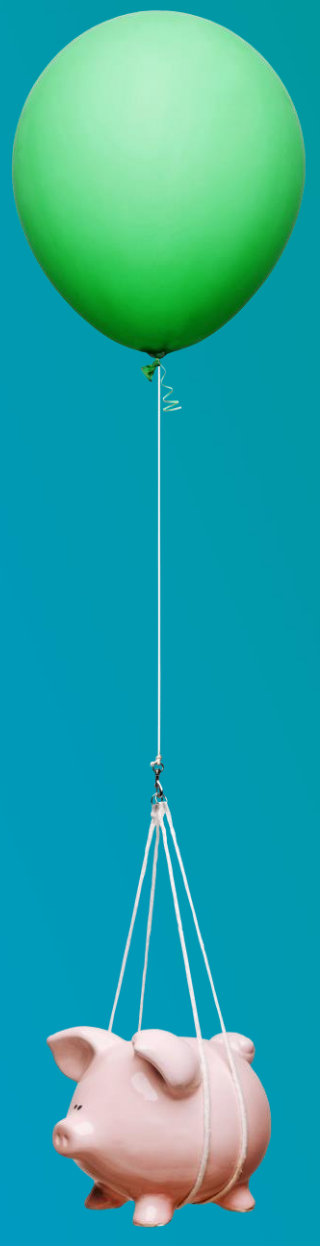
Mercer

University of Zurich[UZH]

Switzerland 2021

investment delegation survey



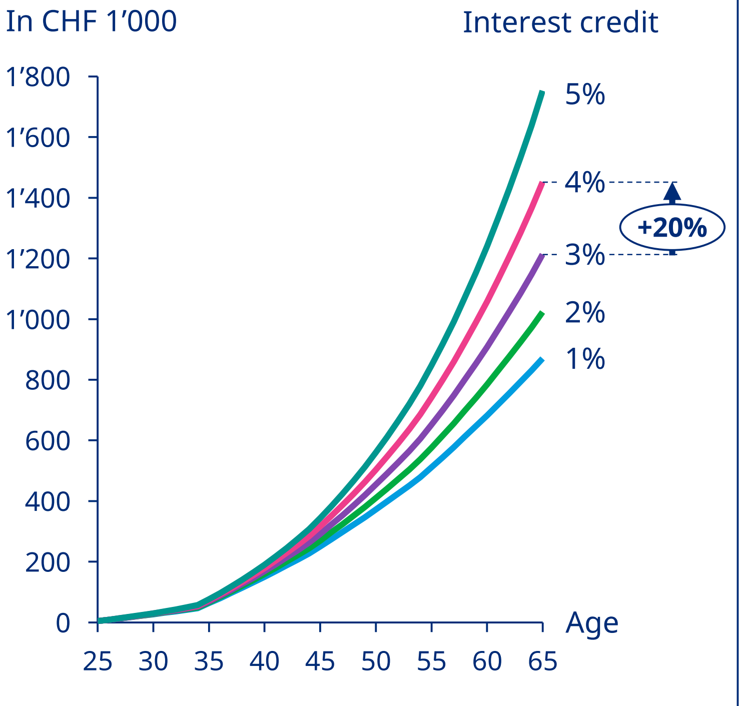
welcome to brighter

Welcome

Over the last decades, Swiss pension funds have focused a lot of effort on their liabilities in order to realign their plan parameters to the market developments driven by negative interest rates, rigid regulation and an ageing population. For many members, this results in significantly lower future pension benefits.

What pension plans haven't done nearly enough during the same time is looking at their main financing source: their investments. More often than not, a Swiss "standard" pension fund investment strategy is followed, focusing on bonds, real estate and equities with a very pronounced home bias. The result, across the board, is that pension funds miss out on real and profitable opportunities that could be salvaged by (a) reducing the home bias, (b) increasing allocations in alternative investments, especially private markets, and (c) adding additional diversification factors like Emerging markets and Small caps.

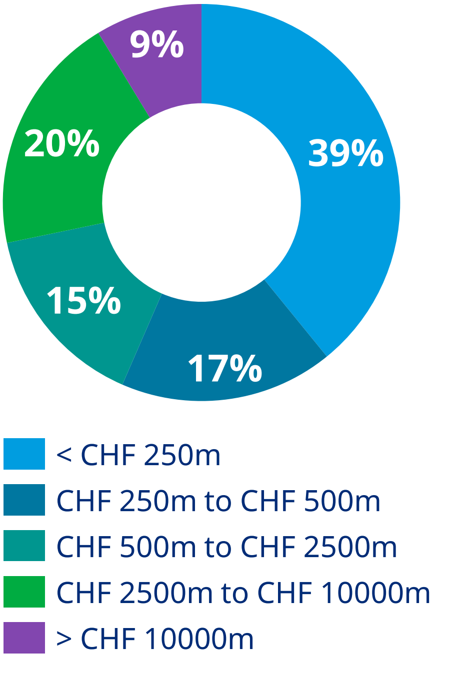
Graph 1: Impact of interest credit on pension savings



Survey Participants

Our survey gathered information from 46 Swiss pension funds, reflecting total assets of CHF 154 billion (15.3% of total Swiss pension funds' assets). Over half of the participants represent plans with assets under CHF 500 million, whereas 18% hold assets over CHF 5 billion (see Chart 2). Although smaller in number, these larger plans dominate the overall assets under review.

