance and investment performance of the fund: 41%
- Revise incentive models: 42%

* The base is all respondents whose funds have some defined benefit [DB] component.

Source: State Street Asset Owners Survey 2015
which ideas on paper can be turned into actual investment returns,” says David Aleppo, Head of DB Investment Advisory Services (UK) at Willis Towers Watson.

The old models may need to be overhauled. Our survey shows that many funds have not yet optimized critical elements of governance — including board composition, the balance of responsibilities between the board and investment staff, and transparency of reporting — that will allow them to execute new investment strategies.

**Evolving the Board**

Many pension funds recognize that governance can be improved: Few of our survey respondents feel their current board is sufficiently equipped for the key challenges in today’s investment environment.

For example, fewer than 1 in 4 respondents say their board has high levels of expertise in alternative assets. The same modest percentage says their board is highly effective at assessing general investment literacy.

**Gaps in Board Capabilities**

How would you rate the knowledge and expertise of your institution’s governing fiduciaries in the following areas?

*Respondents who believe their board has a high level of:*

- General investment literacy: 38%
- Understanding of risks facing the retirement fund: 36%
- Ability to think beyond short-term issues: 32%
- Ability to accurately assess investment managers’ performance: 23%
- Expertise on alternative assets: 23%

*Note: The base is all respondents whose funds have some defined benefit (DB) component. Source: State Street Asset Owners Survey 2015*
the performance of external investment managers. Nearly half (45 percent) intend to increase training and education opportunities for board members in the next year.

As Keith Ambachtsheer, Director Emeritus of the Rotman International Centre for Pension Management, points out, pension boards need a balanced representation of key stakeholders with expertise in strategic management, human resources policy, finance and investing.

According to Oxford University Professor Gordon Clark, leading funds in the UK are attempting to bolster investment knowledge on their boards. In part, this is to help them pursue compound investment strategies that combine approaches such as index tracking and thematic equity investing in the same portfolio. These are designed to reduce the variance in returns over the longer term. “Some boards have been adding independent trustees who have expertise in a specific area. There’s a lot more bespoke education happening, and boards are meeting more frequently to address issues where they’re unfamiliar,” says Professor Clark.

In-house investment professionals as well as specialist external consultants are increasingly driving education of the board. “The investment division within the pension scheme needs to be solid enough in the eyes of the board so that it can be relied upon to deliver the right information and advice. The investment team can play a greater role in improving the board’s knowledge,” says Antonio Iaquinta, Head of Institutional Business, Italy, at State Street Global Advisors.

“Some boards have been adding independent trustees who have expertise in a specific area. There’s a lot more bespoke education happening, and boards are meeting more frequently to address issues where they’re unfamiliar.”

PROFESSOR GORDON CLARK
Oxford University
Our survey also highlights scope for pension funds to create greater transparency around risk and performance. As funds pursue non-traditional investment strategies, regulators will likely demand this transparency. Funds will also need their external partners — including asset managers and consultants — to offer greater assistance in delivering this transparency.

Further, as the industry shift intensifies from defined benefit (DB) to defined contribution (DC), scheme members will need greater insight — 43 percent of those institutions that have both a DB and DC pension vehicle will seek to increase transparency to members about the governance and investment performance of the fund in the next 12 months.

Streamlining Decision-making
Pension funds need to strike a balance. They need to empower investment managers to act swiftly in response to new opportunities and risks, while still ensuring transparency and oversight at the board level. It can be a difficult equation to get right.
Our survey respondents recognize the need for a more streamlined approach to governance: Half of respondents will adjust the balance of responsibilities between the board and management in the next year.

The first step in designing such a structure is for the board to articulate its mission clearly and to set well-defined risk parameters. Only then can the investment team be handed greater autonomy with full confidence. “A clear mission becomes the framework by which an investor can consider and assess every investment opportunity that is taken to them, so they can ask ‘Is the allocation to X, Y, Z asset class consistent with our mission?’” says David Aleppo at Willis Towers Watson. “If you’ve got a clear mission — and clear investment beliefs underpinning it — you can react more quickly to unexpected events or new opportunities.”

In addition, by adapting the investment team’s incentive models appropriately, pension funds can empower the team while ensuring their activity is aligned to the fund’s long-term strategic objectives. In our survey, nearly half (42 percent) of those funds that intend to increase the autonomy of the investment function in the next year will also revise their incentive models.

