ONDRA

Discussion materials

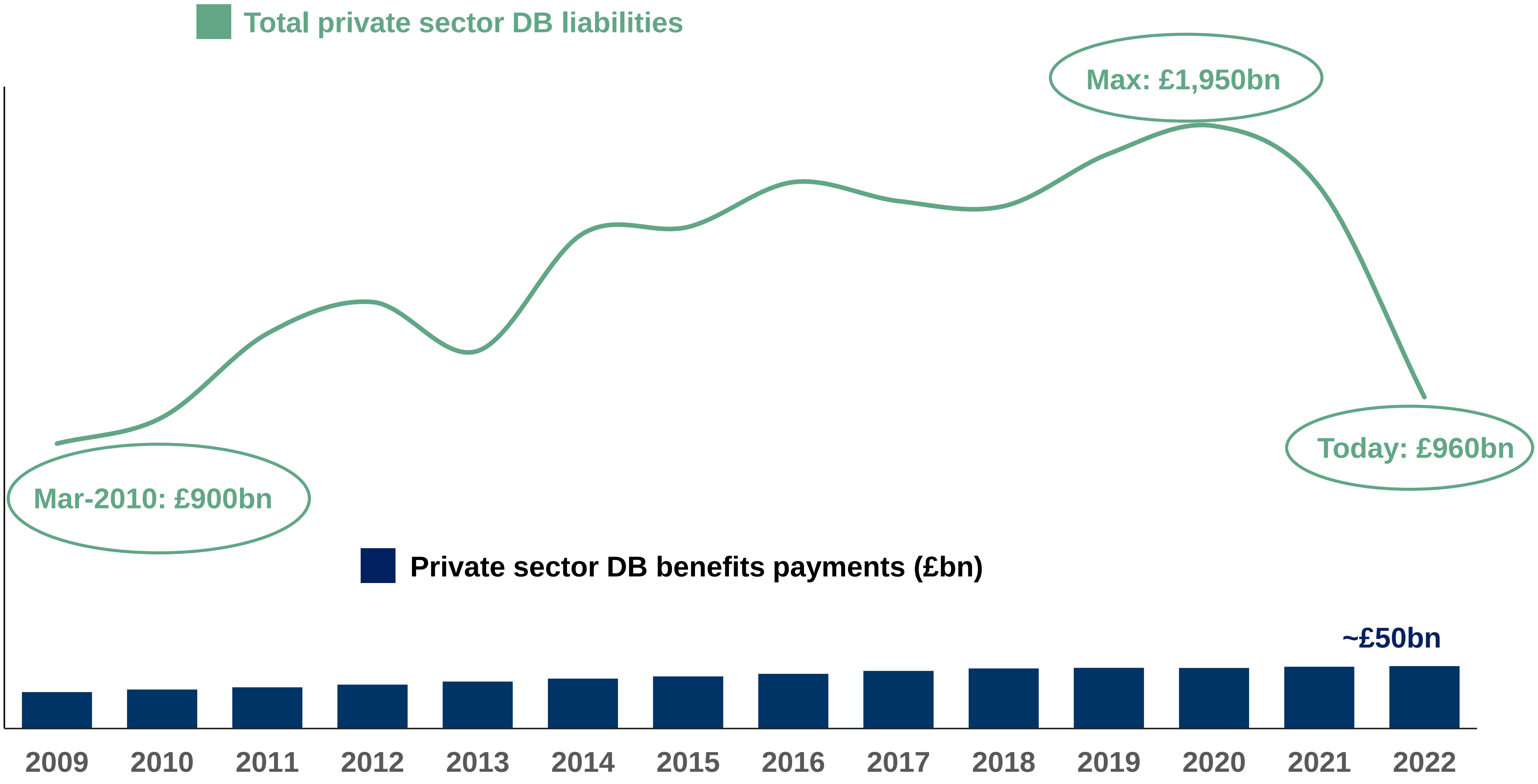
August 2023

Purpose of presentation

1. Stimulate debate around first principles of fund management, finance and economics
2. Address implications for current DB system of applying these principles
3. Framework to compare consolidation / decoupling derived schemes from those layered on top of the existing fragmented, corporate linked system

