Managing collective assets

1. One scandal, or more?

A storm of protest swept across Switzerland in the summer of 2006, when a merger between two banks became the object of a campaign enthusiastically orchestrated by the media. The merger process itself has become a matter for the courts, as a minority shareholder believes he has been disadvantaged. Although the legal verdict is still outstanding, another verdict has already been reached – one party has already been pronounced guilty in the court of public opinion. As a result, a new and generally successful bank has been destroyed and a perhaps excessively sophisticated entrepreneur ground into the dirt. In a country where mediocrity is the greatest virtue, it is easy enough to unleash envy and jealousy against upstarts.

Because the pension fund he managed was involved in the merger, the head of investments of the pension fund of an industrial company was also caught up in the media campaign. The fund in question enjoyed robust financial health, with a coverage ratio of over 140 percent, and one might expect the beneficiaries to be grateful to their asset manager for achieving a return on investment of well over 10 percent for years on end. But what public opinion found more interesting, and indeed shocking, was the manager's private affairs. For, as the resourceful journalists discovered, his assets had risen in less than 20 years to no less than 68 million francs. Quite unacceptable for someone who was ultimately no more than a humble employee – what a scandal!

Scandal? Humbug. Such asset development is by no means impossible – at most, improbable. Let us assume that, for whatever reason, the person has funds of 2 million francs at his disposal at the beginning of 1992. In the unshakeable conviction that share prices will rise, he invests the money on the Swiss stock exchange, not merely 100 percent, but with an additional 50 percent leverage. He gets out at the right moment in 2000, and back in again, also at the right moment, in 2003. With astonishing prophetic gifts, he does everything exactly right (as mentioned, improbability is an option …) On this basis, his assets would currently amount to some 60 million francs – not that far off the published sum. What actually happened may well have been somewhat different, but such asset development is not entirely impossible, and to that extent, a fellow citizen has been subjected to injustice, out of envy and ignorance, that can hardly be made good again.

The improbability of the wondrous multiplication of assets gives rise, in addition to envy and ignorance, to entirely justified feelings of unease with regard to the way pension funds, and thus not personal, but third-party assets, are managed in this country. The involvement of pension funds in fairly intransparent takeovers, significant holdings of high-risk stocks, a remarkable degree of participation in IPOs, dubious submission practices on the property market, commission payments of every variety, indirect advantages and generous gifts to principals – there are too many shady symptoms for it to be possible to return to day-to-day business with a mere shrug of the shoulders.

On a previous occasion (Investment Commentary No. 243) we pointed out that Switzerland, unlike its neighbors Germany, France and Italy, has, in the form of its substantial pension fund assets, a strategic advantage that should not be underestimated with regard to the demographic challenges of the coming decades. Iceland, Ireland, England, the Netherlands, Norway and Switzerland are the only countries in Europe whose aging retired population are not almost exclusively dependent on the pay-as-you-go contributions of a (shrinking) active generation, but rather can cover part of their costs from their accumulated capital and the income from it. The governance of this strategic advantage is thus of extreme importance. The undesirable consequences and side-effects for our society of the management of this enormous amount of money cannot be a matter of indifference. Any signs of corruption – large or small – would be disastrous, as they would (and there are already indications of this) result in the further bureaucratization of this element of national assets. Still less a matter of indifference would be any inadequate returns for structural reasons.

Pension fund assets are extremely long-term investments; every tenth of a percent of lost return results in a compounded loss running into the billions.

This Investment Commentary is devoted to as thorough a review of the topic as possible. We shall see that, for historical and political reasons, the structure of our occupational pension system is far removed from an ideal that is entirely conceivable. As a result, we are obliged to accept any amount of undesirable inefficiency as part of the situation. Such inefficiencies will always produce scandals, or, if a rigorous attempt is made to prevent them, will necessitate expensive control systems, which will inevitably result in reduced returns. One issue is the extent to which one can get outside the structures, and thus, in private at least, compensate in part for the reduced returns. We shall also see that the pension fund manager we have already mentioned was in the wrong job. He should have been a hedge fund manager. Then he would have been left in peace, with no aerial photography of his mega-villa in the Canton of Thurgau.

