

New ideas and models in pension fund investment



**Information for fund distributors and institutional investors.
Not for circulation to private investors.**



Chapter 1

Pension fund management is becoming ever more complex



Chapter 2

An integrated offer combining services and management to solve complexity?



Chapter 3

Allianz Global Investors' value proposition to assist pension funds

CEO Commentary



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Fiduciary management (in all its forms) has become a very important topic for European pension funds over the last few years. Allianz Global Investors has always paid great attention to its clients' needs and therefore is planning to combine its capabilities to offer our pension fund clients in Europe best-in-class fiduciary services

Chapter 1

Pension fund management is becoming ever more complex

The collapse of financial markets on the back of the credit and euro government bond crisis has had a profound impact on funding levels of pension funds. They have had to face unprecedented volatility. The normal distribution commonly used to assess risk was drastically challenged. According to the assumptions of a normal distribution, the European junk bond crash in September/October 2008 was an event that should occur only once every 247 million years. Low or negative correlations used for risk diversification disappeared just when they were needed the most. The common perception is that turbulence is here to stay.

Unfortunately, pension funds do not face issues only on the asset side. On the liability side, an ageing society creates additional pressure. Decreasing mortality rates and consequently increasing longevity raises the issue of transferring the longevity risk. The liability side of pension funds has also been very sensitive to interest rates.

Another secular trend is the increased regulation which is a heavy burden for many institutions. The Frijns report¹ in the Netherlands or stronger corporate governance requirements in Switzerland are examples of tightening regulation. In day to day life, this makes the regulatory reports more complex.

¹ The report was issued in early 2010 by a committee advising the Dutch government. It is headed up by Jean Frijns, former CIO of the EUR200bn ABP civil service pension scheme. The report suggests pension funds should base their investment policy more on the risk levels scheme members are prepared to accept, rather than being mainly driven by returns.

More turbulent markets, importance of returns for liabilities and tougher regulation have reshaped pension investment. The traditional set-up, under which pension funds operate with their asset managers and investment consultants, has been challenged in the last decade. New concepts have been introduced, such as fiduciary management in the Netherlands, which adopts an integrated model managing assets in relation to liabilities. In other countries, such as Germany or France, there has been an increasing request to upgrade the level of service in the relationship between pension funds' and investment providers' topics, including strategic risk advice, manager selection and Environmental, Social and Governmental (ESG) guidance.

In the next chapter we illustrate some of the solutions put in place under these new rules.

Chapter 2

An integrated offering combining services and management to solve complexity?

Pension investing requires an integrated asset-liability view considering the overall funding situation and its development.

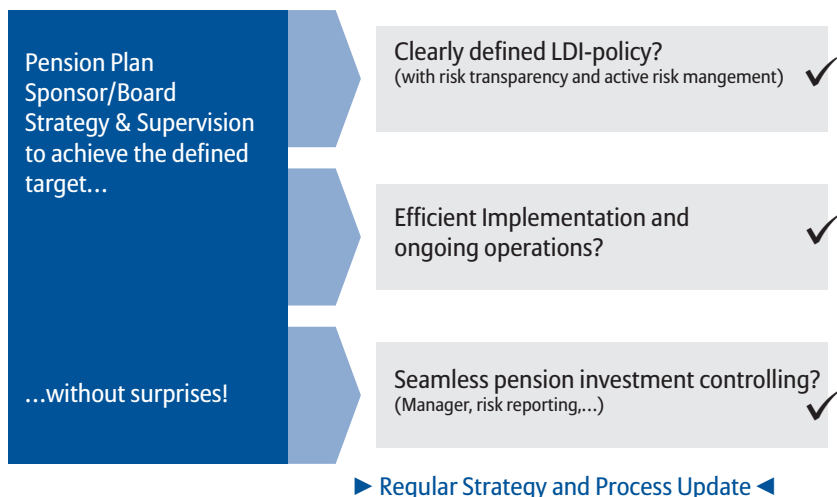
In our view, Liability Driven Investment (LDI) does not imply an investment policy that simply tries to immunise the liabilities but rather considers the characteristics of the liabilities explicitly to derive an asset strategy which outperforms the liabilities in the medium to long term (improving the funding situation, reducing net funding costs) and is able to avoid short term funding problems due to excessive asset mismatch risks.