From 2009-2022, interest rate movements resulted in £1 trillion fluctuations in the accounting value of total DB liabilities

Benefits paid as per ONS, Sector liabilities as per PPF (7800 Index)



Source: PPF 7800 Index (Section 179 basis), ONS (Funded occupational pension schemes in the UK)

Empirical data (CEM) regarding scale and fund performance*

From 9000 observations 1992 – 2020 :

- Clear evidence of *“outperformance delivered by larger funds”,* particularly funds greater than $10bn.
- By contrast, funds under $1bn *“failed to deliver any value on average ….”*
- CEM also analysed whether larger funds’ superior returns were simply as a result of taking on more risk *“but in fact the standard deviation of value added for the largest funds (190bpos) is 33% lower than that of the smaller funds(291 bps)”.*
- *“Not only are larger funds generating higher value they appear to be doing so while taking a lower level of active risk”* (mainly through diversification).

**Source : CEM Benchmarking, February 2022*

We cannot build a prosperous and stable pensions future on a faulty base

- For the 5500 funds comprising the current DB system, it is clear from the empirical evidence that:
  - the distortive effect on asset allocation of the corporate link,
  - funds' small scale and limited diversification, and
  - funds' finite time horizon by virtue of being closed to new members,

  has not only depressed pensioners' returns and left them exposed them to high levels of interest rate risk ….

- It has also (while not the only factor) :
  - artificially increased the burden on UK companies from a decade of low interest rates,
  - depleted the supply of equity capital for domestic UK companies,
  - inhibited investment in long-term growth and productivity,
  - needlessly diverted over £300 bn of productive capital into UK companies' pension funds, and
  - eroded sovereignty through the UK's resulting over-dependence on overseas capital.

- The current DC system – even more fragmented (27,000 mostly small funds) – is not an adequate substitute for the benefits to pensioners of open time horizon, large scale, professionally managed diversified funds.

- Tinkering to preserve a self-evidently broken system is a lost opportunity for all generations to come.

Against this background, how would we assess and compare new proposals ?

- **From Mansion House speech:**
  i. **Increase returns for savers**
  ii. **Unlock capital for growth businesses**

- Local authority fund consolidation - £50bn fund size aspiration – a step in the right direction.