At the Church Pension Fund (CPF) in the US, Chair of the Trustee Board Barbara Creed says they’re already benefiting from recent efforts to redefine the responsibilities of the board and staff: “We’ve cut the number of committees and delegated some functions to staff, and we’re spending more time looking at the issues of major long-term concern to the organization rather than focusing on what’s happening today.” While some of the focus may have shifted away from scrutinizing daily performance, the board has also put checks in place to bring short-term concerns to its immediate attention.

“An investor can consider and assess every investment opportunity that is taken to them, so they can ask ‘Is the allocation to X, Y, Z asset class consistent with our mission?’” says David Aleppo at Willis Towers Watson. “If you’ve got a clear mission — and clear investment beliefs underpinning it — you can react more quickly to unexpected events or new opportunities.”

DAVID ALEPPO
Head of DB Investment Advisory Services [UK] at Willis Towers Watson
Governance Leaders Take Bold Steps to Deliver Better Outcomes

Our survey identifies a group of Governance Leaders that fully recognize the need to optimize their governance. We have defined this group as those respondents that are taking actions to upgrade four or more areas of their governance models in the next 12 months.

By adopting an advanced approach to governance, the Governance Leaders are giving themselves the best chance to achieve strong member outcomes while managing risk exposure. They are:

- Expecting to eliminate their deficits more quickly than the rest of the industry (an average of 7.4 years, compared to 9.3 years for other respondents)
- Shifting into alternative asset classes — such as hedge funds, real estate and private equity — to a greater extent (60 percent will increase hedge fund exposure in the next year, compared to 34 percent of others)
- Targeting environmental, social and governance (ESG) investing to help deliver returns supporting long-term liabilities of pension funds while meeting the demand for social responsibility (38 percent have a high interest in ESG, compared to just 18 percent of non-governance leaders)
- Prioritizing longevity, liquidity, investment and operational risk management (33 percent say investment risk is a very high priority, compared to just 19 percent of others).

See our governance special report for in-depth analysis and commentary on the Governance Leader group.
7 Steps to Becoming a Governance Leader

1. Optimizing balance of responsibilities — board vs. management
2. Increasing training/education opportunities
3. Changing board member recruitment
4. Revising incentive models
5. Increasing transparency to members
6. Increasing reporting frequency to board
7. Increasing autonomy of investment function

Note: The base is all respondents whose funds have some defined benefit (DB) component
Source: State Street Asset Owners Survey 2015
#2
Own the Strategy
Traditional investment strategies and scheme models employed by pension funds are under strain as funds seek to meet the future retirement needs of members. More than one in three (37 percent) DB respondents say their scheme is in deficit.

Pension funds will need to transform their investment strategies — and in many cases the structure of their schemes — to deliver sustainable outcomes for members. The industry must find new ways of generating higher investment returns as equity and bond markets continue to struggle. In the US, the S&P 500 declined 0.7 percent for 2015, its worst showing since the financial crisis in 2008, while the UK FTSE 100 Index lost nearly 7 percent. The start of 2016 saw the worst performance for global stock markets since the Great Depression, as bond yields remain at historically low levels.

DB Schemes Face Shortfalls Across Markets

Is your defined benefit scheme in deficit?

32% North America

37% Europe

42% Asia Pacific

Note: The base is all respondents whose funds have some defined benefit (DB) component
Source: State Street Asset Owners Survey 2015
“Over the past few years we’ve ramped up private equity, and to some extent hedge funds, and we’ve been doing a lot more private real estate.”

WILLIAM LEE
Chief Investment Officer at Kaiser Permanente

Transforming Investment
As pension funds seek to improve risk-adjusted returns, our survey indicates they are accelerating the move into alternative assets: Over the next three years, 51 percent will increase exposure to funds of hedge funds, 50 percent to real estate, 46 percent to private equity and 41 percent to infrastructure.

At Ilmarinen Mutual Pension Insurance Company in Finland, President and CEO Timo Ritakallio says increased allocation to alternatives is a core component of their investment strategy to 2020.*

We’re aiming to increase real estate investments from around 9 percent today up to more than 15 percent. And we have around 5 percent in private equity today and are seeking to take this to around 8 percent,” he says.

William Lee, Chief Investment Officer at Kaiser Permanente, tells a similar story: “Over the past few years we’ve ramped up private equity, and to some extent hedge funds, and we’ve been doing a lot more private real estate.”