With focus on risk management, a pension fund should have a clear investment perspective regarding the risks it can bear, to earn a corresponding risk premium and which risks it should mitigate – such as unrewarded fat-tailed risk events with high impact.

From the perspective of the Board of the pension plan, setting the strategic investment portfolio is one of the most important decisions to achieve its objectives. A holistic LDI policy will also include aspects on pension indexation policy, the contribution policy set by the plan or potentially required by the regulator.



Diagram 1

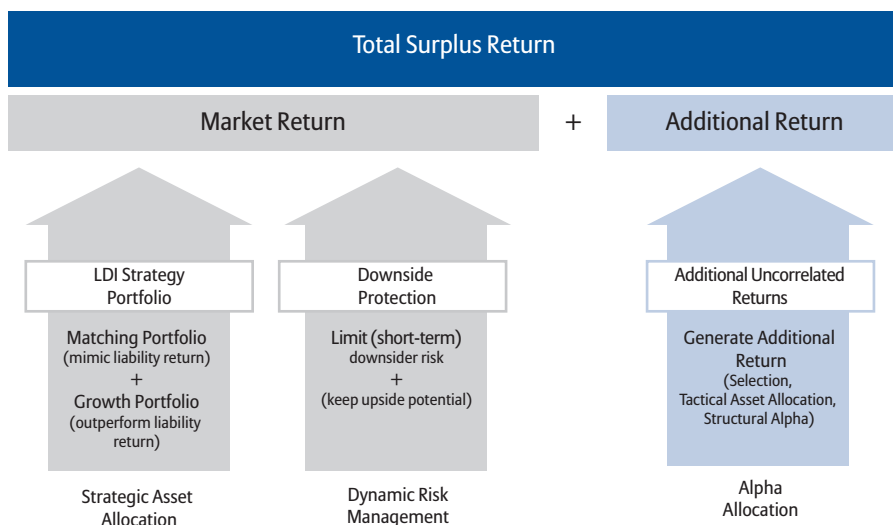


The investment and risk policy should be translated into reality on the basis of a consistent pension investment and risk management framework. Diagram 1 illustrates three steps for portfolio implementation.

How to translate into a real portfolio?

There are several ways to translate that strategic risk approach into a real portfolio. Let us detail our experience of that process within Allianz Global Investors through a three pillars approach, as shown in Diagram 2:

Diagram 2



The first pillar is the **Strategic Asset Allocation (SAA)**. It includes the LDI matching and growth portfolio. The matching portfolio is designed to mimic the return of the pension liabilities by limiting mismatch risks. The LDI growth portfolio is designed to outperform the return of the pension liabilities by realising attractive risk premium.

The second pillar is focussed on **Dynamic Risk Management** and aims to minimise (short-term) risks while keeping the upside potential as much as possible. Rule based solutions are commonly used here to realise attractive target returns and reduce the probability and size of losses.

The third pillar (**Tactical Asset Allocation – TAA**) is the alpha component designed to add additional correlated return components.

The first two pillars are strategic components based on a long-term view while the TAA component exploits short-term views.

A seamless approach from defining a strategic asset allocation to implementing it in the portfolio with a dynamic (or even passive) approach brings together asset management and liability constraints. It must be reported as such by adding the asset and liability reporting on the funding surplus and deficit to the classical investment performance reporting.

Manager selection: Advice of the Fiduciary Manager

This integrated approach should not prevent the pension funds from having access to the best managers in each asset class. Indeed, with an overlay approach to perform dynamic management versus the SAA or a passive index management replicating the SAA, the pension funds may set-up an underlying vehicle invested in the managers of his choice.

Within an integrated model, the manager selection could also be performed with the advice of the integral or fiduciary manager. For the purpose of integrated risk management, there could be an overall risk budget versus the SAA allocated between the Dynamic Asset Allocation (DAA), the TAA and tracking error left for manager selection.

