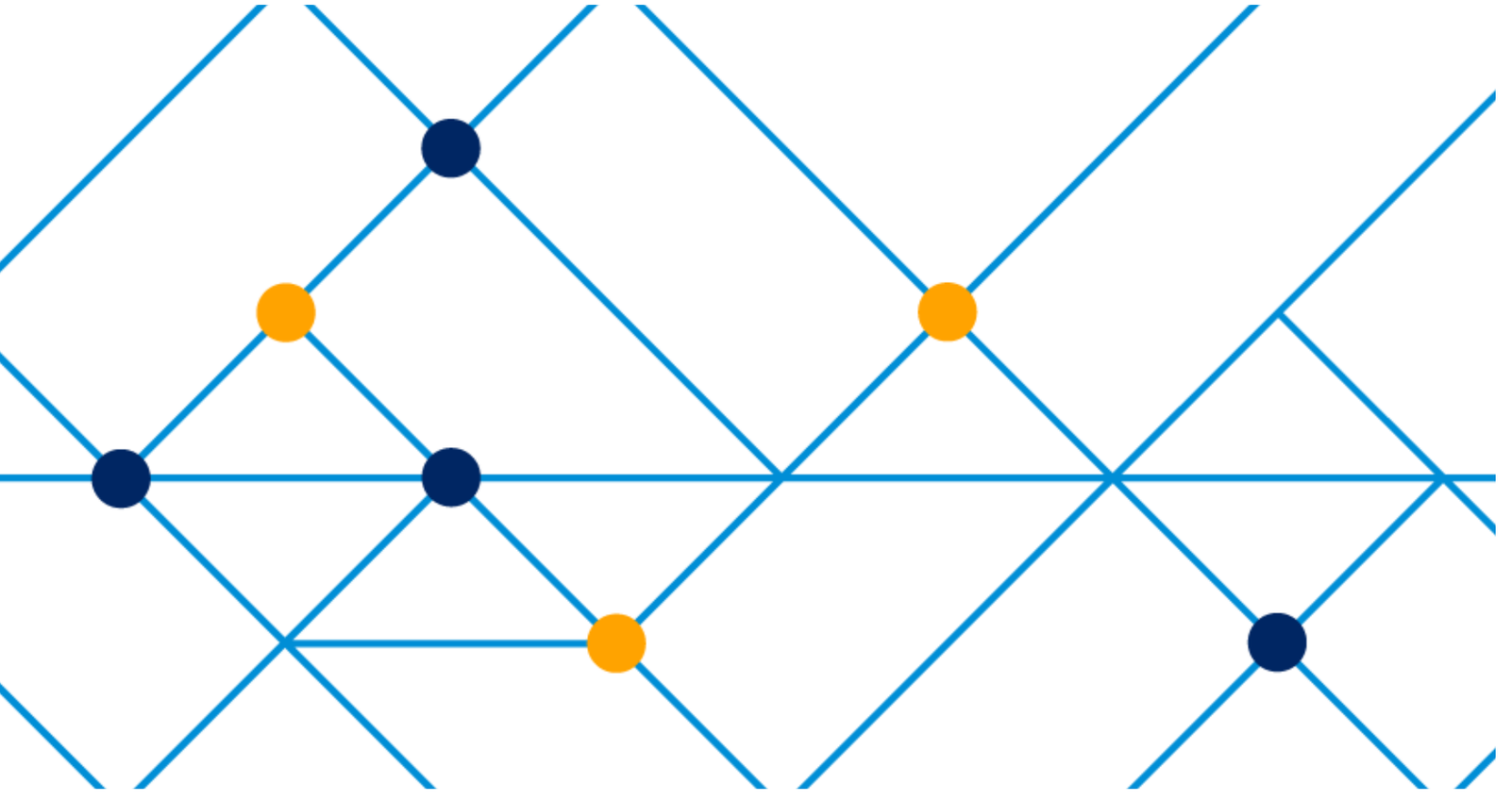
CFA Society Netherlands

DEVELOPMENT OF A BLUEPRINT TO EASE THE TRANSITION UNDER THE NEW PENSION FUND REFORM FOR ALTERNATIVE INVESTMENTS

WORKING GROUP CFA SOCIETY NETHERLANDS



In July 2022, Anne Marie Munnik and Hanneke Veringa started an initiative to form a working group to adopt recommendations to ease the transition for investments in alternatives under the new pension fund reform. Meetings of the working group have been organized thereafter and the working group developed a priority setting thereafter where portfolio construction, liquidity and valuation were identified first. Informal meetings have been organized thereafter to broader discussion on some of the issues throughout 2023.

The working group is composed of 10 members and coordinated by Hanneke Veringa.

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Executive summary

This article discusses the significant reforms in the Dutch pension system, shifting from a Defined Benefit (DB) to a Defined Contribution (DC) scheme. The reforms introduces two new regulations: the "Flexibele Premie Regeling" (FPR) and the "Solidaire Premie Regeling" (SPR), focusing on individual pension capital and collective investments.

Within the new regulation pension funds need to align their investment portfolio explicitly with participant risk preferences and adapt to new regulatory demands, which result in increased required flexibility and thorough preparation to navigate these changes successfully. The article outlines the implications of this shift across preparation, transition, and post-implementation periods. The implications for alternatives investments are subsequently subdivided in portfolio construction, liquidity management, and valuation strategies.

With the new pension system there will be a larger focus on the connection between the individual risk preferences of participants and the total investment allocation of the pension fund. This means that the underlying building blocks that make up the investments of a pension fund should be able to facilitate changes. In addition the change in regulation is expected to lead to a move to a higher risk/return profile where both appropriate risk – and return metrics and methods are recommended to be confirmed again during the preparation and implementation period. As alternatives may help in increasing both the return as well as reducing the volatility of the return, there will be a natural tendency under the new pension law to allocate more to alternatives.

