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Good Practices in Social Security

Good practice in operation since: 2007

Limiting financial losses at time of crisis through active portfolio management

A case of the Labour Market Supplementary Pensions Institution

Labour Market Supplementary Pensions Institution
(Arbejdsmarkedets Tillaegspension (ATP))
Denmark

Published 2010 **www.issa.int**

Summary

Since the start of the financial crisis in 2007, many social security institutions in the industrialized world have suffered significant financial losses. The outcome has been the loss of several years of potential pension income and a loss of confidence. Nevertheless in spite of the near across-the-board losses experienced by these funds, the approach and experience of the Labour Market Supplementary Pensions Institution (Arbejdsmarkedets Tillaegspension (ATP)) stands out as an exemplary model of good practice. The experience of the ATP demonstrates that the effect of financial crisis does not have to be as catastrophic as it might first appear. With a sound approach comprised of active portfolio management and the use of appropriate financial instruments, the ATP has been able to emerge from the crisis relatively unscathed by keeping losses to a minimum. Of course, the ATP method cannot be assumed to be one hundred percent water-tight in all contexts. Nonetheless, it is suggestive of what might constitute an appropriate crisis approach that can be replicated by other similar institutions.

CRITERIA 1:

What was the issue/problem/challenge addressed by your good practice?

The financial-turned-economic crisis that began in 2007 delivered a tumultuous couple of years for the financial world, sending many financial institutions and governments into a tail spin and disarray. As one might expect with such a pervasive crisis, social security institutions also fell victim to its contagion. A large number of these institutions witnessed a sharp contraction of their asset portfolio values, jeopardizing the future retirement income prospects of individuals, especially those close to retirement age. For example, the losses suffered by institutions in the industrialised countries in 2008 ranged from -29.5 per cent to -3.2 per cent.

While most industrialised funds have recovered in terms of positing positive investment returns, it is important to identify how such dramatic losses can be avoided in the future so as to ensure continued financial security. Arguably, the strategy of the Danish pensions' institution ATP provides an example of good practice which can help social security institutions ensure fund security.

Foreseeing in 2007 the potential damage that could be wrought by the approaching crisis, the ATP took a conscious decision to actively manage its funds in such a way that would render them less exposed to risk. As a result, the ATP suffered a mere -3.2 per cent loss on its fund's returns during 2008. Compared with its peers, who faired much worse, this was a rather moderate loss.

This moderate loss was thanks to the ATP's active portfolio management approach which made use of extensive financial instruments to stem the hemorrhaging of fund revenue. This active approach was *inter alia* applied in a context where the crisis had generated pressure on the Danish Krone (DKK). Consequently, the ATP reallocated a large portion of its assets from foreign securities to DKK assets. Thus ATP extraordinarily invested more than 40 billion DKK in Danish banks and purchased new 30-year bonds with more than 50 billion DKK. In this connection, ATP sold foreign currency worth 80 billion DKK. The major reallocation of its investment portfolio, instigated before the crisis began to really bite, in combination with a targeted use of financial instruments, protected the ATP from sustaining greater losses in the extreme market situation. Thus, this active portfolio management approach can serve as an example of good practice for social security institutions when they find themselves in a similar situation.

CRITERIA 2:

What were the main objectives and the expected outcomes?

During the Technical Seminar on Social Security in Times of Crisis: Impact, Challenges and Responses, held by the ISSA in April 2009, and in the ATP's 2008 annual report it set out its key objectives for confronting the crisis and the outcomes such objectives were expected to deliver:

Objective 1: To ensure basic financial security for all of Denmark.

Objective 2: To encourage investment activity oriented to preserving the long-term purchasing power of ATP pensions.

Objective 3: To protect ATP's solvency.

Objective 4: To hedge uncompensated risks.

- Interest rate risk
- Foreign exchange rate risk.

Objective 5: To diversify aggressively (and take into account "Black Swans" and other tail risks i.e. the need to run drastic risk scenarios in order to understand how an institution might cope in the face of a crisis).

Expected outcomes:
The main overarching expected outcomes of these objectives were to avoid large losses and earn the highest possible real value on future pensions.

CRITERIA 3:

What is the innovative approach/strategy followed to achieve the objectives?