Graph 2: Split of Total Survey Participants by Plan Size



46 Swiss pension funds

154 bn CHF AUM

By doing so, Swiss pension funds could diversify and strengthen the single most important financing source of their pension plans, their investment results, and – crucially – achieve better returns to improve the interest rates for their members. Just 1% p.a. additional return could, on average, easily compensate for the benefit cuts we experienced in Switzerland over the last ten years due to lower conversion rates.

After pension funds have already done their homework on the liability side to significantly improve their financial position for years to come, a potential increase in investment returns could be the next step to act in the best interest of their insured members. So why don't they?

More often than not, pension funds are not fully aware of the shortcomings of their asset allocation and the fact that they cannot reasonably expect to harvest significant returns in the future. We know that the asset allocation is the key driver of return, accounting for about 80% of the total. As such, it must be defined with sufficient diligence and needs to consider the full set of investment opportunities available in order to achieve high efficiency.

In addition, however, there are also weaknesses in the implementation of this asset allocation, e.g. due to a lack of scale and skills within smaller and mid-sized pension funds. This often leads to a limited view of the investment universe, combined with limited access to opportunities, in particular when looking at private markets.

With our survey, conducted together with the University of Zurich, we aim to shed light on some of the key areas that affect the investment strategy and performance of pension funds in Switzerland. In particular, we want to focus on the asset allocation and investment processes/implementation as the key drivers for investment efficiency, effectiveness and returns. In total, 46 Swiss pension funds of all sizes (from small to very large) have participated in the survey, representing a total of >150 billion CHF assets under management (AUM).

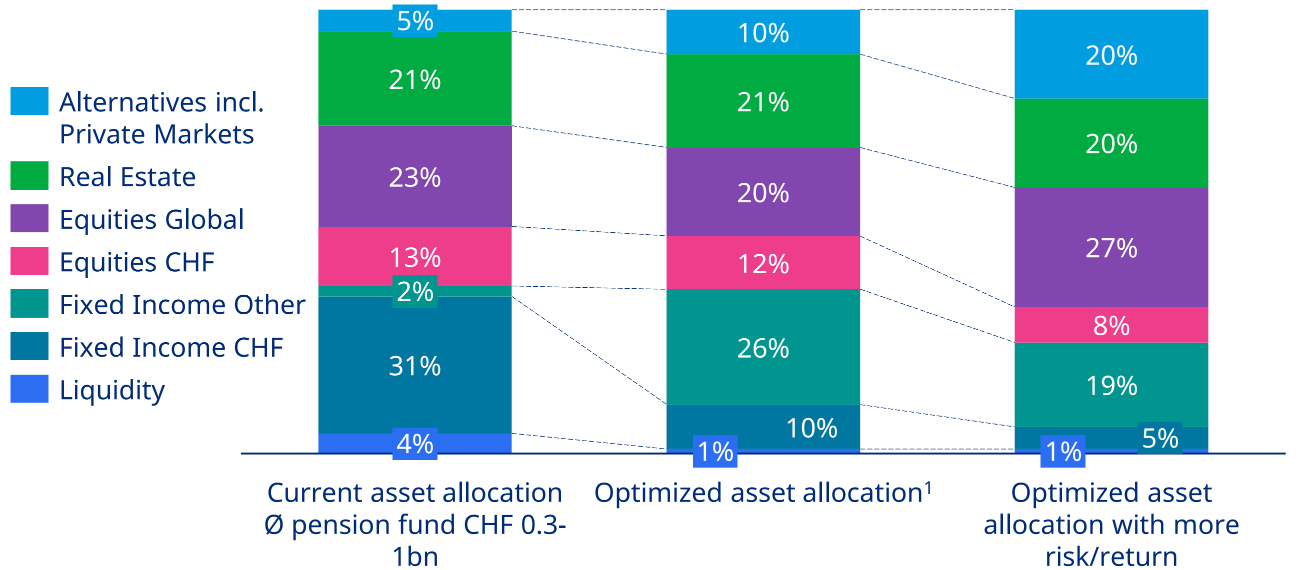
Survey results and assessment

Asset Allocation

Strategic Asset Allocation (SAA)

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

Graph 3: Case example - Optimization of typical Swiss pension fund portfolio



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

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

Strategic asset allocation is also a way to realize potential for higher investment efficiency. The average Swiss pension fund shows a significant home bias, with more than 30% of the portfolio concentrated in CHF Fixed Income, and 13% in Swiss equities. An optimized, balanced portfolio would aim for broader diversification while decreasing home bias and capturing multi-asset factors including Emerging Markets and Small Cap.