The addition of additional illiquid assets to the asset allocation will require extra effort under the new pension system. In general, the FPR is expected to be more restrictive for less illiquid investments. The required degree of liquidity will most likely be higher for FPR as compared to SPR. The final degree of liquidity will have to be agreed upon between the pension fund owner, asset manager and fiduciary manager. Liquidity needs should be planned strategically with both a short-, a medium and a long term horizon by adjusting the portfolio, reviewing operational activities, such as collateral management, and managing the pay out of lump sums and the transfer of assets over the timeline.

With regards to valuation, this article highlights the importance of valuation frequency as well as review of performance metrics in combination with possible independent valuations. These metrics are becoming more important in general. They will not only facilitate the overall management, but also supporting the management of the potential for arbitraging in light of delayed “stale” valuations. It also covers the governance of valuation methodologies, the impact of market conditions during transition, and the alignment of valuations with transaction prices.

This article concludes with a discussion on the key roles of the Board and Investment Team in managing the risks and returns of alternative investments, emphasizing the need for solid governance and strategic decision-making in the transition process.

Introduction

On July 1, 2023, the Dutch senate approved a new pension law. This concluded a 15-year legislative process that saw multiple proposed changes. The new law, which essentially moves the Dutch pension fund system from a defined benefit (DB) to a defined contribution (DC) system, must be implemented by all pension funds by 2028.

Pension funds have always played a key role within employee benefits in the Netherlands. Employees and employers pay contributions so that employees receive approximately 70% of their average income earned during their employment period as a retirement benefit. The new pension fund law will make pension payments more explicitly dependent on realized investment returns going forward. This change will thus also imply that pension payments can be adjusted faster both downwards and upwards.

THE NEW PENSION SYSTEM IN A NUTSHELL

The new law creates two new pension regulations: 1) the Flexible Premieregeling (FPR) and 2) the Solidare Premieregeling (SPR). Both regulations are in essence DC systems in which the participants have their own private pension capital. The important distinction between the two types of pension regulations is that under the FPR participants in the accrual phase will have their own specific investment allocation and the pension capital will grow or diminish according to the realized returns of this investment allocation. Under the SPR the investment portfolio will remain collective.

FPR – FLEXIBLE CONTRIBUTION SCHEME

An alternative form of contract in the renewed pension system. This is the type of contract that offers the most flexibility and freedom of choice, such as lifecycle investments and social partners can opt for a solidarity reserve.

SPR – SOLIDARITY-BASED CONTRIBUTION SCHEME

This is the most solidarity-based form of contract, with more collective characteristics such as a uniform investment mix and less freedom of choice. This form of contract also includes a solidarity reserve as standard. The current projection is that a large number of pension funds will opt for the solidarity based contribution scheme.

SOLIDARITY RESERVE

The solidarity reserve is a collective buffer that a fund can use to absorb major shocks in the investment returns for a group of participants. In this way, a pension plan can distribute the investment risks as fairly as possible between current and future generations. The funding for this reserve comes from the premium and/or from the excess return. There is no solidarity reserve in the current system. There is, however, a solidarity reserve in the solidarity-based contribution scheme, one of the possible new contracts. And in the flexible contribution scheme (the other contract), whether or not to include an additional risk sharing mechanism comparable to the solidarity reserve is optional. This decision is taken by the social partners. The rules for building up and distributing the reserve must be laid down by a pension fund in advance and for a longer period of time. The maximum addition to the reserve may amount to 10% of the pension premium and/or 10% of the excess return achieved over the target return.

The evolution of the individual pension capital will, be dependent on the attribution of the return of the total portfolio on the basis of predefined "attribution rules." Both regulations imply a more profound link between the individual risk preferences of the participants and the investments of the pension fund than is the case under the current financial regulatory regime for pension funds (Financieel Toetsingskader or FTK).

FUTURE PENSIONS ACT

The Dutch Pension Act consists of three pillars. The Future Pensions Act ("Wet toekomst Pensioenen") amended the second pillar, supplementary pension, which serves as a complementary pension arrangement provided by employers. It is a supplement to the pension provided by the state (first pillar). The change in the Pensions Act will have implications for pension funds in three periods, the Preparation Period, the Transition Period, and the Post Implementation Period.[1]

PREPARATION PERIOD

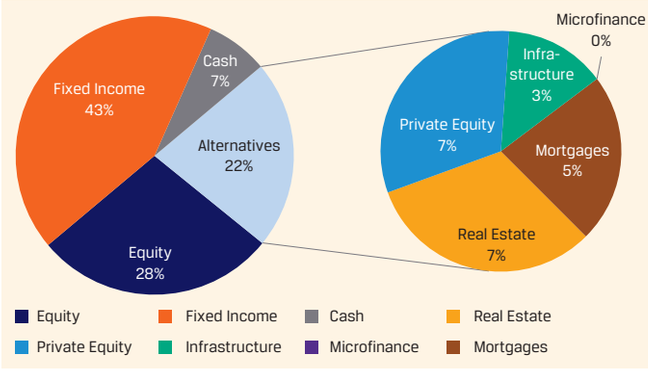
Employers and pension funds need to be well prepared for the changes required by the new pension legislation. The most significant change is that, going forward, only DC pension plans

1 With the introduction of the Future Pensions Act, several pension legislations have been amended, including:
- The Pensions Act ("Pensioenwet")
- Mandatory Participation in a Sector-wide Pension Fund Act 2000 ("Wet verplichte deelneming in een bedrijfstakpensioenfonds 2000")
- Payroll Tax Act 1964 ("Wet op de loonbelasting 1964")
- Income Tax Act 2001 ("Wet inkomstenbelasting 2001")
- Decree Implementing the Pensions Act and the Compulsory Professional Pension Schemes Act ("Besluit uitvoering Pensioenwet en Wet verplichte beroepspensioenregeling")
- Mandatory Occupational Pension Schemes Act ("Wet verplichte beroepspensioenregeling")

are allowed under Dutch law. Based on the current pension legislation, it is possible to implement three types of pension plans, namely defined benefit agreement, defined capital agreement and defined contribution agreement. After the amendment, defined benefit and defined capital agreements will not be allowed. All existing pension plans must be converted to DC agreements within the next 4 years.