This Investment Commentary is devoted to as thorough a review of the topic as possible. This review is based on the Swiss pension system, but we believe that our conclusions can equally be applied to other systems. We shall see that, for historical and political reasons, the structure of our occupational pension system is far removed from an ideal that is entirely conceivable. As a result, we are obliged to accept any amount of undesirable inefficiency as part of the situation.

2. The carefree cricket

What is a pension fund, and what are pension fund assets? The customary, socio-politically motivated response in Switzerland is roughly as follows: pension funds are assets funded jointly by employer and employee and controlled by the state, with the aim of providing pensions on a basis of solidarity. Economics would answer the question rather differently: a pension fund is an institution for the collection and management of compulsory savings contributions with the aim of providing the beneficiaries with a solidarity-based pension or lump sum on retirement, in accordance with easily adjusted regulations and subject to influence from political bodies. The tax-advantaged compulsory saving has to be done via the current employer, who thus also has joint determination in the pension fund bodies.

The insight that the second pillar of the pension system is an institution of compulsory character is of great consequence for the entire discussion. The legislation dictates that saving must take place. It prescribes (in the so-called obligatory part) how much *must* be saved and it also provides (in the so-called super-obligatory part) a window of opportunity in which tax-advantaged saving *may* take place. It also determines *how* saving is to occur, inasmuch as it attempts, by means of investment guidelines and appropriate controls, to ensure orderly portfolios. Furthermore, the pay-out process is also fixed, or the authorities have some room for maneuver in the pension conversion rate, to be able to do some redistribution across the generations. Now, one could of course regard this compulsory nature, in serf-like fashion, as a more or less divine ordinance. In our view, however, it is appropriate not only to recognize it as a significant fact, but also to ask how on earth our legislators came up with the idea of issuing their citizens with rules and regulations governing such a personal and private matter as saving for their retirement.

Compulsory saving has ethical, socio-political and economic roots. Western ethics in general regard saving a good thing per se. In La Fontaine's fable, the ant may seem to us to be rather hard-hearted, but he is utterly serious. The cricket on the other hand, which has spent the whole summer long chirping and singing, instead of accumulating and saving resources, strikes us as wholly frivolous and negligent. The family-based pension provision that prevailed for thousands of years required a disciplined ethic that has remained largely unshaken by the gospels' exhortation to take no care for the morrow ("Take therefore no thought for the morrow … Behold the fowls of the air: for they sow not …"). Ne'er-do-wells and the lackadaisical had no place in the largely self-sufficient family and village structures: the role model absolutely had to be the industrious ant, and not the carefree cricket. The ethical inclination to saving still obtains today, as when it is said of the Americans, for example, that "they save too little", or of urban youth that "all they can do is consume". And experience teaches that the step from ethical norms to compulsion by law is a small one.

The socio-political roots of compulsory saving lie in the transition from self-sufficient family and village structures to an industrial society. The factories needed freely available labor, that was mobile and not bound to any village structure. In addition to the undoubted presence of paternalistic ethical considerations, labor market calculations no doubt also lay behind the employers' interest in the development of social institutions. The concept, or, from an economic perspective, the fiction of parity in the provision of compul-

sory savings contributions is rooted in this socio-political constellation, as is the absence of any freedom in the choice of fund, which by its nature is enormously employer-friendly.

The third, economic root lies in the national economic models that became popular particularly in the 1930s. Savings play an important role in the concept of GDP: in the fairly closed national economies of the time, investments, together with private and state consumption, made up the asset side of the national balance sheet, and, omitting foreign contributions, represented domestic savings. In today's much more open economies things are no longer so simple. But the pattern of the link between savings and investment persists, and of course still applies, taken with a grain of salt: aggregated (domestic) savings are required to finance investment and service national debt, to the extent that these cannot be financed from abroad. This positive, determinative model rapidly changed into a normative one: because domestic savings are required to finance investments, someone must see that enough saving takes place. The savings rate can be influenced by the interest rates, or, alternatively, by means of compulsory saving. Thus, also from the perspective of macroeconomic feasibility, saving is "a good thing" .