The manager selection could follow different approaches depending on the investment beliefs of the pension fund:

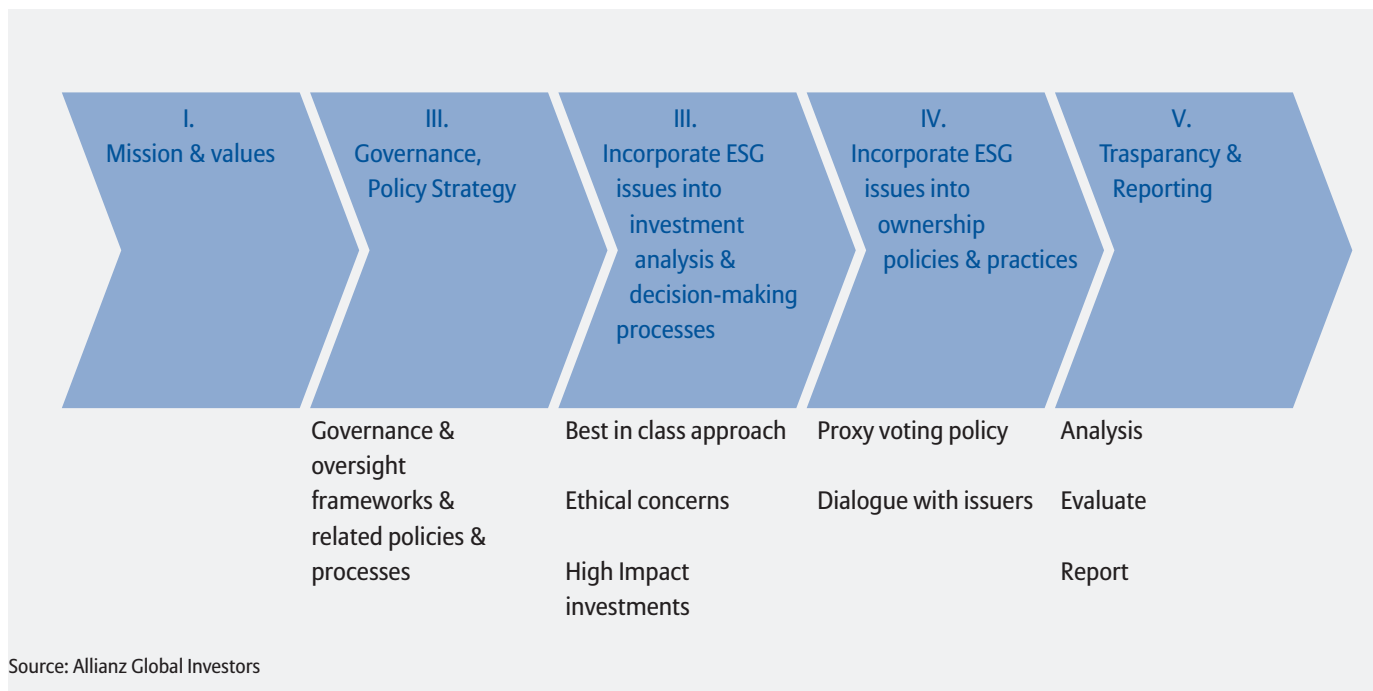
- Active or passive managers depending on the asset class with the common belief that asymmetric asset classes require active managers more than any other
- Core/satellite approach
- Manager selection oriented to capturing managers in their alpha cycle or focusing on managers

delivering stable alpha in different market conditions

Main criteria of selection are to be agreed with the pension fund and the centralised operating manager. In most of the cases, analysis of track-record in all market conditions, rigorous investment process combined with a strong investment team, coherence between the investment process and the portfolio over last years, the transparency of the portfolio manager to explain his investment strategy and compliance/best execution are part of the screening.

Beyond the prudent person principle a pension investment policy should also include the promotion of environmental, social and good corporate governance compliant investing.