The current allocation to alternatives in Dutch pension funds is approximately 20%, in combination with 25% to equities, 50% to fixed income and 5% to cash. This means that Dutch pension funds have allocated approximately EUR 322bn to alternatives according to 2Q 2023 data as published by the Dutch Central Bank. Alternatives consist mainly of large allocations to Dutch mortgages, real estate, private equity and infrastructure. The role of these asset classes, as well as the requirements for Dutch investors, should be re-evaluated in light of the new pension fund law.

Figure 1
The average investment allocation of Dutch pension funds (asset weighted)



Source: DNB

In our analysis of the impact of alternatives, we will use a wider range of asset classes, including private credit and real estate debt.

The new law will also require pension funds to complete the transfer of current DB capital to individual DC capital for individual participants in the next 3.5 years. This means the majority of assets in Dutch pension funds, currently amounting to EUR 1.5tr, will have to be divided between the participants.

As the pension law puts more emphasis on individual pension capital, what will this means for alternative investments? Adding alternative asset categories generally improves the risk-return profile of an investment allocation. However, alternatives generally also add complexity to a portfolio, as liquidity and valuation might be less straightforward.

The investment compass will increasingly move from a focus on the coverage ratio toward realized returns. We expect this will cause investment committees and boards of pension funds to amend their current investment plans. As returns will become one of the most important objectives, we expect considerations in respect to (1) volatility, (2) reporting standards and (3) composition of the returns income versus valuation returns) will grow in importance in the decision-making process.

TRANSITION PERIOD

The new pension legislation became effective on July 1, 2023. Since this is one of the most fundamental changes in Dutch pension history, the legislature has drawn up a timeline for a transition period that consists of various phases. In the first phase, the employment conditions phase, social partners must reach an agreement on the new pension scheme and are obliged to draft a transition plan. This plan needs to include information regarding the adjustment of the pension scheme with agreements on collective value transfer (conversation or "invaren"). It provides employers, current and former participants and pensioners with an overview of the decisions made and the considerations on which they are based.

The default route for pension fonds to convert accrued pensions in a SPR or FPR is a collective value transfer ("waardeoverdracht"). Pension funds can refrain from the standard of conversation when this would be "disproportionately unfavorable" to pension stakeholders or employers. The value of accrued pensions is converted into entitlements in the new contribution scheme. Normally, in the case of an internal collective value transfer, the pension fund must seek the consent of its beneficiaries. This is not required for the value transfer of the new legislation. The exclusion means that the right of – any individual – pension holder to object to the value transfer for himself does not apply.

Dutch regulators (the central bank of the Netherlands ("De Nederlandsche Bank"(DNB)) and the Netherlands Authority for the Financial Markets ("De Autoriteit Financiële Markten" (AFM)) have prepared various general guidance documents to provide employers and pension funds tools to make the transition properly. DNB drafted a template for the collective value transfer. It describes legally required elements that must be considered regarding the collective value transfer. This template will be submitted by pension funds to DNB as part of the notification of the collective value transfer. The pension fund is responsible for executing the new pension scheme and for the investment policy during and after the transition period.

In regard to asset management, there are additional activities required because there is an increased duty of care, including an obligation to offer more guidance on pension choices to participants. Additionally, pension funds are obliged to set risk reference ("risicohouding") based on, among other things, the results of a risk preference study. The risk preference study should take the new regulations into account and consider that the compass is moving from coverage ratio to expected and realized returns.

The risk preference determines the scope of the investment mix. It provides insight into what extent participants can *and* want to take investment risks and provides input for the pension fund's

investment policy. It is important that the investment policy matches participants' risk preferences.

Pension funds are advised to share financial information in the transition plan. After finalizing the transition plan, it should be made available on their website within two weeks. The AFM has announced that pension providers must publish a comprehensive explanation on their website alongside the transition plan. This explanation should list benefits as well as risks of the transition.

We envisage that the allocation to alternatives will be a regular topic within investment committees as we move closer to the deadline for implementation. In this article we propose a decision-making process consisting of six key steps: (1) setting investment objectives around the expected return and risk metrics, i.e. volatility of this return, (2) checking buffer requirements, if any, as well as new investment constraints, (3) assessing diversification and cash flow characteristics, (4) testing liquidity requirements and (5) reviewing required valuation frequency, all in combination with (6) reporting standards.

The following decision wheel describes the various steps in the investment process for alternatives for the planning period, transition period, and final target allocation. The next section will focus on:

A. Portfolio construction setting investment objectives and checking buffer requirements and/or risk considerations, as well as assessment of diversification and cash flow benefits
B. Liquidity requirement testing
C. Review of valuation frequency as well as reporting standards

Figure 2
Decision Wheel on Investing in Alternatives

POST IMPLEMENTATION PERIOD

Flexibility will become increasingly important in the investment portfolios of pension funds going forward. The transition to a DC system will require building blocks that both deliver the expected returns and allow sufficient liquidity in managing the investment portfolio.

In anticipation of the approval of the new law, we formed a working group in 2023 to focus on alternative investments under the new pension system. We identified three key areas that will require more attention for the implementation for alternatives: (1) portfolio construction, (2) liquidity and (3) valuation.