[1] A sample portfolio: appropriate investment risk, liquidity requirements, investment strategy etc. should be determined as part of an ALM study; CVaR Simulation: Time Horizon 1 Year . Sources: UBS Pensionskassen Index, Mercer analysis

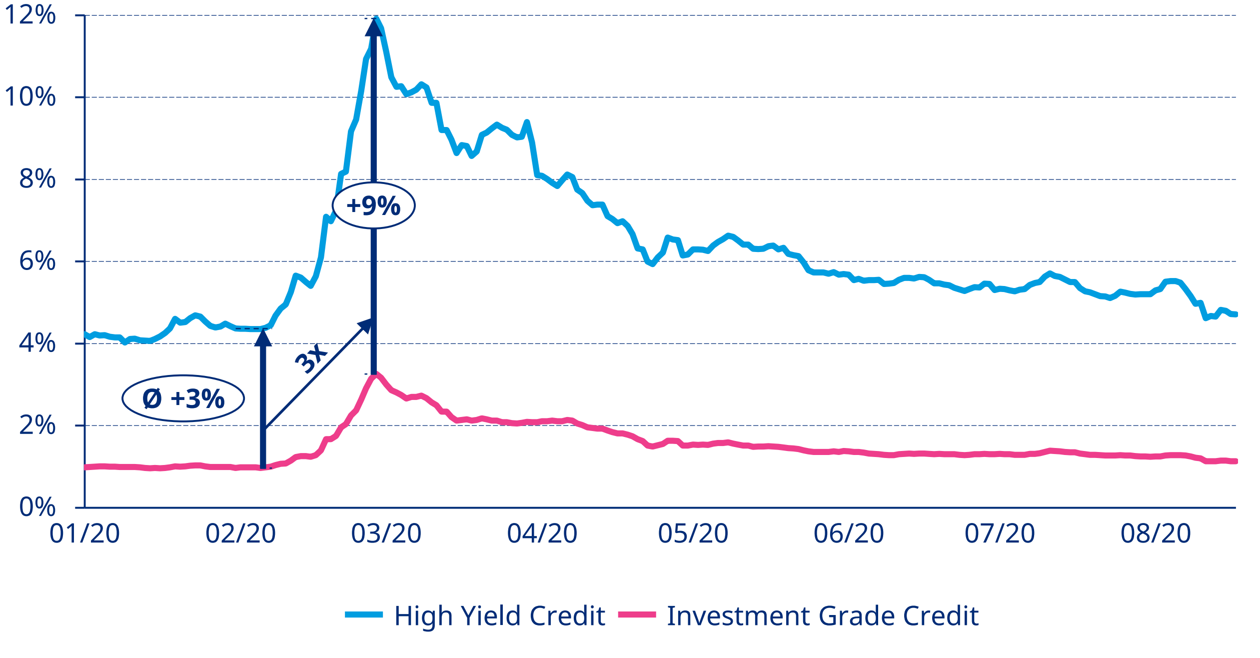
Especially during times of negative interest rates, the historically grown high share of fixed income investments creates challenges for a pension fund from a return perspective. In addition, the following 4 points explain why harvesting illiquidity premia through private market investments should be strongly considered as a strategic choice, as illustrated in the above case example in Graph 3:

1. **Greater Alpha Potential:** Greater alpha potential through active management with highly rated managers persistently demonstrating significant value-add.
2. **Better Diversification of Return:** Diversifies risk away from listed public market performance.
3. **Broader investment opportunities** Access to investment opportunities that are not accessible through public markets.
4. **Long-term Investment Horizon:** Potentially capitalize on the illiquidity premium available to the providers of long-term capital.

Dynamic Asset Allocation (DAA)

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

Graph 4: Use case for DAA – High yield versus investment grade credit spreads



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

1. First, they need to have the resources to monitor capital markets, identify relevant investment ideas and, most importantly, need to have the expertise to identify relevant investment solutions in which they want to invest.
2. Second, they must have implemented investment processes that allow such short-term investment decisions. If it takes two months for the whole process from the idea generation to implementation, the opportunity will often be gone.