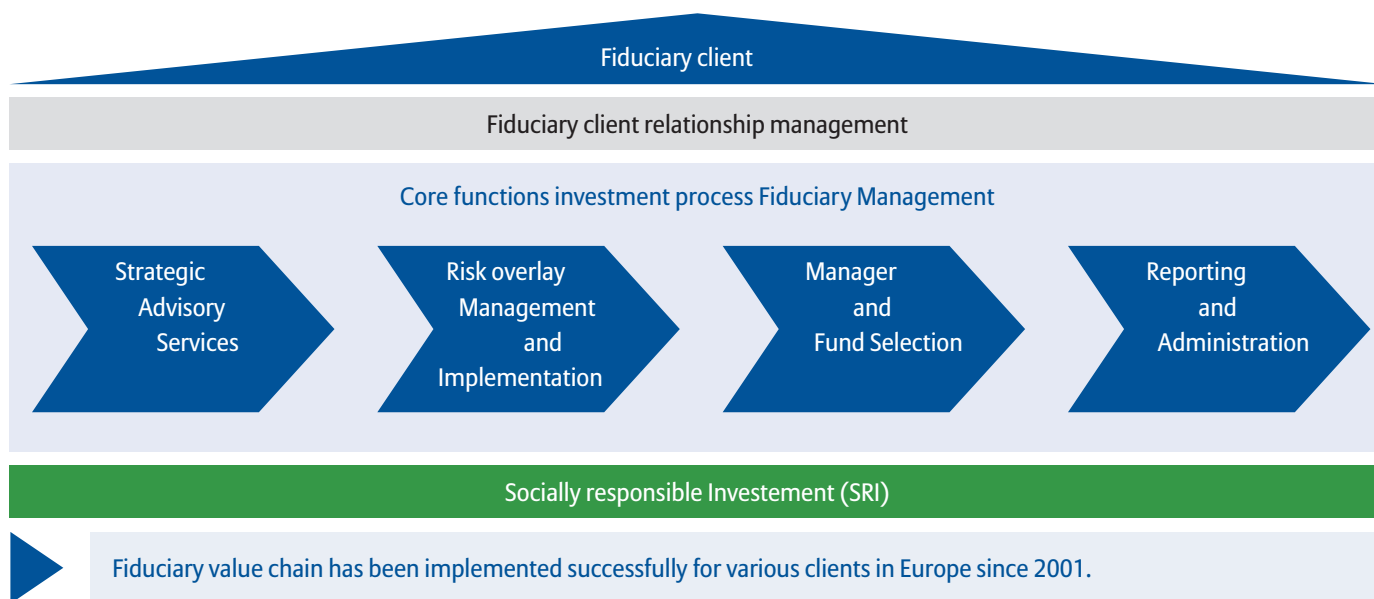
Diagram 3



Chapter 3

Allianz Global Investors' value proposition to assist pension funds

Diagram 4



Source: Allianz Global Investors

Aggregating these services with day-to-day contact with the pension fund is the duty of the fiduciary manager. They should be close to the client and have a deep understanding of its culture and investment goals. Most of the time it requires a dedicated service.

Being an institutional leader, Allianz Global Investors (AllianzGI) have provided all services required to run fiduciary services since 2001.

AllianzGI, via the associated company risklab, can provide strategic advisory services through a team of highly qualified professionals with key expertise in advising or challenging the SAA, asset/liability management and risk manage-

ment. The financial crisis has challenged all established set-ups of correlation and volatility of traditional assets classes. Clients and consultants investigate new illiquid asset classes such as renewable energy or infrastructure as a shelter. Across the value chain, AllianzGI is able to optimise these asset classes in a SAA, select appropriate managers/advisors and monitor these investments.

On the issue of investment risk monitoring, a complete and reliable system – adequate to each fund's operations – seems to be of essential importance to comply with the prudent person standard. Indeed, it should be possible to make sophisticated investments only if

an appropriately sophisticated risk management system is in place, without forgetting however the principles of freedom, adequacy and proportionality in deciding how to structure each one's internal organisation.

Bringing risk management to a portfolio level, AllianzGI has a proven track record in overlay management in a seamless approach with our strategic advisory services. An integrated reporting from asset-liabilities to portfolio-level demonstrates the integrated approach.

Interacting with the strategic and overlay teams, the manager selection is able to search, recommend and monitor ap-

appropriate managers/investment companies in all liquid and illiquid assets classes in accordance with principles and criteria that have been provided by the client (budget of tracking error/core satellite approach/defined split between passive and active managers, operational and compliance constraints).

AllianzGI is able to advise and implement a responsible investment policy across the entire portfolio based upon the principles and values defined by the client.

Nevertheless, we believe that having the know-how, resources and expertise is necessary but not sufficient to becoming a reliable partner. Above all it requires a clear understanding of the client's needs, objectives and philosophy. For this reason, we apply equal attention to the specific set-up of each pension fund.

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