We started with a definition of the potential problems in these areas, and then combined this with interviews with U.S. DC experts, expert knowledge from our working group and academic research. In this article we will discuss these three areas and review the need for refreshing the investment case for alternative asset classes to facilitate the implementation of the new law and create increased flexibility and transparency for all stakeholders.

The removal of capital requirements (or in Dutch Vereist Eigen Vermogen) is one of the major differences between the current regulatory set up and the framework under the new pension fund system. This effectively means that the management of risks is more at the discretion of the pension fund. Risk management teams will need to take on a larger role, together with investment committees, boards and advisors, to assess allocations for investment portfolios that fit the specific requirements of pension fund participants.

As a consequence, the measurement of participants' risk attitudes will become more important and need to be assessed at least once every five years. The risk attitude will have to be translated into an investment policy in which investment beliefs as well as traditional economic models are integrated. We recommend starting with this assessment, as it will play a fundamental role in the investment policy.

Our findings are summarized at the end of this article in the form of a scorecard for the various asset classes. Throughout this article we will address a range of considerations for the decision-making process when investing in alternatives under the new pension fund system.

Portfolio Construction Under the New Pension Act

The change of investment mix has a major influence on participants' (expected) pension benefits. That means pension funds must make decisions regarding their investments. It is possible to make adjustments to the investment strategy before the moment of collective value transfer. The pension funds must indicate within which timeframes the investment mix will be fully implemented in the new pension contract. To achieve that, they must (1) prepare a plan for a managed implementation of the adjusted investment mix and (2) determine how to manage uncertainty surrounding the valuation of (illiquid) asset classes around the moment of collective value transfer.

Pension funds are advised to share financial information in the transition plan. After finalizing the transition plan, it should be made available on their website within two weeks. The AFM has announced that pension providers must publish a comprehensive explanation on the website alongside the transition plan. This explanation should list benefits as well as risks of the transition.

Pension funds must be aware of the new risks that might occur during the transition period. For example, the use of derivatives in funding protection might not only lead to higher costs but also to increased liquidity risks and investment portfolio complexity. When the pension fund decides to use non-linear derivatives, it must be able to demonstrate that this is in compliance with the law. It can impact their reputation if the decision is not well balanced.

REVIEW OF FITNESS OF CURRENT PERFORMANCE METRICS FOR BOTH RISK AND RETURN MEASUREMENT

As mentioned previously, with the new pension system there will be a larger focus on the connection between the individual risk preferences of participants and the total investment allocation of the pension fund. This means that changes in the participants or their preferences can result in a shift in the overall allocation of the pension fund. For example, a relatively young pension fund could potentially allocate more toward return-seeking assets. As participants mature, this will gradually progress to a more defensive investment allocation. This means that the underlying building blocks that make up the investments of a pension fund should be able to facilitate changes.

There will be two different methods under the new pension regime to allocate Return to Participants (a) Portfolio Method versus (b) Interest Term Structure. These two different methods can be used to allocate the return to the participants. In the "portfolio method" there is a separate protection portfolio and a return portfolio. The first portfolio is expected to contain among others bonds and interest rate derivatives and determines the level of the protective yield. With the return portfolio, the excess return is to be achieved with the investments in return seeking assets like for instance equities and real estate. In doing so, the pension administrator allocates investments to individual participants in advance.

The Interest Term Structure (RTS) method calculates the return needed to protect the pay out against changes in interest rates. This return is then allocated to participants. The RTS is independent of the return of the pension fund's portfolio, and so is the RTS protection return. In this method, the excess return is what remains after deduction of the granted protection returns. The collective investment portfolio can be set up with, debt instruments e.g. bonds and derivatives that match the protective return to be allocated to all participants.

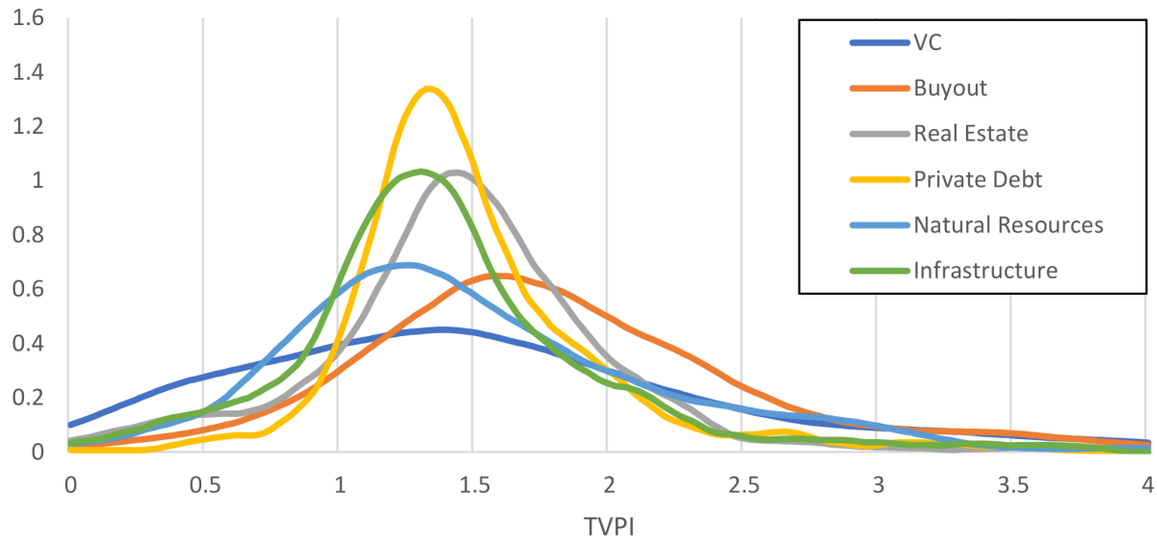
MARKET STANDARDS AND PERFORMANCE MEASUREMENT METRICS FOR ALTERNATIVES

In light of the process in which return must be allocated to participants we recommend to decide upon the performance measurement method chosen for alternatives. This can also be valuable for the communication of the performance to participants.