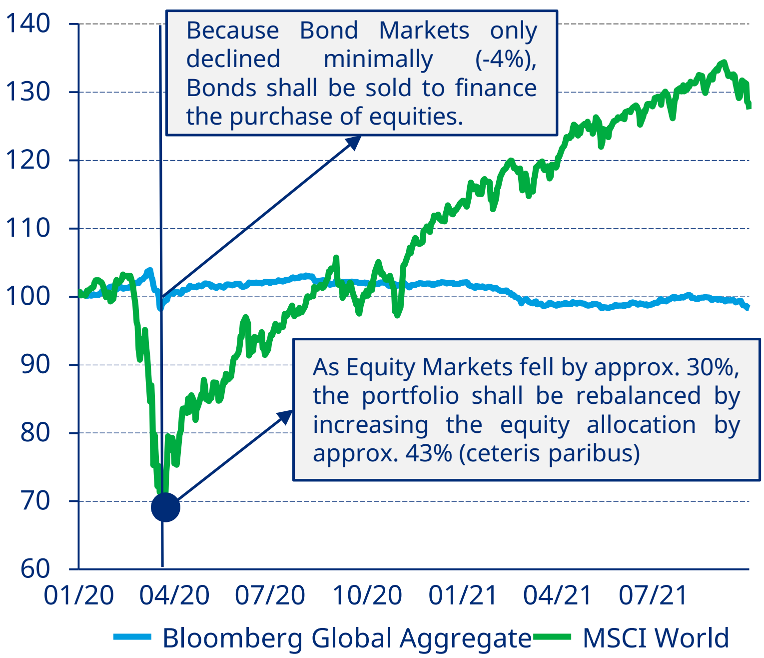
These factors should also be considered within a pension funds governance framework that keeps pace with increased complexity.

Rebalancing

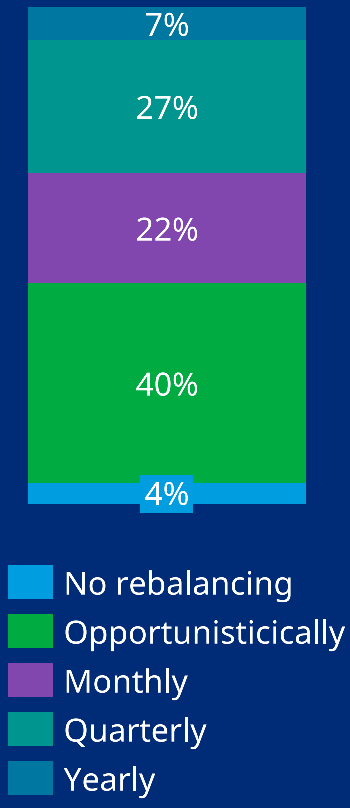
Rebalancing allows to achieve and hold the long-term SAA in the context of market movements. Still, numerous Swiss pension funds do not have a rebalancing schedule, which is why we assessed the rebalancing level for Swiss pension funds. The results are presented in Graph 6.

Graph 5: Example for Rebalancing Opportunity – March 2020 Covid Crash

Data source: Thomson Reuters, Mercer



Graph 6: Frequency of Rebalancing



44% of Swiss pension funds do not have a planned schedule when to rebalance their portfolio.

Advantages of continuous rebalancing:

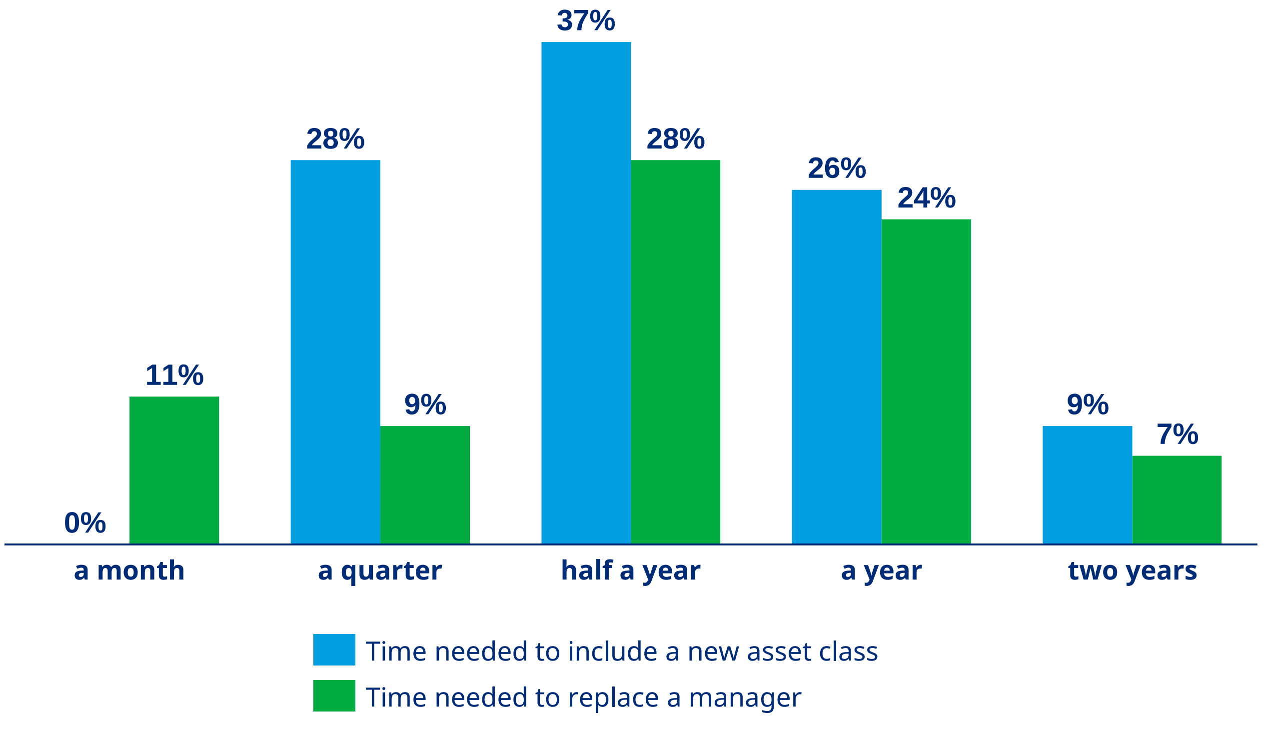
Maintaining the intended asset allocation and risk exposure: As the SAA defines 80% of the total return expectation, rebalancing aligns the return expectation of the current portfolio with the return expectation of the SAA, thereby better aligning the return/risk profile of the portfolio with the one of the SAA that was originally defined through an ALM study. Therefore, risk and return are continuously realigned with the adequate risk capacity / return needs of the pension fund.