The Shift to Alternatives Deepens
Is your institution planning to increase its exposure to any of the following alternative asset classes over the next three years?

- **51%** Funds of Hedge Funds
- **50%** Real Estate
- **46%** Private Equity
- **41%** Infrastructure
- **36%** Direct Loans
- **35%** Hedge Funds (single manager)

Note: The base is all respondents whose funds have some defined benefit (DB) component
Source: State Street Asset Owners Survey 2015

* Investment Strategy 2020, Ilmarinen
While our survey suggests that funds of hedge funds will see the greatest increase in allocation over the next three years, real estate and private equity are not far behind. Martin Sullivan, State Street’s Head of Asset Owner Solutions for the Americas, says that more public pension plans in the US are now looking to invest directly into alternative asset classes. “Public plans are making direct investments in real estate and private equity. The California Public Employees’ Retirement System (CalPERS) has already moved in this direction and now the smaller end of the market is also starting to look at this more closely,” he says. “In Canada, most large public pension plans have been investing directly in such asset classes for many years and achieved exceptionally strong returns. In some cases, the plans are overfunded.”

Direct debt has also become a more popular option. More than one-third (36 percent) of our survey respondents will increase their exposure to direct loans in the next three years. “We’ve seen a number of pension funds, including ourselves, moving much more into different types of credit, especially in light of banks being less willing to undertake loan credits,” says Jens-Christian Stougaard, Director of PensionDanmark, a Danish not-for-profit labor market pension fund. “This really opens up the market for pension funds to move in and provide those types of long-term credits in different sectors of the economy.”

Marco Chinni, Founder of Swiss consultancy Primecoach, believes that the pensions industry should work harder to capitalize on the long-term nature of its liability profile: “We see funds taking too much of a short-term view on investment performance. Their liabilities are long-term so they should be working to an investment horizon of at least 10 years.”

ESG Investing Gathers Momentum

Our research shows that pension funds will not only increase their exposure to alternative assets. It will also become more important to consider investments through the lens of sustainability as the global economy changes, and companies with responsible, sustainable practices form a better fit for meeting the long-term liabilities of pension funds.

According to the Global Sustainable Investment Association (GSIA), the sustainable investment market grew from $13.3 trillion at the start of 2012 to $21.4 trillion at the start of 2014, when it represented 30.2 percent of
professionally managed assets. Sarah McPhee, Senior Advisor on Sustainability at Norwegian financial services firm Storebrand, says growth in unfamiliar sectors represents a huge investment opportunity over the next few decades too. Storebrand is seeking to seize early-mover advantage. In 2014, it became one of the largest participants in Europe’s green bond market, increasing its investments in these assets by NOK 4 billion ($449.4 million).

The majority of our survey respondents see opportunity here as well. Over four-fifths (83 percent) express moderate or high interest in environmental, social and governance (ESG) investing over the next three years. Implementing successful ESG strategies will require a new approach to analyzing investment decisions that many pension funds may not be equipped for today. “I think the successful players will be the ones that change their entire front office because it’s a different investment theme — one that most people in the front office are not used to coping with,” says McPhee. “The front office will need people who understand the structural transition to a more sustainable economy, who can analyze that and invest in it.”

External consultants and investment managers will have an important role too. Of those respondents with a moderate or high interest in ESG investing, 76 percent say they are more likely to consider hiring a manager who has ESG capabilities than one who does not.

**Sustainable Strategies Move Up the Agenda**

Which best describes your institution’s anticipated level of interest in ESG investing over the next 3 years?

<table>
<thead>
<tr>
<th>Level of Interest</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>High</td>
<td>26%</td>
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<tr>
<td>Moderate</td>
<td>57%</td>
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<tr>
<td>Low</td>
<td>16%</td>
</tr>
<tr>
<td>None</td>
<td>1%</td>
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</table>

* The base is all respondents whose funds have some defined benefit (DB) component

Source: State Street Asset Owners Survey 2015
Pension funds face clear choices about the future structure of their schemes. They should consider whether a DB-only model is sustainable, or whether a shift to a hybrid DB-DC or DC-only model is necessary.

In the Netherlands — one of the few European countries still with a majority of DB schemes — Gerard Riemen, Managing Director of Pensioenfederatie, says the country’s system will become unmanageable if low interest rates persist: “In a DB system, this will eventually lead to either reduced benefits or higher premiums — neither are popular options.”