Thus, although saving is always primarily a matter that concerns the private individual – who must personally refrain from consumption in order to save – the normative element is highly developed in this area; even more so indeed than in other areas of personal concern, such as healthcare, married life, and such unhealthy occupations as drinking. It is important to be aware of this fact in considering the pension system. The probability of any abandonment of the compulsory element is, and will remain, extremely small. The compulsory element must thus be accepted, for better or worse, as a prevailing condition. This sin against the political order does however have its price. A significant part of (what are essentially private) national assets come under the partial responsibility of, and are thus exposed to intervention by, the state. The state attempts to meet this obligation by means of a collective investment vehicle sui generis, the pension fund. This specific collective investment vehicle exists alongside a wide variety of other collective investment vehicles, such as life insurance, investment funds, fund-based savings schemes, investment companies, hedge funds and many others. Their economic origins, however, lie not in compulsory savings, but in voluntary asset development, and because this is the case, investors have a free choice of vehicle, and can (more or less) easily shift from one to another. We shall return to the differing constellations of compulsory and voluntary activity at the end of the Commentary. First however, we need to revisit the world of the ant and the cricket.

3. Hard-hearted ant or carefree cricket?

Apart from macroeconomic considerations, there are also other serious, more microeconomic, arguments that seem to advocate a degree of compulsion about saving. To the extent that we – that is, society – are not prepared to be as hard-hearted as the ant, which, as we recall, turned the starving cricket from its door, there does need to be a reserve in place that can, if need be, ensure the survival of both ant and cricket. Or, with rather more specific reference to retirement pensions: if it is desired to use society's means to avoid individual distress in old age, there is no way round some sort of transfer mechanism. This transfer may occur on a basis of complete solidarity, "from ant to ant", so to speak, with the balance being adjusted between longer and shorter-lived examples of the species, or it may take place "from ant to cricket", in that the rich finance the pensions of the poor. The latter approach is practiced extensively in Switzerland by means of the state retirement pension (Alters- und Hinterlassenenversicherung, or AHV), which is structured as a progressive tax on wealth. There is no objection to this in principle, at least inasmuch as there do indeed tend to be industrious ants among the poor, who are nevertheless unable to gather reserves, and chirping crickets among the rich, who are in a position to still be happily chirping away in a hundred years time. Thus far, the principle appears just and justified, but only thus far. For the problem is that the knowledge of the availability of extensive reserves causes the cricket population to expand, and attracts crickets from far and wide. Herein lies the moral hazard of the welfare state. It can only continue to function as long as the ants are not put off by the idea of continually having to amass reserves for others, and do not simply walk away. Hello Germany!

With regard to pension systems, we need to be clear that there is no need for compulsory saving on the grounds of an actual or supposed need for transfer mechanisms between rich and poor, so long as the state pension is in a position to prevent distress among the aged. There remains, however, the oft-heard argument that people, and particularly the young, are not able themselves to plan their affairs so far in advance. Thus, not only at national but also at individual level, there would be "too little" saved if things were left to take their course. It may well be, though, that

there are individual preferences and differing levels of intelligence regarding pension planning, and it may also be that there are self-destructive behaviors in the area of pensions, just as there are smokers, drinkers and gluttons who put momentary pleasure above its long-term consequences. Whether or not people should be protected against themselves is a philosophical question. It seems to be part of the unquestioned self-image of the Western welfare state that it not only attempts to relieve the distress of its citizens, but also aspires to preserve the standard of living they have achieved, at the price of fairly fundamental interventions in property rights and freedom of disposition.