Profiting from market opportunities: Buying low and selling high, therefore securing profits and profiting from market pullbacks. This could be seen in March 2020 when capital markets reacted to the Covid-19 crisis. Global Equites had a quite heavy pullback as opposed to Investment Grade Bonds that did not (see Graph 5). Therefore, the allocation of bonds compared to Equities increased. If a pension fund rebalanced, i.e. if it sold Investment Grade Bonds and bought Global Equities when the Allocation of Equites declined, the pension fund performance would have greatly benefited.

Investment processes and implementation

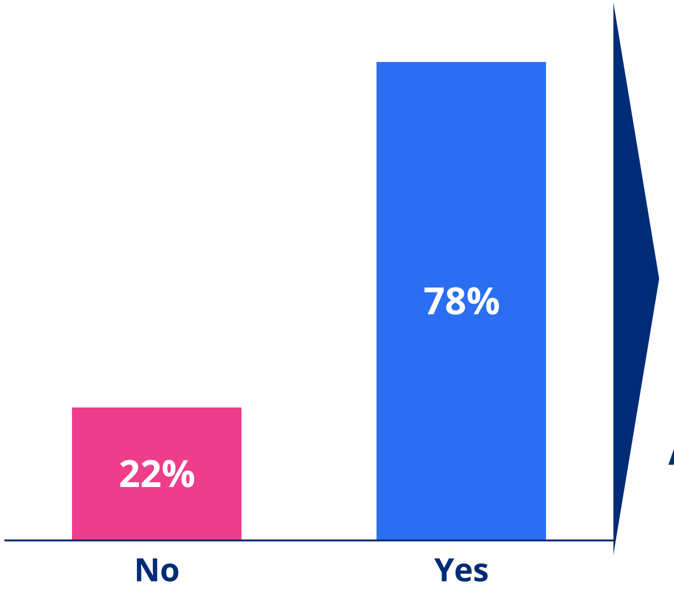
As investment processes/implementation are the key drivers for investment efficiency, effectiveness and returns, we analysed this for the Swiss pension fund universe. We could observe that long decision making processes for new asset classes and manager replacements, long meeting cycles as well as potentially limited time spent of pension fund trustees on strategic investment matters do not allow the pension funds to make full use of market opportunities as described in the previous chapter and could lead to inefficient portfolio implementation.

Graph 7: Implementation speed of pension funds



Our survey observed a strong desire to have access to more asset classes which reflects our experiences from working with clients. However, 72% of the participants take half a year or longer to include a new asset class and 35% take one year or longer.