Our survey respondents paint a similar picture. More than half (56 percent) of DB-only funds believe their institution will introduce a DC scheme or a hybrid model within the next three years.

For funds that are making the transition, DC brings new rules for success. The most sophisticated providers will stand out through an IT infrastructure that delivers transparency and greater autonomy to plan participants, with respect to setting investment risk tolerance, for instance. They will also offer broader investment choice. In our survey, 76 percent of institutions that plan to introduce DC schemes say they have the overall infrastructure needed to successfully manage this transition and realize the benefits of the new structure.

**A Global Shift to DC is Underway**

Does your sponsoring institution have any plans to introduce a defined contribution scheme over the next 3 years?

North America: 70%

Europe: 53%

Asia Pacific: 45%

* The base is all respondents whose funds have some defined benefit (DB) component

Source: State Street Asset Owners Survey 2015
#3
Own the Risks
Pension funds face a dilemma on risk. They are torn between the desire to reduce investment risk and the need to seek the higher returns that come with a risk premium. The concern that plans will be unable to meet the increasing demands of their members is universal, but the “right” answer on risk strategy will be unique to each fund.

Our survey shows a clear divide in the industry with respect to risk appetite: 45 percent of respondents are looking for ways to decrease their investment risk profile [a group we’ve called the “Risk Cutters”], while 36 percent are pursuing higher-risk, higher-return strategies [“Return Hunters”]. Our survey shows that a greater proportion of private funds are Risk Cutters, while more of the public funds are Return Hunters [see chart on next page].

Martin Sullivan at State Street says many US funds are taking the question of risk a step further. They are assessing whether to take risk off the table by either paying out to participants now or...

An Industry Divided by Risk Appetite

What best describes your institution?

19%  
No change to risk profile

36%  
Increasing risk profile

45%  
Decreasing risk profile

Note: The base is all respondents whose funds have some defined benefit (DB) component
Source: State Street Asset Owners Survey 2015
obtaining cover from third-party insurers. This latter option is more accessible to private corporations than public sector pensions, thereby reinforcing a difference of approach. “Most of the public funds are underfunded, but as a matter of public policy they will remain in the market,” says Sullivan.

Upgrading the Risk Capability

Only 14 percent of our survey respondents rate themselves as highly effective at managing investment risk, while 15 percent say the same about liquidity risk. This is a real concern for pension funds, especially as many move into new investment areas that require specialist understanding of different risk types.

Alternative asset classes such as hedge funds, private equity and infrastructure expose funds to various types of investment and liquidity risks. In addition to requiring specialist investment knowledge, alternatives tend to be more illiquid and may tie up capital over a longer time period. Fewer than half (46 percent) of funds in our survey are confident they have achieved real transparency on the risk associated with alternative assets.

“As the pension industry moves into more real assets, the danger is that you’re moving away from the more transparent, volatility-based risk management where things are clearer because you have mark-to-market prices,” explains Guan Seng Khoo, Head of Enterprise Risk Management at Alberta Investment Management Corporation. “Now you’re going more into mark-to-model scenarios so you have to change your performance and risk metrics.”

Private and Public Plans Plot Different Paths

“Now you’re going more into mark-to-model scenarios so you have to change your performance and risk metrics.”

GUAN SENG KHOO
Head of Enterprise Risk Management at Alberta Investment Management Corporation

* The base is all respondents whose funds have some defined benefit (DB) component
Source: State Street Asset Owners Survey 2015
Funds need the capability to evaluate portfolio risk across a diverse range of assets. These risk tools must be able to aggregate and normalize data across all asset classes including private equity, hedge funds and derivatives while providing exposures, sensitivities and stressing the portfolio by asset type or in aggregate. Clients should also be able to incorporate liabilities within the risk analysis.

Some larger funds may have appropriate tools in-house that can be optimized for more sophisticated risk-testing, while smaller funds may need to seek outsourced solutions. As pension funds increasingly employ more sophisticated risk modeling, the accuracy of the data feeding the models becomes more significant. As we discuss in section 5 of this report, hiring new risk expertise will be key in enabling such increased sophistication in risk analysis.