In the private equity industry different performance measurement instruments are used: the IRR (internal rate of return) as well as the Total Value to Paid In Ratio. The TVPI ratio is a cash multiple equal to the total fund value and the distributions to date, divided by the sum of capital calls. IRR is a textbook measure of returns that is used across many investment settings. In the PE space IRR is computed as the discount rate that, when applied to the fund net cash flows (distributions minus contributions) yields a funds net present value.

Next to IRR and TVPI Dutch Fiduciary Managers have adopted other performance measurement standards like Time Weighted Returns, GIPS, as well as Modified Dietz. The latter may deliver results comparable to the IRR method.

Figure 3
The distribution of the Total-Value-to-Paid-In metric varies per alternative asset class



Distribution of private equity fund returns. TVPI for private equity funds with a North American geographic focus and vintages from 1996 to 2014, by PE asset class. Fund- – of-f-Funds, secondary funds, co-investments, and venture debt funds are excluded.
Source: Asset Allocation with Private Equity, Arthur Korteweg, University of Southern California, and Mark. M. Westerfield, University of Washington, January 2022.

In figure 3, we have provided an overview of the dispersion in returns on the basis of the TVPI for the various asset classes. This dispersion is larger for asset classes such as venture capital and natural resources when compared to private equity, real estate and infrastructure.

SETTING INVESTMENT OBJECTIVES AROUND THE EXPECTED RETURN AND RISK METRICS, I.E. VOLATILITY OF THIS RETURN

The risk management lens has been impacted in the past largely by the regulatory capital requirements for each of the asset classes (VEV/FTK). Pension funds were often constrained to allocate to private equity and infrastructure. Under the new system, the lens will move increasingly toward economic assumptions, and liquidity and valuation challenges need to be tackled. This may lead to a shift in allocations to alternative debt and private credit. Table 1 compares various alternative debt asset classes. Going forward, the FTK buffer will no longer need to be taken account.

Note that the characteristics of the various asset classes are shown here for illustrative purposes only. The objective of this table is to support the development of a decision-making process. Real credit spreads can be obtained via the asset managers of the displayed asset classes.

The change in the regulation is expected to lead to a move to a higher risk/return profile for pension fund investors, as the current regulatory risk framework will no longer be a requirement. The optimization of the risk/return profile will continue to play an important role. As alternatives may help in increasing both the return as well as reducing the volatility of the return, there will be a natural tendency under the new pension law to allocate more to alternatives.

Please see also below an overview in which a comparison is being made between the perceived market risk and the regulatory risk per asset category.

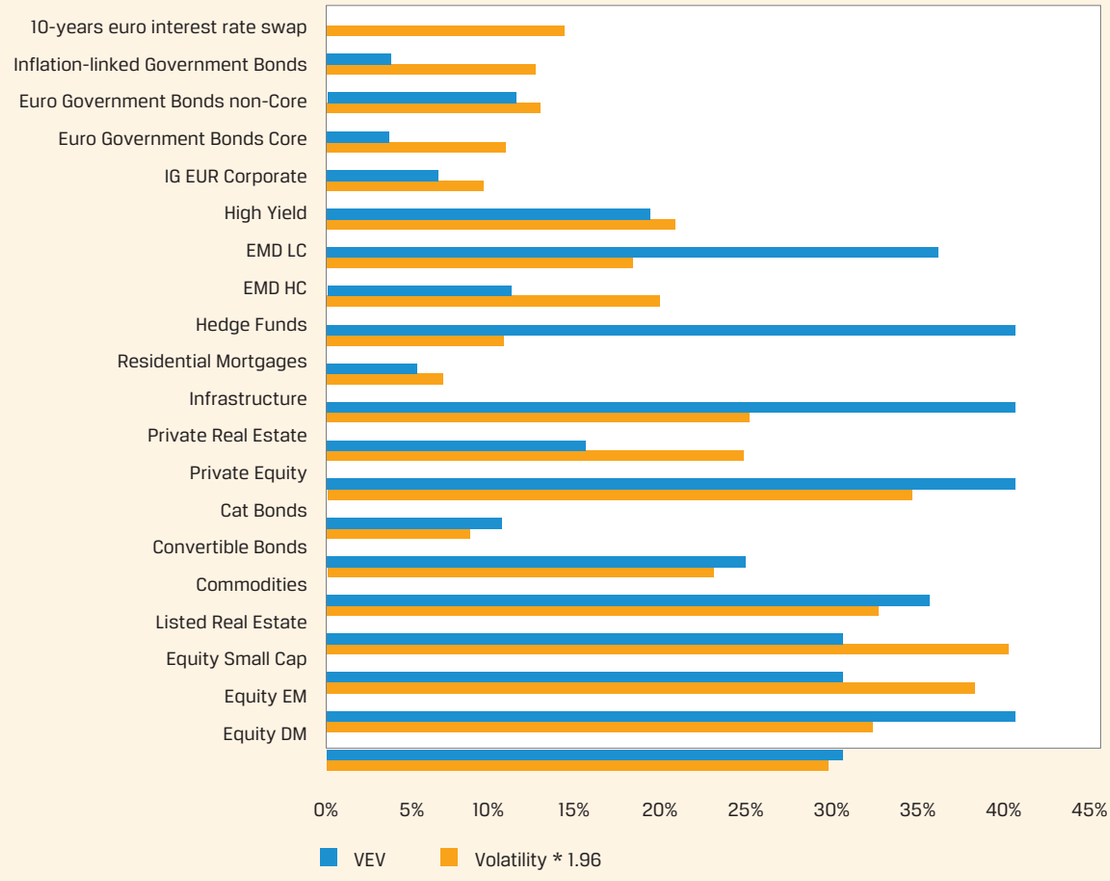
Table 1
Overview alternative asset classes focused on debt instruments