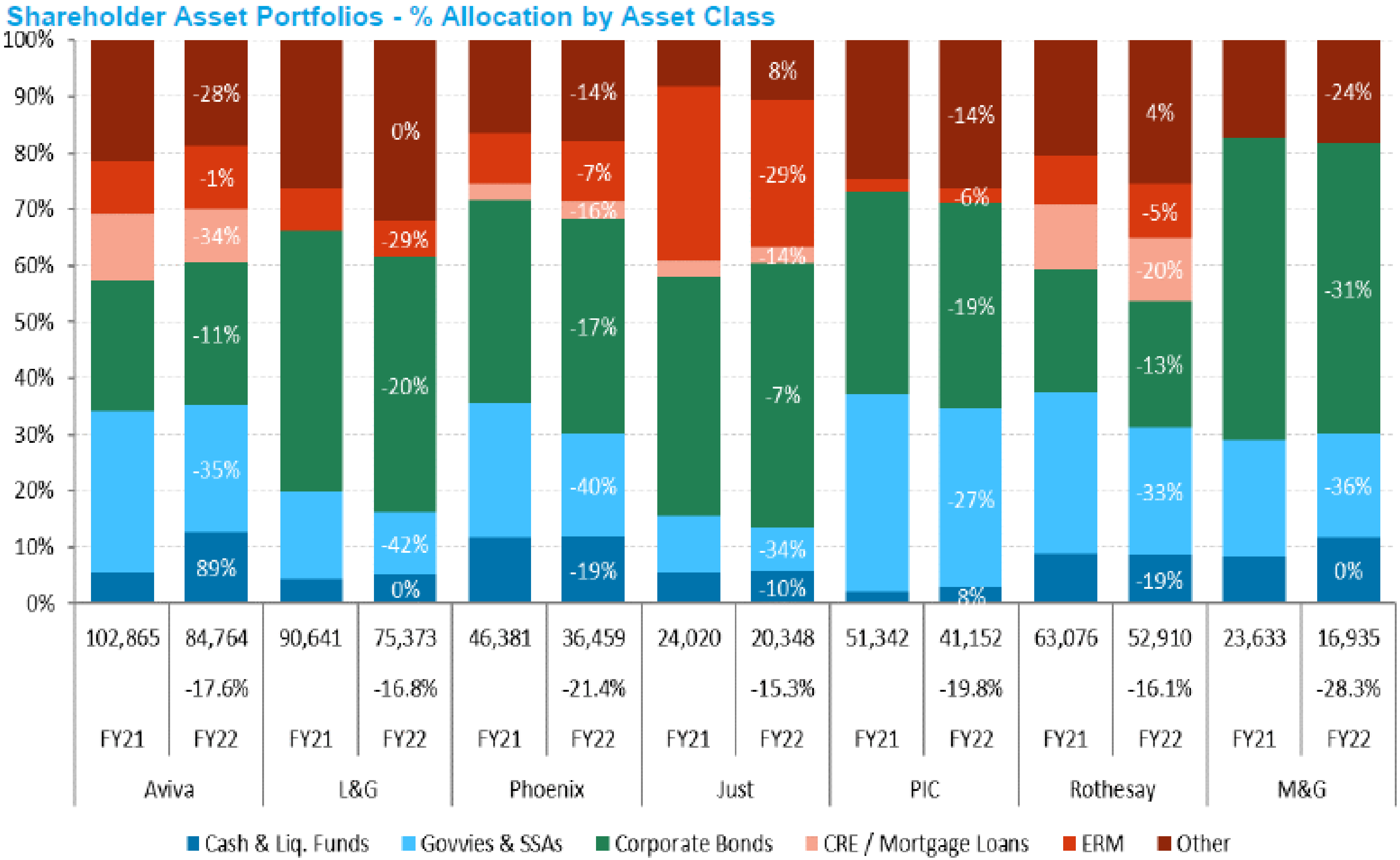
- Encouraging DC consolidation also makes sense but diversification and scale will persist as issues.

- For the DB system, any policy choice that does not address: (i) fragmentation and small scale, (ii) the distortive impact on asset allocation of the corporate link, and (iii) funds' finite time horizon, will be insufficient to put the system on a sound basis for the future.

- Any scheme that pre-supposes higher returns and therefore surplus generation from within the existing system lacks the three crucial ingredients above and will therefore be ineffective.

- The PPF – while not the only solution – is well established, well governed and has proven its ability to act as a successful consolidator and, through its demonstrated ability to generate surplus, clearly reduces the probability of BoE/taxpayer support (as was required for the DB system last September), and does so on a non-profit basis.