4. Compulsion – where; how much?

If, then, we accept as a given that the welfare state enforces saving, and we also accept that the relevant institutions have grown historically, we are nevertheless entitled to ask structural questions. For example, concerning the parity between employer and employee. In economic terms it is quite clear and indeed unchallenged that pension contributions are by no means paid half-and-half by both sides – that is by employee and employer – but make up part of the employee's overall entitlement. Whether his or her employment is justified, and whether his or her wage corresponds to the productivity in question can be determined on the basis of the overall entitlement; it would thus be wrong or illusory to falsify the market value of any job performance by any pension fund contributions. This makes it quite clear who the pension funds belong to: the beneficiaries, as the ultimate recipients of future pensions or lump-sum payments. Employers can expect nothing from pension funds.

This is painful to the extent that most pension funds have a paternalistic history: founded on a voluntary basis, mostly as occupational pension funds, and originally funded with genuine employer contributions. The legal entitlement of the employees has however brought about an irrevocable right of ownership for the beneficiaries. We suspect that part of the problem with pension funds is the excessive distance between the owners and their property. There are too many "agents", ultimately uninvolved or with other interests, in the procession; there is no way that responsibilities can be fulfilled in such a process. It may be objected that the problem with the supervisory boards often lies precisely in the lack of knowledge and commitment on the part of the employees' representatives, while the employers (or, in fact, usually just the Finance Director …) effectively dictate what happens. This is to confuse cause and effect. Lack of quality within the supervisory board is the effect and not the cause of the fact that the body cannot function on the basis of parity. For responsibility cannot be shared, but only delegated.

The traditional proximity of pension funds to the employers is most obvious in the (rapidly falling number of) funds that calculate their pension entitlement according to the so-called "final salary" principle ("Leistungsprimat"). This means that the fund's pension liability is determined, not by the aggregated total contributions, but by the external factor of the final salary (a defined benefit pension scheme). In economic terms, this represents an option written by the employer for the employee on the final salary, something the employee can influence only to a limited degree. In exchange, the employer receives an option on the potential investment income. The value of these options causes headaches, particularly on the balance sheets of the businesses in question, as the necessary reserves are extremely difficult to calculate, and liable to fluctuate severely under the influence of changes in financial indicators such as interest rates, forecast returns, expected inflation and possible wage increases. Their calculation requires the employment of hordes of actuaries and auditors, and completely overtaxed finance directors, executive boards, audit committees and boards of directors have to take decisions on matters they barely comprehend. Once again: poorly chosen structures have their price. The fact that final-salary schemes are on their way out in Switzerland is at least a small glimmer of hope. But only a small one. For the Swiss version of the contribution-based system ("Beitragsprimat")represents a type of final-salary system, given the specification of a minimum rate of interest.

A further structural question concerns the freedom of choice of pension fund. If the employer plays no role in the pension system, there is then no justification for any constraints on freedom of choice between pension funds. The delegation of responsibility by the owners might, for example, result in the emergence over time of several large cost-efficient institutions in free and open competition with each other. Such open competition could have a beneficial impact on both the statutory range of benefits and the return on investment, on the size of pensions and lump-sum payments – given due regulation with rigorous standards to prevent the infringement of property rights of the various generations of beneficiaries, or of individual beneficiaries. The security of small co-owners or of weak groups of co-owners

in collective vehicles is of decisive importance, and that is what state supervision should focus on.