Asset Class	Credit Spread	Risk	Liquidity	Role in Interest Rate Hedging	Options for ESG integration	FTK capital requirement
Dutch Mortgages	1.5 – 2.0%	Low (AA)	Low	High	V	6%
ECA Debt	0.5 – 1.5%	Low (AAA- AA)	Low	Low	V	0%
AAA St ABS	1.0%	Low (AAA)	High	Low	V	0%
AA – A ABS	3.0%	Low (AA-A)	High	Low	V	5%
BBB/BB ABS	7.5%	Average (BBB/BB)	Average	Low	V	12%
Secured Loans	2,0 – 2,5%	Low (AA-A)	Low	Average	V	6%
Secured Trade Finance	1,75 – 2,25%	Low (AA-A)	Average	Low	V	1%

Source: Aegon Asset Management[2]

2 Van Bragt, D. & Medendorp G. (2023). Kansen in alternatieve vastrentende waarden voor pensioenfondsen. Aegon Insights. *Aegon Asset Management*: https://www.aegonam.com/globalassets/aam/news--insights/nl-news-insights/documents/2023/kansen-alternatieve-vastrentende-waarden-pensioenfondsen.pdf

Figure 4
Comparison 15 year volatility comparison to VEV per asset category



Source: Columbia Treadneedle Investment, 2023

Generally speaking the life cycle funds will compete on the risk/return profile as well as on the accessory costs. In selecting an alternative asset class it is recommend to carefully review the impact on the risk/return profile as well as on the costing. Transparency of management fees and other fees is important. There could be additional costs involved which are included in the total expense ratio of the fund. Standardization around the communication of the fees and cost structures will improve the overall quality of this service. In the US the standard approach is to work for alternatives in DC with a cliff pricing structure. This implies that for all investors the pricing structure is similar and depends on the aggregate size of assets in the investment. Any price adjustments are implemented within the brackets of investment size and they regard the entire investment pool. This pricing structure has been stimulated by the US regulation which requires DC pool managers to communicate changes in the pricing of the entire pool for individual investors. The cliff pricing technique simplifies this process. It creates transparency to all investors within the DC pool.

MANAGING LIQUIDITY

Under the new pension system, the addition of illiquid assets to the asset allocation will require extra effort. Depending on the specifics of the participant data and pension regulation chosen, the demand for liquid assets will vary. In general, the FPR will allow for fewer illiquid investments as the funds underlying the lifecycles – the building blocks that make up the individual investment policy – need to be liquid to accommodate monthly in- and outflows of the participants.

Under the new Dutch pension fund law, the required degree of liquidity will most likely be higher for FPR as compared to SPR. The final degree of liquidity will have to be agreed upon between the asset owner, asset manager and glidepath/fiduciary manager.

In order to determine the modalities of the liquidity, the specific purpose thereof must be clear. The purpose of managing liquidity is a combination of strategically adjusting the portfolio, operational activities, like collateral management, and managing the pay out of lump sums and the transfer of assets over the timeline. A liquidity buffer is created to manage liquidity. We recommend reviewing the alternatives bucket through the lens of a strategic investment, with a longer time horizon.

The liquidity factor should be considered in light of the target portfolio over the long term, to allow for the time necessary to put the capital to work, but also considering the natural liquidity that can be created or accelerated by investing, for instance for private credit strategies in shorter dated investment strategies.

The role and position of the liquidity buffer can be defined at a central level of the portfolio in combination with a buffer for either a building block or at an asset class-specific level.

Next to the control level for the liquidity buffer, a second consideration is the specific nature of the asset class the buffer is assigned to. In addition, the frequency of the rebalancing process is important, as well as the process of subscriptions and redemptions. The impact of adding a specific alternative asset class needs to be taken into account on a more strategic level for the overall portfolio construction. The following characteristics have to be integrated:

- Size of the bandwidths for the overall strategic and tactical asset allocations
- Frequency for rebalancing the overall investment portfolio
- Assessment of the impact of the illiquid components on overall portfolio management

Typically, allocations between private and listed liquidity buffers are strategically set and include tolerance bands to allow for cash flow and market fluctuations. Generally, the fiduciary manager is not making tactical decisions when weighting private and listed real estate; rather, the listed allocation is for liquidity purposes only.

It is recommended that a timeline to create a target percentage of liquidity for each of the asset classes be incorporated in the portfolio construction. This timeline can be on daily, weekly, monthly or quarterly basis. In the U.S. market, it is for example feasible for open-end private real estate funds to create approximately +/- 10% liquidity on a quarterly basis at an aggregated level inclusive of participant-directed and default fund rebalancing. Liquidity constraints can be managed by setting targets for the liquidity profile; this implies that an investment strategy with a shorter maturity will naturally have a higher level of liquidity.

Liquidity can also be tailored to the nature of the asset class. As a basic approach, one could assume to use for the purpose of liquidity management only for the most liquid instruments alongside the lines of eligible instruments. In order to ensure that the strategic exposure is completed as well as to be able to create liquidity around an in-principle illiquid asset class, the following proxies can be used:

- Private equity – SP&P 500;
- Corporate credit private debt – Barclays Aggregate bond benchmark;
- Real Estate estate – REITs
- Mortgage loans – RMBS

A material advantage of this method is that it will enable the management of the Strategic Asset Allocation. An investment process should be designed to carefully manage the related transaction costs to rebalancing.