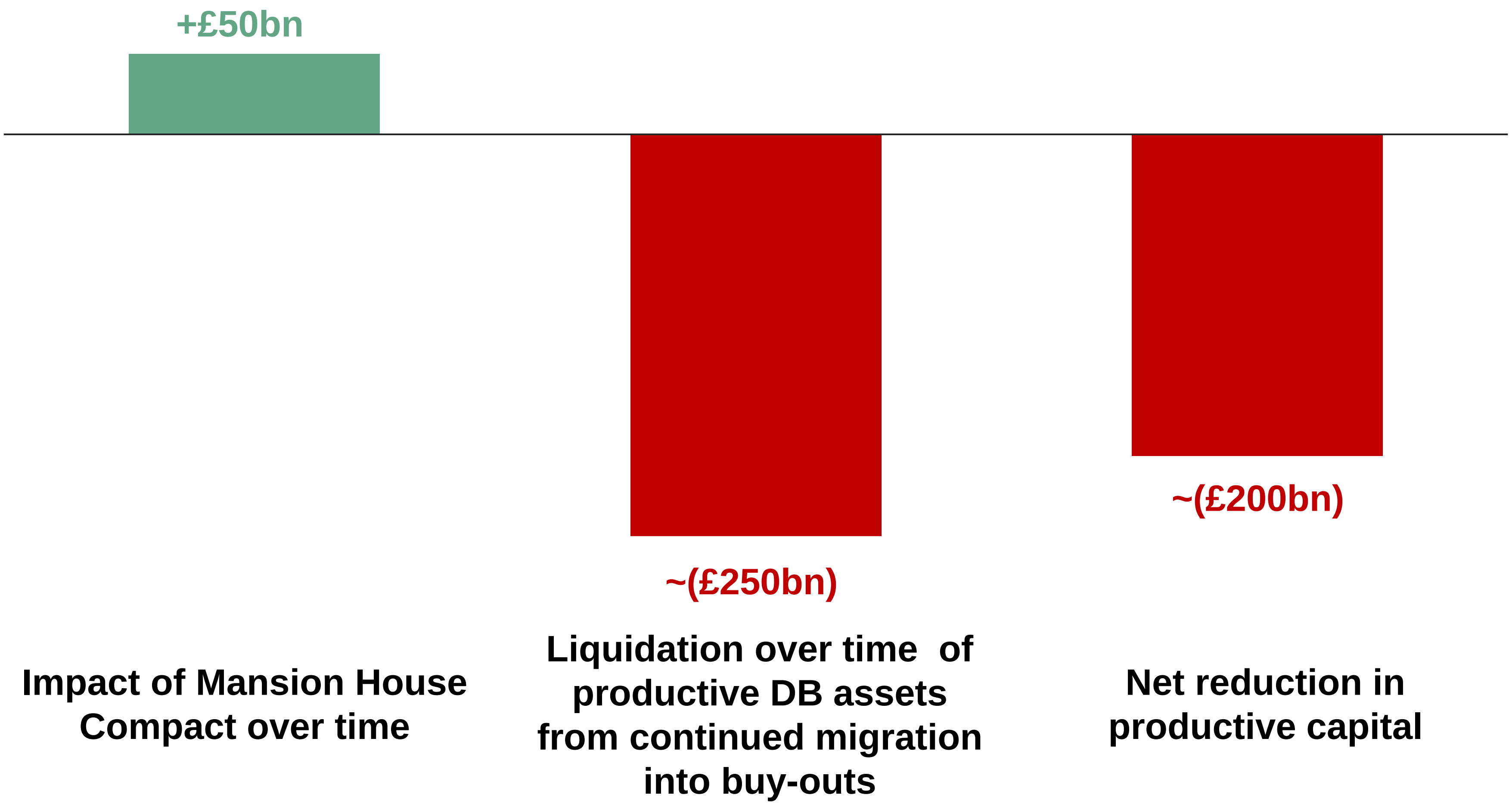
Asset portfolio of buyout universe – total liquidation of equities and even gilts



Source: Company disclosures, MS UK Life & Pension Sales

Whatever new capital flows in over time to productive investment will be swamped by the liquidation outflow that follows migration to buy-outs

New Financial data



Concluding observations

- Last September’s DB system induced gilts crisis exposed the perverse consequences of the attempt to “eliminate” risk, which is of course not possible.

- The level of awareness also created a historic opportunity for a fresh start and a licence to modernize the DB system by thinking beyond the confines of its existing fragmented and archaic structure.

- This body is uniquely positioned to influence both the debate and policy and a public recognition of the current system’s fundamental flaws would be a good place to start.

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