The question is, of course, whether we ultimately trust the power of competition. Not that far, apparently. Thus, this spring, the Swiss government definitively rejected the option of a free choice of pension fund. As arguments against deregulation, they offered "higher costs" and the "destabilization of the system", without wasting a single word on the higher returns on investment that could undoubtedly be expected. How did the Federal Council reach this decision? It was, and is, advised on pension issues by an "expert" body, composed almost entirely of representatives of the production side. A classic mercantilist set-up then, that would obviously never opt for competition. This is a serious matter when we consider what the long-term impact would be of even just one additional percent of return on investment (and also of lower management costs, which contrary to the opinion of the "experts", would also be expected if there were fewer, more efficiently run funds). If the average return on his investment is 3½ rather than 2½ percent, for a beneficiary who today at the age of 30 earns 8,000 francs gross a month, and for simplicity's sake earns the same till he is 65, this represents an additional 120,000 francs on his old age pension of 570,000 francs. That is a lot of money for the individual, but in aggregate it is a great deal more money for the whole country. How the current 650 billion francs or so of the accumulated state pension capital is managed, and whether it generates more or less income, is not insignificant for the prosperity of our country. This is a matter of many billions of national assets that a badly advised body can put at risk with a stroke of the pen. The younger the beneficiary, the harder hit, as the compound interest impact has the greatest effect in the long term. Thus, the great national outcry should not have occurred only in summer 2006, on the discovery of the assumed enrichment of individual pension fund managers, but already in the spring, when the far more significant negative decision on the free choice of funds was taken by the Federal Council. And the outcry should have come not from the media, but from young employees. Obviously there is no party or trades union that takes up their concerns. It's easier to get votes from the older generation.

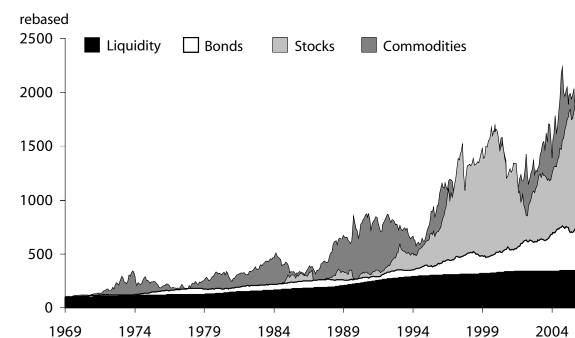
Given the current situation, it would be entirely illusory to expect any rapid and radical improvement of the structural defects of the Swiss pension system. The fiction of parity is far too firmly anchored, and pretty much belongs among the mantras of bourgeois identity. Free choice between pension funds, on the other hand, would require both the abandonment of this fiction, and a commitment to competition – an entirely absurd idea, given the current political constellation. So, we must accept the structural defects as part of the prevailing set-up.

5. The time horizon is key

Pension funds' assets represent the asset side of a balance sheet against which are set, on the liability side, a variety of future pension or lump-sum payment obligations. These liabilities can vary widely, depending on the fund. An "old" fund must above all pay out pensions to its retired beneficiaries. To do this, it must generate as constant cash-flows as possible, and invest its capital with as little risk as possible, as payments will soon become due. Its selection possibilities, from the whole range of financial instruments, are severely restricted. For younger beneficiaries, there is a significantly greater degree of freedom, as their obligations are still far off, so that the capital can withstand higher fluctuations, such as are associated with financial instruments delivering higher returns.

The figure below shows the fluctuations in four investment categories – liquid assets, bonds, stocks and commodities – over the last 36 years. The varying characteristics are clearly shown. While the value of liquid assets fluctuates hardly at all, and that of bonds only slightly, stock and commodity prices reveal a series of peaks and troughs. As it is impossible to tell, when making an investment, whether one is at any given moment down in the trough or up on the peak, it is essential to have sufficient time available to get through the next dip.

A roller-coaster ride, with a rising trend



Source: Datastream, analysis

Note: 1969=100

Many pension funds are ideally positioned to operate with a very long-term investment horizon. However, the legal solvency requirements act against this to the extent that the required coverage is calculated from a liquidity perspective – as if all liabilities fell due on a given date, regardless

how young or old the individual beneficiaries are. This does of course correspond to the precautionary principle, which is undoubtedly appropriate for semi-state institutions. De facto, however, it results in an insufficient risk appetite on the part of the pension funds for their younger beneficiaries. At 25, 35, and perhaps even 45, one may well be able to accept a stock exposure of up to 100 percent. But most funds limit their strategic allocation to stocks to between 25 and 40 percent, and many advisory boards and pension fund managers have great problems in managing even this low proportion of stocks satisfactorily in the face of recurring financial market crises, as the legally stipulated minimum interest rate remains a threatening presence in the background. In practice, then, annual or quarterly optimizations take place with far too short-term an investment horizon. What results is an average return on investment that is utterly inadequate for younger beneficiaries.