As pension funds increasingly recognize the importance of applying more sophisticated risk modeling, the accuracy of the data that feeds those models grows in importance. But only 26 percent of respondents are highly confident in the reliability and accuracy of their risk data. This is an area of focus for the Church Pension Fund. “We’ve been honing our techniques for assessing risk as carefully as we can to make sure that future generations enjoy the same level of benefits that the current generation does,” says Barbara Creed.

Each pension fund will need a clear picture of the short- and long-term liabilities it could face, under different scenarios, to set the most appropriate overarching risk strategy. Whatever risk strategy it needs to pursue for the sake of its members, it’s clear that a combination of new skills, risk analytics tools and specialist knowledge will be required to succeed.

### Mastering the Risk Challenge

How effective do you believe your institution currently is at managing each type of risk?

**Effectiveness on Risk**

<table>
<thead>
<tr>
<th>Type</th>
<th>High</th>
<th>Medium</th>
<th>Low</th>
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<tbody>
<tr>
<td>Longevity</td>
<td>21%</td>
<td>73%</td>
<td>6%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>15%</td>
<td>81%</td>
<td>4%</td>
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<tr>
<td>Investment</td>
<td>14%</td>
<td>80%</td>
<td>6%</td>
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<tr>
<td>Operational</td>
<td>20%</td>
<td>80%</td>
<td>.03%</td>
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</tbody>
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Note: The base is all respondents whose funds have some defined benefit (DB) component
Source: State Street Asset Owners Survey 2015
#4
Own the Efficiency
Across the industry, many pension funds are under intense scrutiny by boards and stakeholders to cut costs.

“The beta for markets isn’t going to be as high as it has been and that places a greater emphasis on costs — we still think there’s far too much cost leakage in the industry,” says David Aleppo at Willis Towers Watson.

Some pension funds are turning to asset pooling to make efficiency gains. More than one-third (35 percent) of pension institutions surveyed are planning to pool assets and liabilities with other pension plans within the next three years. In other instances, pension funds are choosing to share resources, such as staff, to make savings. “In the Danish market, we’ve seen funds coming together to reduce the costs of administrative functions,” says Jens-Christian Stougaard of PensionDanmark.

Iain Cowell, Interim Head of Investment Affairs at the Pension and Lifetime Savings Association in the UK, says that consolidation could lead to reduced costs and more effective governance: “We encourage all UK pension schemes to explore the sharing of capabilities and investment opportunities. If more schemes pooled their expertise together it would help bring costs down but also increase the scope for innovation.”

**Cost Pressures are Industry-wide**

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<tr>
<th>Under Pressure to Cost-cut Across Fund Sizes</th>
<th>Under Pressure to Cost-cut Across Scheme Types</th>
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<tr>
<td>$10 billion or more</td>
<td>Defined contribution</td>
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<tr>
<td>$5 billion-$9.9 billion</td>
<td>Defined benefit/Defined contribution</td>
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<tr>
<td>$1 billion-$4.9 billion</td>
<td>Defined benefit</td>
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<td>$500 million-$999 million</td>
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<td></td>
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<tr>
<td>22%</td>
<td>68%</td>
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<td>28%</td>
<td>61%</td>
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<td>42%</td>
<td>52%</td>
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<td>2%</td>
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* The base is all respondents whose funds have some defined benefit (DB) component

Source: State Street Asset Owners Survey 2015
In the UK, some local authority funds are actively pursuing this strategy. At the end of 2014, for example, the Lancashire County Pension Fund and the London Pensions Fund Authority announced a partnership to create a £10 billion ($14.3 billion) pooled investment fund with the aim of bolstering internal investment expertise and liability management.*

Meanwhile, the German government has advocated a plan for strengthening occupational pensions and increasing coverage that would involve large-scale consolidation. “Politically, there’s a drive toward creating industry-wide funds to help those smaller players who would otherwise look to an insurance solution to manage their liabilities,” says Nikolaus Schmidt-Narischkin, Director of Consulting Services (Germany) at Willis Towers Watson. The German government has commissioned external legal experts to further research its proposals, and they are due to submit a final report in March 2016.**

Technology also has a role to play in cost reduction. Raj Mody, Head of PwC’s Pensions Consulting Group, stresses the importance of putting the right IT systems in place to keep costs down. “If you can achieve a single system for asset management information, asset liability modeling, actuarial valuations and so on, you can probably halve your advisor and analytics costs,” he says. Joined-up systems will also help pensions to identify and act swiftly on new investment opportunities.