The ingredients for the ATP's successful approach have included the following:

1. The hedging of uncompensated risks by hedging risks of adverse changes in the value of liabilities. The hedge is lodged in a separate portfolio. The investment risk is lodged in the investment portfolio, which consists of an Alpha and Beta portfolio with separate management and risk budget:

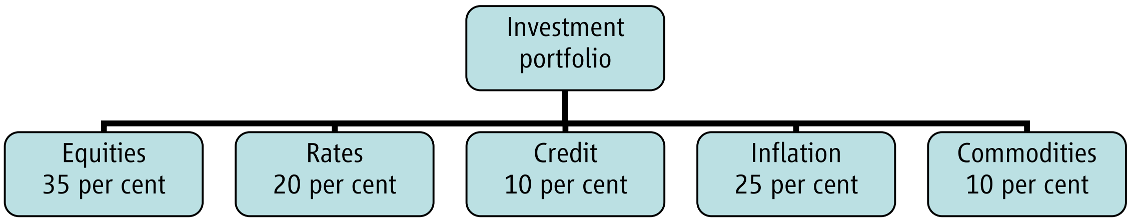
    - α: Short-horizon investment strategies – relative price change;

- *β:* Long-horizon investment strategies – market risk premia, true diversification, active.

Both portfolios have an absolute return target resulting in:

- full alignment with members' interests;
- farewell to benchmarks.

2. **Aggressive diversification and reallocation of portfolios.** The investment portfolio is invested in risk classes with very different return profiles in different economic environments.



- Each of the five risk classes contributes substantially to returns.
- Portfolio expected to be robust in a broad range of environments.
- Reduced risk of large losses.
- Higher risk-adjusted return.

3. **Running appropriately drastic risk scenarios** (i.e. remaining mindful of Black swans and other such grave contexts) in order to anticipate what the losses could be when a crisis hits and thus limit potential losses.

CRITERIA 4:

Have the resources and inputs been used in an optimal way to implement the practice?

The portfolio management is run by a small team with clear objectives and substantial discretionary power to adjust the portfolio according to the current environment. This power has been used to its full extent to ensure that the objectives of the fund were met.

CRITERIA 5:

What impact/results have been achieved so far?

The way the ATP rode out the crisis was testament to the effectiveness of its approach. In isolation, the ATP's results (i.e. a negative 25.7 billion DKK after bonus additions) were not satisfactory. However, in a contextual comparison, we can see that the ATP's management of its funds was effective. For example, the Irish National Pensions Reserve Fund suffered losses of -29.5 per cent in 2008. Likewise, the oscillating fortunes of the French *Fond de Reserve pour les*

Retraites tells a similar story; albeit perhaps marginally less drastic. In 2008 this fund experienced a loss of -24.8 per cent on its returns. These examples cast the ATP loss of -3.2 per cent in quite a successful light, considering that most other industrialised countries experienced losses of at least -15 per cent on their funds. Thus, the ATP has proved particularly adept at keeping its losses to a minimum.

And more recently, its active portfolio approach was vindicated further, as it seems that the ATP has turned this negative result around by returning a positive 3 per cent performance for its first semester results at the end of June 2009. It seems that the use of financial instruments had a positive impact on both risk management and earning capacity. The main reason the ATP was able to contain the loss at 21.4 billion DKK in the face of adverse market conditions was the hedging of the equity portfolio through the purchase of financial instruments.

Furthermore, the lion's share of the investment-activity loss is attributable to the historic drops in equity prices seen in 2008. Overall, equity-related returns for the year were a negative 22.5 billion DKK, equivalent to a loss of 31.3 per cent. The loss recorded by ATP should be seen in the context of losses of more than 40 per cent in most equity markets. Again, the reason that ATP managed to contain its equity losses is based on the gain realized on financial instruments purchased for hedging part of the ATP's equity exposure.

In addition, despite the negative investment activity results of 2008, ATP's reserves – the bonus potential – were sufficient to increase all current and future pensions by 2 per cent at the start of 2009. After the pension increase, ATP's reserves, the bonus potential, totaled 47.5 billion DKK.

CRITERIA 6:

What lessons have been learned from the introduction of this good practice?

In order for social security institutions to ride out a crisis in a smooth and risk-free way, good prior planning is required, along with proactive and reactive approaches to the management of funds. With the right approach it is possible to retain a pension system with a high degree of security and predictability for the individual.

Key lessons that have been learned include the following:

- It is imperative in the long run to hedge uncompensated risks;
- it is important to diversify portfolios;
- it is necessary to focus on investment tail risks;
- hundred year storms happen every 2-3 years;
- need for adequate regulation.

CRITERIA 7:

To what extent would your good practice be appropriate for replication by other social security institutions?

Within many of the industrialized nations, there is considerable scope for the replication of the good practice outlined here. Providing there are no limits on foreign investment (such as those that apply to the Jordanian SS fund), there should be considerable opportunity for the diversification of portfolios. The approach of the ATP may also be conditional on the availability of adequate opportunities for national investment (i.e. government backed bonds).