This constricting corset must be accepted as a condition, unless and until the fundamental structure of the pension system is changed. The most recent revision of the federal legislation governing occupational retirement, bereavement and invalidity pensions (BVG) does at least enable a limited number of people to get out with part of their pension fund assets. If the statutes of the fund permit it (which can by no means be taken for granted) then a part (sic) of the super-obligatory part of individual pension fund assets – i.e. the funds contributed over and above the compulsory savings component – may be managed by the beneficiary personally. As pension funds for retirement, however, the assets are not available for free disposal, so that this individual management must be done via a specific vehicle, provided exclusively for this purpose. Despite the fact that the revised legislation does not stipulate this in so many words, according to the Federal Office for Social Security the same investment regulations apply to the management of these assets as to other BVG funds, such as, for example, a maximum proportion of stocks of 50 percent. This is of course idiotic, but must also be accepted as a prevailing condition.

In our view, despite all these constraints, it is still worth exploiting this new room for maneuver. Our bank offers solutions for such super-obligatory escape attempts, such as the PensFlex foundation, in which the individual vehicles can be managed as sub-foundations, cost-efficiently and, unlike collective pension fund assets, completely transparently. Our investment method allows the funds to be managed efficiently, which is important, as it can obviously not be the case that bank charges ultimately consume the expected increased returns while the higher risk must still be borne one-to-one. The use of index-linked products is essential on cost grounds, particularly for relatively small assets.

6. Chinese and Indian support for the aging Swiss

The room for maneuver permitted by the legislation may only be a drop in the bucket, but it does at least make it possible to do, at the individual level and with part of one's pension fund assets, what regulation prevents pension fund managers from doing. Taking an overall view, however, it must still be said that the really impressive Swiss BVG assets of currently some 650 billion francs are probably wrongly allocated, to the detriment of our prosperity. And this not only because far too little stock-related risk is incurred, due the regulatory requirement for a short-term investment horizon. More importantly, because of the liquidity perspective and the investment stipulations of the legislation, the investments are far too strongly oriented on the domestic economy, its currency and its investment opportunities. Or, in the jargon, the home bias is too great, with the result that Switzerland and neighboring Europe represent a risk cluster for Swiss pension fund assets.

Given that Europe, including Switzerland, will experience a dramatic aging process over the next 50 years, this is utterly foolhardy. For it might well be, indeed it is fairly probable, that as our societies age, not only will our economies shrink relative to other younger, up-and-coming economies, but so will our capital investments, and perhaps also our real estate markets. If we reach the point when, because of the pay-as-you-go system, we are dependent on the performance of the domestic economy for the basic security part of our pensions, the retirement and bereavement pension (AHV) – which will represent a serious risk cluster – then the pension funds will have to compensate for this in some way.

The global financial markets offer a wide range of possibilities here. Risk is not reduced by giving preference to domestic investments, but by encouraging more global allocation. All over the world, there is a large number of investment opportunities whose returns are little correlated, if at all. A mix of such investments based on the best insights from financial theory would probably be far lower-risk in the long-term than the preference for government bonds of Swiss or, if need be, European origin that is induced by the BVG.

In the coming years there will be regions of the world, in which masses of unemployed labor wait for work and unused land waits to be put to use, that will need any amount of capital. This represents a unique global opportunity, both political and economic, to compensate, at least in part, for the problems of an aging Europe. So long as there is capital available. Unlike our neighbors, this is the case for Switzerland.

As it must be assumed that here too, there is only a marginal likelihood that this opportunity will be seized, we would point our investment clients to the so-called third way: taking appropriate action at least with that part of one's own assets that is not under the control of compulsory saving and management systems. Private assets can provide a counterbalance to the home bias of the first and second pillars of the pension system. The instruments for doing this are available, and so are the concepts.