** Sharing Resources for New Opportunities

Sharing resources should not only be viewed as a cost-saving measure. It is also an important means of developing new capabilities and opening up fresh opportunities.

For smaller pension funds, joining forces with similarly sized or even larger funds may be an effective route to obtaining the necessary scale, investment know-how and risk expertise to move into

* “London, Lancashire schemes to create £10bn pooled investment fund,” Investment and Pensions Europe, December 2014

** Legal experts weigh alternatives to ‘Dutch-style’ pensions in Germany, Investment and Pensions Europe, December 2015
What we see is partnerships being formed between funds — that is, between asset owners in the same geography or asset owners across different geographies — to access opportunities they would otherwise need to use external managers to access.\[PROFESSOR GORDON CLARK, Oxford University\]

Larger funds are also taking this approach. In 2015, Sweden’s AP2 fund joined an investment partnership launched by Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF) that will target high-quality farmland assets across North America, South America and Australia. A TIAA-CREF majority-owned subsidiary — Westchester Group Investment Management — will help to provide expertise in local farmland assets.

Professor Gordon Clark at Oxford University also notes the trend toward a more collaborative approach: “What we see is partnerships being formed between funds — that is, between asset owners in the same geography or asset owners across different geographies — to access opportunities they would otherwise need to use external managers to access.”

There are significant benefits to be gained by pooling assets and by sharing knowledge and resources. Such options are likely to become more important too, as pension funds come under greater pressure to cut costs and to access new investment opportunities. And for those pension funds seeking to pool assets, finding partners that share similar risk tolerance levels and a similar approach to governance will be the key to ensuring the strategy pays off.
#5
Own the Talent
As pension funds diversify their investments, their need for specialist talent is amplified. Investment professionals with expertise in niche assets are in demand — as well as new risk management, data analysis and board-level skillsets. Our survey shows that almost half (45 percent) of pension funds are expanding their internal investment team over the next three years, with 48 percent expanding the internal risk team.

Japan’s Government Pension Investment Fund, which has around $1.1 trillion in assets under management, recently announced that it will deepen expertise in alternatives in its in-house investment team. Meanwhile, the Korean National Pension Service (NPS) has been opening overseas offices — with the latest in Singapore last year — in a bid to hire more foreign fund managers and increase its overseas investments. The NPS is planning to increase its share of overseas investment from 20 percent in 2014 to more than 25 percent in 2019.

The pension industry’s increasing focus on sustainable investing is creating strong demand for managers with capabilities in ESG investing too. As Sarah McPhee at Storebrand points out above, funds will need front-office personnel that can apply new analytical lenses to select the assets that will thrive in a sustainable economy.

**Pension Funds Need to Compete for Talent**

Pension funds face huge competition in attracting specialist talent away from high-paying investment banks, asset managers and consultancies. Funds will need to pay market-competitive remuneration rates in order to build certain capabilities in-house, particularly funds that plan to increase their exposure to alternatives. “If you’re going to hire people to be creators of private markets transactions, it’s an expensive labor market, and people need to know the rewards are there for them.”

KEITH AMBACHTSHEER
Director Emeritus of the Rotman International Centre for Pension Management

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**Boosting In-house Capability Takes Priority**

*Resourcing intentions over the next 3 years*

<table>
<thead>
<tr>
<th>Resourcing Intentions</th>
<th>Internal Risk Team</th>
<th>Internal Investment Team</th>
<th>External Asset Managers</th>
<th>External Consultants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will increase</td>
<td>22%</td>
<td>30%</td>
<td>34%</td>
<td>27%</td>
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<tr>
<td>Will decrease</td>
<td>48%</td>
<td>45%</td>
<td>39%</td>
<td>49%</td>
</tr>
</tbody>
</table>

* The base is all respondents whose funds have some defined benefit (DB) component.
Source: State Street Asset Owners Survey 2015
them,” says Keith Ambachtsheer at the Rotman International Centre for Pension Management.

Ilmarinen’s Timo Ritakallio notes that they have enhanced their remuneration schemes to attract the best talent. But they also apply other approaches to gain the necessary expertise, such as improving the transfer of knowledge from third parties to in-house teams. “We target hedge fund managers and others working in financial centers such as London who are looking for a move back to Finland,” he explains. “We’ve also set up a Hong Kong office as a base for a separate fund managed by external managers. We send our own managers over there to gain experience in the Asian market too.”