Graph 8: Pension funds with a separate Investment Committee



Investment Committee insights

69%
Engage external specialists

4.6
Average number of IC members

6.3
Average number of IC meetings p.a.

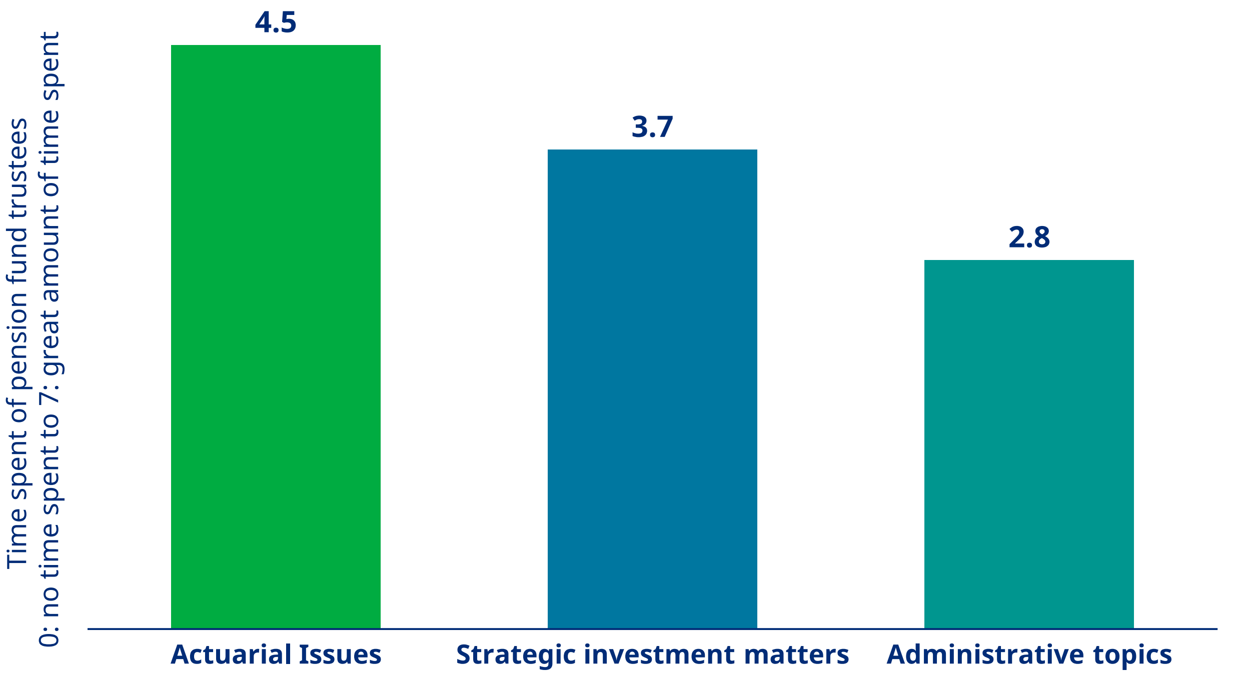
58%
IC members with investment background

Only 44% have at least one investment committee meeting every second month. Only 15% of the sample have at least one board meeting every second month.

Efficient replacement of non-performing investment managers is important. Avoiding value-destroying funds and explicitly selecting value-adding funds can increase investment performance significantly Remarkably, 59% of participants take half a year or longer to replace a manager and 31% take one year or longer.

With the increasing complexity of investment management in a challenging market environment, trustees perceive it to be challenging to find enough time to confront all the issues they face (see Chart 9). Generally, time spent on the different elements of pension fund management are weakly to mediumly correlated, except for time spent on administrative topics that is negatively or very weakly correlated with the other topics.

Graph 9: Average time spent on elements of pension fund management



Trustees spend more time on actuarial issues than on strategic investment matters, while administrative topics fall last. Especially during turbulent markets as last seen in early 2020 when the COVID-19 pandemic hit the financial markets, spending an adequate amount of time and focus on investments, secures performance and enhances pension fund governance as it enables to make use of market opportunities.

Swiss pension funds face difficulties to implement new asset classes and manager changes with the desirable speed.

Frequency of board and investment committee meetings and therefore lack of time spent on strategic investment matters as well as lack of expertise-driven appointments of pension fund executives indicate why.

Internalization vs. Delegation

Current status of investment delegation

Investments can be delegated across the full investment process: from the strategic definition to the implementation and through to the delegation of operations and ongoing oversight. We assess the current level of investment delegation across the full investment process in Switzerland and present the results in Table 1.