TESTING LIQUIDITY REQUIREMENTS

The size of the buffer depends on the liquidity that is required to fulfil the liquidity needs. This relates to portfolio management, (i.e. derivatives), asset allocation rebalancing, and operational management (i.e. payments to stakeholders). The liquidity requirements have a direct impact on portfolio construction and vice versa. The liquidity buffer depends on the defined bandwidths as well as on the frequency of the adjustments of the portfolio. This regards the mutations in the tactical and strategic asset allocation. Under the new Dutch Pension Fund Reform the required degree of liquidity will most likely be higher for the FPR as compared to the SPR. The final degree of liquidity will have to be agreed between the asset owner, asset manager and glidepath/fiduciary manager.

DETERMINING TIMELINES PER ASSET CLASS TO LIQUIDATE EXPOSURE OR PUT CAPITAL AT WORK

Considering the required timeline to liquidate an alternative portfolio per asset class in the short and medium term, as well as the impact thereof on the required liquidity, is recommended.

Natural sources of liquidity are coupon, pre-payments, dividend, distributions and redemption. An indication of liquidity for an asset class can, for instance, be the availability of regular pricing, and its frequency trading can be effectuated. Another factor that should be considered is the variability in the capital calls and disbursements of the particular asset classes. As Figure 4 shows, these are a lot more predictable for infrastructure than for venture capital. An investor in the latter category should consider the risk that – even though the valuation is solid – it might take several years for the actual exit to happen and the cash to be received.

The combination of private assets can enhance the ability of a portfolio to generate liquidity.

The liquidity level for each investment is determined on the basis of investment management and operational and organizational requirements.

The available liquidity level should be assessed under normal and stressed market circumstances. Sources of liquidity can be provided by the structure of the instrument or the fund, as well as the existence of a secondary market. It is expected that liquidity buffers per alternative asset class start at a relatively high level and may shrink over time as the management will be more mature and sophisticated

Table 2
Liquidity Level (medium/low/high)

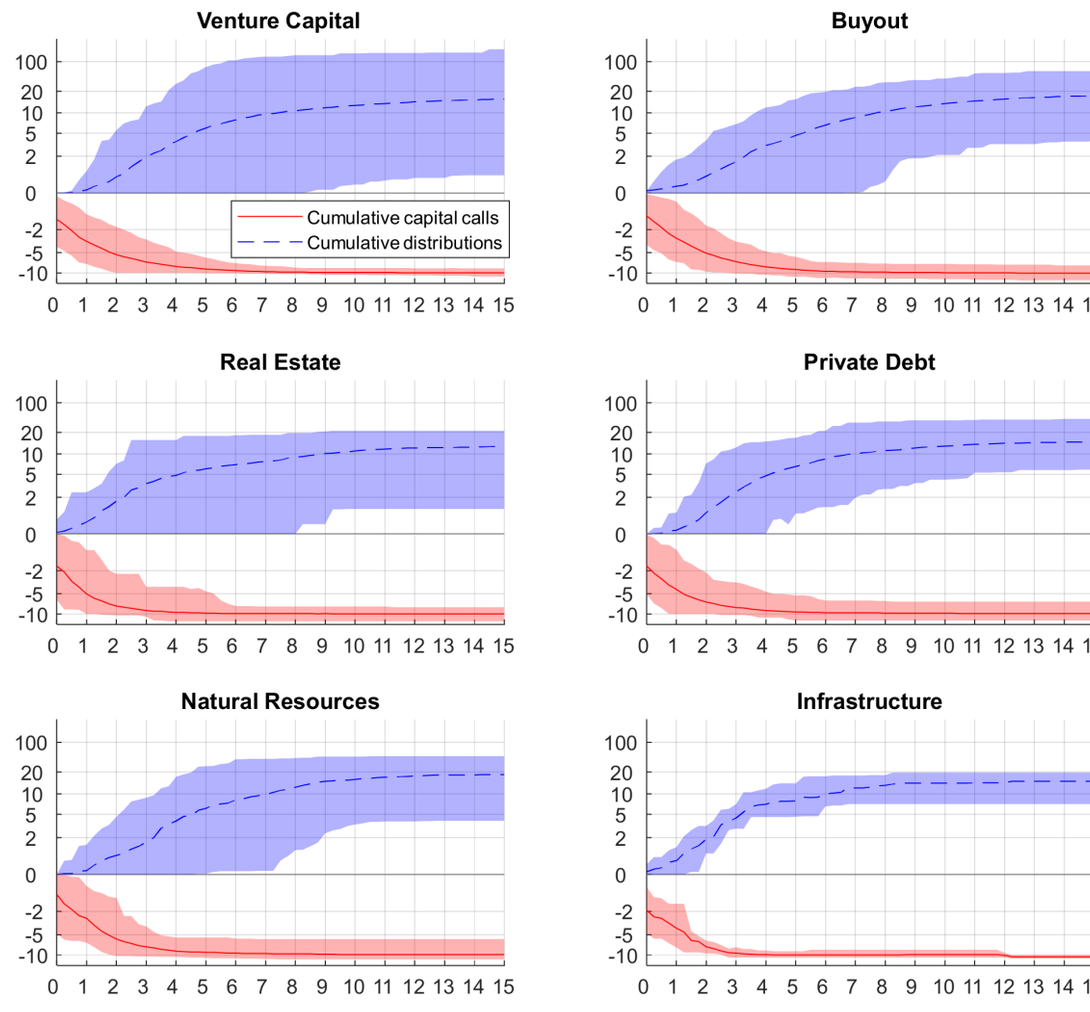
Asset Class	1 month	1 quarter	1 year	3 year
Dutch Residential Mortgages	Low	Medium	Medium	High
Infrastructure Equity	Low	Low	Low	Medium
Infrastructure Debt	Low	Low	Low	Medium
Real Estate Equity	Low	Low	Medium	Medium
Real Estate Debt	Low	Low	Medium	High
Private Equity	n/a*	-	Low	Low
Private Credit	n/a*	-	Low	Medium

* Investors should take in to account that full liquidity for these asset classes on these time horizons is generally not available. Although for example the secondary market for certain asset classes such as for Dutch mortgage loans and private equity is professionalising contributing to improved liquidity in recent years.