Pension Funds Rationalize External Support

While building stronger in-house investment and risk management capabilities is appealing to many funds, it is unlikely to be a complete solution — consultants will continue to play a vital role in key areas.

In our survey, 65 percent of respondents agree that consultants are essential to guiding their investment process. Yet at the same time, the use of external support is being rationalized as internal teams grow. For instance, half (49 percent) of funds will decrease their use of external consultants over the next three years, while 27 percent will increase their use.
“We run a board effectiveness program that covers board dynamics, risk definition and oversight.”

KEITH AMBACHTSHEER
Director Emeritus of the Rotman International Centre for Pension Management

Pension funds may be looking for fewer, more valuable relationships with external consultants. This trend will intensify competition among consultants, but it will open up new opportunities for the most forward-looking firms. “With newer and more complex problems arising for pension funds, consultants are having to specialize and really become experts in financial technology in addition to asset allocation and investment issues,” says Daniel Gerard, State Street’s Head of Advisory Solutions for Asia Pacific.

Third parties can offer significant value in unexplored investment areas where in-house talent is too expensive or tough to recruit. This is evidenced by Ilmarinen’s approach to outsourcing. “We feel it’s more effective to manage our European equity portfolio in-house and bring in external help for developing markets,” says Ritakallio.

Consultants will also be asked to provide broader educational services to boards, as well as advice relating to key strategic decisions. Keith Ambachtsheer says improving the board’s effectiveness is high on the agenda for many funds: “We run a board effectiveness program that covers board dynamics, risk definition and oversight. We also develop a skills experience matrix for a pension board to understand where any gaps in experience and skills lie, so we can help them to address those.”

Finding the best talent means arriving at the optimal balance between in-house teams and specialist external advisors. More in-depth due diligence of managers and audits of how consultants are currently used will help ensure pensions make the most of their third-party engagements. Although there’s no one-size strategy that applies to all funds, all pensions should share the ambition to engage the best talent they can, and a willingness to explore multiple routes to achieving that.
Conclusion

Owning the Accountability
Leading pension funds are overhauling their old models to take greater control of the outcomes delivered to members.

Delivering long-term success in such a challenging environment means reallocating investments to diverse asset classes that combine return potential and sustainable performance. And it means putting stronger governance frameworks in place that strike the right balance of autonomy for the investment team and oversight of risk.

Pension funds need a more diverse talent pool to fulfill these strategies. Leading funds are closing the remuneration gap between pensions and external asset managers. They’re also getting strategic about using external advisors — managing more investments in-house and engaging external specialists that add value in niche areas.

There is no one-size-fits-all solution for pension funds. But as our research shows, industry leaders are taking bold steps in five key areas:

**Own the Outcome**
- Trustees must articulate a clear mission and well-defined risk parameters
- The right balance of responsibilities must be set between the board and management teams
- Bespoke education of boards to address unfamiliar issues is critical

**Own the Strategy**
- Pensions must adopt appropriate strategies to meet long-term liabilities
- Asset allocation is realigned for the new economy — sustainable investing is here to stay
- Pensions must do more to capitalize on their long-term liability profiles

**Own the Risks**
- A risk-on vs. risk-off decision must be taken based on accurate data about the fund’s position
- Risk and performance metrics must be adjusted to fit higher risk/return strategies
- New systems will aggregate and normalize data across diverse asset classes to deliver a fuller picture to risk officers

**Own the Efficiency**
- Pooling assets and knowledge can create new investment opportunities at lower risk
- Consolidation delivers administrative savings and cost-effective governance
- Efficiency gains are achieved through joined-up systems for risk and performance analytics

**Own the Talent**
- Funds need to offer competitive packages to attract the right talent
- Diverse investment strategies call for risk management and analytics specialists
- External consultants will add greatest value in unexplored areas where in-house talent is expensive or elusive
Learn More
For more information visit statestreet.com/PensionsWithPurpose.
About the Research
This report is based on a State Street survey of 400 senior executives in the pension fund industry. The State Street 2015 Asset Owners Survey was conducted by Longitude Research in October and November 2015. Respondents of the global survey included representatives of public and private pension or retirement systems, and superannuation funds across 20 countries. The quantitative research was supplemented by in-depth interviews with 43 pension industry experts from 13 countries.

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