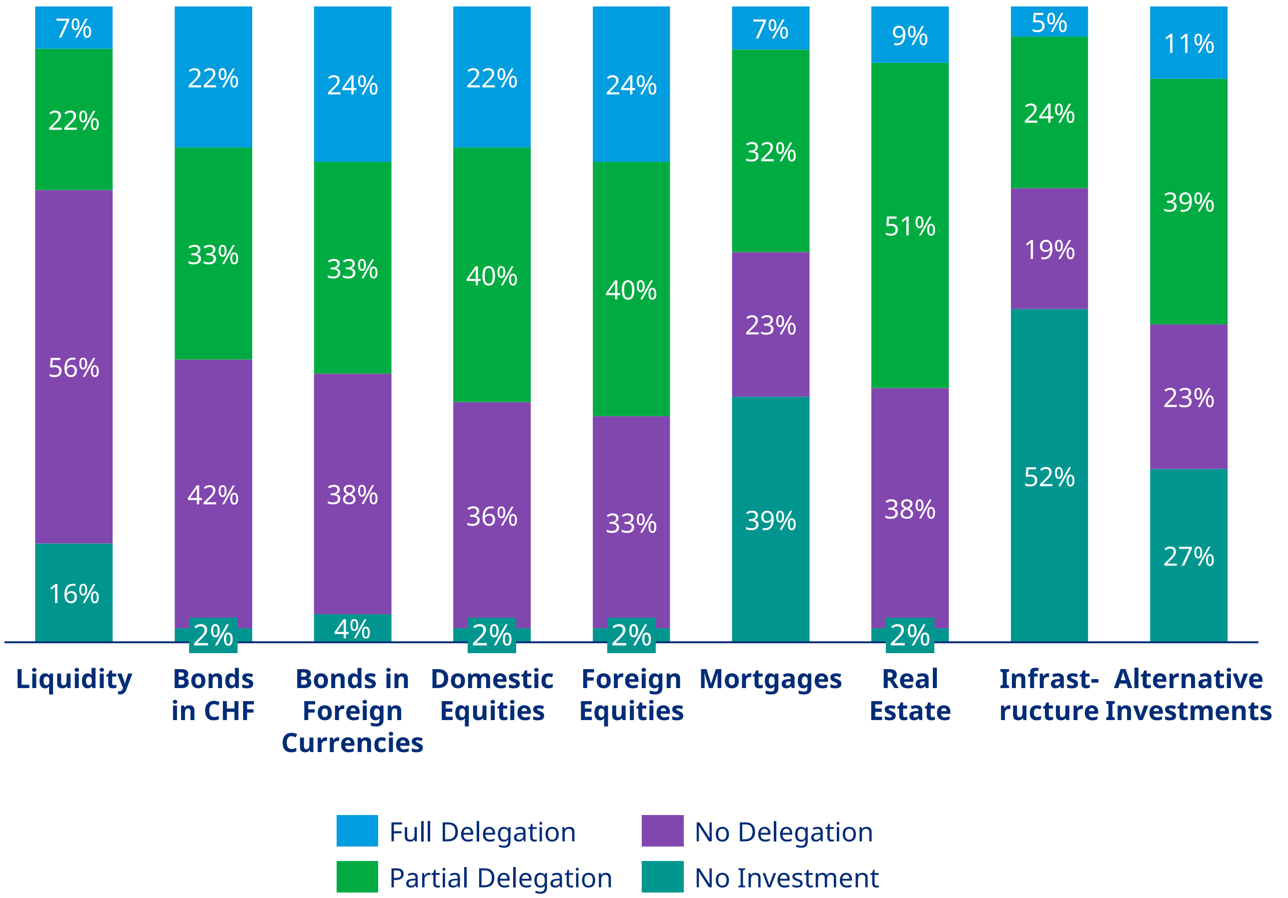
Table 1: Investment Delegation in Switzerland

Green represents the element that is delegated most often and red represents the element that is delegated least often

Element of the investment process	Fully or partially delegated	No delegation
Delegation of strategic definition		
Delegation of strategic objectives	45.6%	54.3%
Delegation of key decisions regarding the portfolio structure	26.1%	73.9%
Delegation of investment implementation		
Delegation of portfolio construction within asset classes	47.8%	52.2%
Delegation of manager selection	36.9%	45.7%
Delegation of portfolio transition	47.8%	52.2%
Delegation of investment related documentation	39.2%	60.9%
Delegation of operations and ongoing oversight		
Delegation of manager monitoring	47.8%	52.2%
Delegation of cash flow management	19.6%	80.4%
Delegation of rebalancing	47.8%	52.2%
Delegation of custodian coordination	36.9%	63.0%
Delegation of performance reporting	76.1%	23.9%