7. Eunuch or sultan

The legal and political conditions for managing pension funds as a collective investment vehicle are one thing; the people who have to function within the system are quite another. At the start of this Commentary, we pointed to the existence of symptoms that indicate the presence of a shady environment for the pension system. To immediately nip in the bud any supposition that we may be numbered among the naive Mr Cleans who believe that they can achieve 24-carat cleanliness on a global basis, let us take a wholly disillusioned look at the microeconomic situation of any collective investment vehicle. Given that there is a large number of highly dispersed co-owners and a very small number of "managers", we inevitably encounter an immense asymmetry. Any – positive or negative – action or omission by the manager has such a marginal impact on the individual co-owner that it is only worthwhile taking any action in really crass cases. In most cases, even gathering the necessary information is hardly worthwhile. Honestly now; when did you last read the annual report of your pension fund? What was your pension fund's return on investment over the last five years? What is the breakdown of their (your!) assets?

This asymmetry also means that there is an enormous incentive for managers of any collective vehicle to commit minor, or even major "errors of judgement", to their own benefit and at the cost of the collective. The impact of even the big ones on the dispersed individual co-owners is risibly small. This applies, to make it abundantly clear, to all collective investment vehicles, including those that function in the open market: to classic investment funds, to private equity vehicles or hedge funds, to life insurers just as much as to investment companies. Which is why such major or minor "errors of judgement" undoubtedly occur here too from time to time.

With the difference, of course, that because they must survive in the open market, these vehicles, do everything possible not to lose their reputation, and so have strategies in place to demonstrate that they have the asymmetry issue under control. These strategies can be roughly divided into the eunuch principle and the sultan principle. With the eunuch principle, the manager's competences are strictly limited and rigorously controlled. The fact that governance is in order is manifested by the approval of auditors regarded as competent, and by voluntary submission to supervisory authorities such as the SEC, FSA or the Swiss Banking Commission. Elegantly designed annual reports, prestigious boards of directors, quotes published daily, and the claim that all sorts of Chinese walls are in place all contribute to a reputation of being squeaky clean. Tight constraints on own trading for the managers aim to impede the most undesirable practices – "front running" and "parallel running" (best expressed in plain English as the inverse Cinderella principle: the plums for me; the junk for the fund).

The sultan principle is diametrically opposite. Managers' own interests are internalized to the extent that they are expected to also invest a good portion of their own assets. A check on the manager's personal engagement is one of the most important due diligence checks on hedge funds and private equity companies. There is absolutely no point in front running or parallel running if the manager is really also on board and contributes a good part of the fund's assets. And collective investment vehicles that operate on the sultan principle can largely do without the insignia of approval by supervisory authorities or auditors. Indeed, they do not even need to calculate net asset value on a daily basis, never mind accepting daily redemptions. This is the world in which our unfortunate pension fund manager, who fell so foul of the media, should have been operating. No-one has any objections to a sultan's palace.

The open market for collective investment vehicles functions almost entirely unproblematically, and if an accident does happen then all the (voluntary) investor has to do is to get out and take his property with him. The "exit" sanction – selling out – is powerful enough to maintain the discipline of the system.

It is not possible, or possible only to a very limited extent, to get out of pension funds. There is no

place for sultans in pension funds, because their structure does not permit them. So where do pension fund managers belong? Undoubtedly among the eunuchs, indeed in an even more extreme form (which is where this metaphor comes to an end …), because not only do they manage a vehicle that it is almost impossible to get out of, but also one that one may never have really wanted to get into in the first place. What is absolutely unacceptable for pension fund managers is front running, parallel running, investments by the fund in illiquid instruments, personal involvement in IPOs, loans by the fund to own or related companies, the purchase of real estate from related individuals, and so on. And what would also be advisable, to prevent things going wrong, would be the maximum possible use of index-linked funds or products, both for the fund and for themselves. Which also makes sense from an investment perspective. For the chances of beating the index are small enough. For those who seek outperformance, it can always be had from those sultans who are likely to deliver it. They do exist.

KH, 9.10.2006