91% delegate at least one element

Graph 10: Investment delegation across asset classes

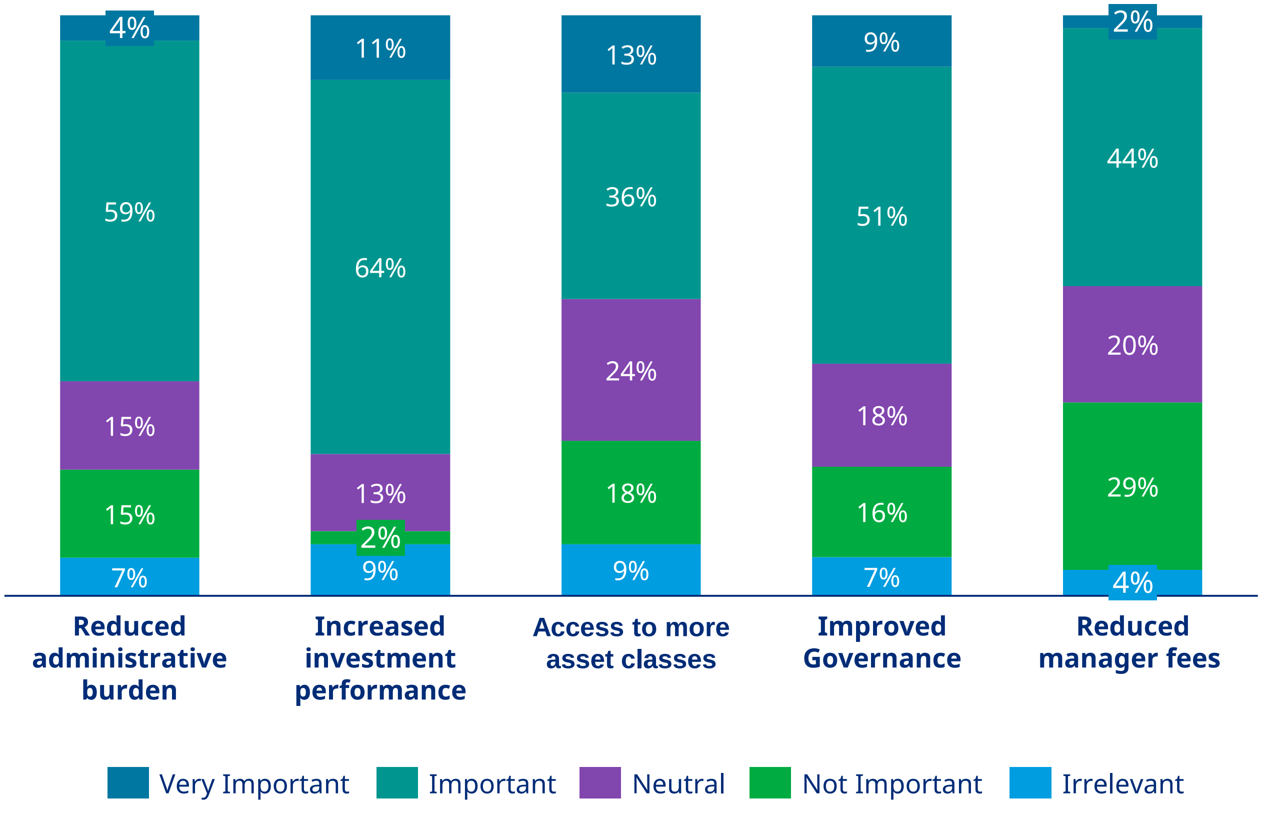


Generally, the delegation of elements along the investment process are positively correlated to each other, i.e. when one element is delegated, the likelihood that a second element is delegated increases.

Delegation levels are similar across all major asset classes (see Graph 10), except for liquidity and for bonds in Swiss francs which are delegated significantly less often, which can be explained by a strong home bias.

Expectations of pension funds when delegating assets

Graph 11: Importance of considerations with increased delegation



Higher performance and improved governance are key considerations for investment delegation. Notably, access to more asset classes was increasingly brought up under an open question format where we asked for expectations with increased investment delegation. Both key considerations for delegation, increased performance and increased governance, are indeed a key advantage of delegation, which is best described by an example:

> A Swiss pension fund decides to invest into emerging markets and is therefore searching for a manager. However, the universe of emerging market managers is very large (~500 hundred managers[2]) which makes it very difficult for in-house teams to be able to efficiently and effectively screen the universe to identify those who can outperform, i.e. deliver alpha. On the other hand, professionals that fully concentrate on rating and finding managers that can deliver alpha are able to provide efficient support for the manager selection exercise of a pension fund. This is validated by the fact that **36.6%** of the sample already partially or fully delegate manager selection to achieve better returns, thereby clearly demonstrating awareness of their situation.

[2] Source: MercerInsight (October 2021)

Furthermore, a better selection of investment managers is compliant with better governance because that way the pension fund is better able to serve the needs of the insured members. Also, delegating the manager selection improves the governance of pension funds and vice versa, i.e., pension funds profit from delegating the manager selection as they often acquire knowledge from that.

Moreover, the study shows that pension funds wish to delegate assets in a way that leads to investment in best-in-class solutions which implies an independent and unbiased decision making process. If delegated to a professional, the probability of investing into best-in-class solutions increases as well as securing an independent decision making process, because objective analysis is applied.

Case for action

Given the observations we made in the analysis of the survey results, we see a strong need and case for Swiss pension funds to run a review of their investment governance, following on these five dimensions:

Investment Target

Is there a clear understanding within your pension fund as to what you want to achieve with your investments? Do you have the right target set? Is there a potential to readjust the target?

Efficiency of Asset Allocation

Do you achieve your investment target in the most efficient way? What restrictions/ preferences should be considered and for what reasons?

Investment Implementation

How shall the strategy be implemented? Are you making use of additional opportunities to enhance returns or reduce risk (active/passive, DAA, sustainability)?

Operating Model & Processes

How can the investment organization run most efficiently? What processes must be in place to meet the requirements for your investment strategy and implementation?

Accessing Return Drivers

Are you considering the full investment universe – both globally and in terms of asset classes? Do you know how you can access interesting opportunities (e.g. in the private markets), and how you can implement strategies efficiently and at low cost?

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Acknowledgements

We would like to thank **Prof. Dr. Thorsten Hens** at University of Zurich and **Fabian Mugrauer**, Investment Analyst at Mercer Switzerland, for their great support and valuable contributions towards conducting the survey and completing the report. We would also like to thank **Steffen Zwink**, Head of Marketing at Mercer Switzerland, for his copywriting and design support.

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