In Figure 5, we have shown the cumulative cash flow patterns for private equity asset classes, including average cumulative capital calls (red solid line) and distributions (blue striped line) for private equity funds with a North American geographic focus by asset class. Fund-of-funds, secondary funds, co-investments and venture debt funds are excluded. Cash flows have been scaled to USD 10mn commitment, and they are net of fees paid by the limited partners to the general partner. Capital calls are shown as negative numbers because they are outflows to the limited partners. The horizontal line is the time since inception in years. The vertical axis is the cumulative cash flow in USD millions on a logarithmic scale. The shaded rows are the 5th and 95th percentiles. Source: Preqin.

The time horizon and liquidity differ materially by asset class. For venture capital, it can take a decade before take out is realized, whereas real estate funds tend to have a lower duration as intermediate cash flows are generated from property rental income.

Figure 5
Cumulative capital calls and distributions for various alternative equity asset classes. The shaded area corresponds to the 5th-95th percentile range for a given, while the dashed line represents the average



Source: A.Korteweg and M. Westerfield, Asset Allocation with Private Equity, 2022 and Preqin

An important element of operational management of the liquidity for alternatives is the management of commitments. The "liquidity shell" is meant to fund the capital call for illiquid investments. It is noteworthy that management commitments can be binding or non-binding. It is advised to develop a liquidity projection on the basis of the binding and non-binding commitments. Commitments should balance the need for illiquid assets versus the available opportunities in the market.

The liquidity shell can be combined with a second level of defense, which would be a highly liquid buffer enabling rebalancing at all times. This buffer should consist of instruments that are typically defined as "eligible collateral." Liquidity comes at a price. Sleeves that are providing liquidity may offer liquidity at discounts. Institutional investors could decide to "sit it out" instead of rebalancing. It is important to clearly define roles and responsibilities with regard to liquidity management. The execution of liquidity management can be insourced or outsourced to a third party.

Considerations in this decision can be a combination of operational benefits (i.e., pooling of liquidity) but also management responsibilities/liabilities as well as potential litigation risks. Defining a targeted timeline for repairing liquidity issues is recommended. In general we recommend to establish a management process around liquidity management decisions which is tailored to both the requirements of the end investor as well as the roles and responsibilities of the liquidity management team within the investment organisation. In order to warrant accountability and control of this team and/or liquidity management activity we recommend to decide and communicate target liquidity percentages within the overall asset allocation process at a strategic and tactical level.

ALTERNATIVES VALUATION

Coverage ratio and data quality are essential during the transition process to the new pension system because they determine how the available capital will be allocated among the participants. There is still significant work to be completed in respect to the data quality of the pension liabilities, but the quality of the data of the investment portfolios is generally still being viewed as a given.

However, this may turn out to be an oversimplified assumption. Pension funds have invested en masse in illiquid investments in recent years, and it is precisely in this asset category where the quality of the valuation of the investments may need to be improved. This section discusses the valuation of illiquid investments and how the uncertainty surrounding the valuation of these investments can be addressed at the moment of transition as well as going forward.

On average, 20% of pension fund investments today represent less liquid investments. Illiquid investments are often not valued on the basis of market-observed prices, but instead are either based on fundamental models or are independently valued by appraisers on an annual basis with parts of the portfolio being valued each quarter. As a result, the valuations of illiquids are typically solely based on current market conditions, where liquid investments also take market sentiment into account as well as a forecasts of market developments. Therefore, valuations sometimes diverge in the short term. This effect can often be seen, for example, in REITs, as well as in high yield and private credit.[3]

Illiquid investments are not only valued differently but also at a difference frequency. In the case of private equity, valuations are usually only issued once per quarter.

A final point is that valuations of illiquid investments are typically made on the basis of a range of assumptions. The verification process of valuations can be complex. In general, valuations are audited at the end of the year; however, it is common (for example, in the case of financing of unlisted companies) that part of the assumptions are based on data/input from asset managers. In addition, when completing this annual exercise, a bandwidth is often used within which the valuation must lie, because exact approximations of the valuation are often difficult.

The above restrictions mean that valuations of illiquid investments are uncertain and do not include short-term expectations of the market. For example, if there would be a real estate market crisis at the end of 2025, it may create a situation in which the funding ratio is overestimated, because valuations may be lagging. We recommend addressing these issues in advance and integrating them into the decision-making process around the allocation of the assets when transitioning to the Nieuwe Pensioen Stelsel NPS.

In the following section, we explain what can be done by a pension fund to further improve the quality of the valuation process ahead of the transition to NPS.

(DATA) QUALITY OF VALUATIONS

Over time, market standards are being further refined for illiquid asset classes. In operational due diligences, when candidate asset managers are being evaluated for portfolio management, valuation is increasingly an important topic. In view of the upcoming transition, we recommend reviewing the valuation process again during visits to managers and updating your information on these processes, if this has not already been formally reviewed and captured.

3 There are other reasons for the difference, but this does not explain the large difference in volatility between the two investments.

What standards can be expected from managers in any case?

- Dutch mortgages, DNB published market standards on March 7, 2022[4]
- Real estate, INREV provides a best-in-class framework for valuation and governance[5]
- Private equity, IPEV valuation guidelines were published in December 2022[6]
- Private credit, ELFA technical guide for valuation of private debt investments was published in February 2022[7]
- For all AIFMD funds, there is detailed regulation in place on the governance around valuations including the usage of external valuations[8]

These standards are generally also used by reputable investors. However, these methods still offer a lot of room for choices.

For example, they do not prescribe which assumptions are used for the valuation. The latter is especially important for managers who are rewarded on the basis of a performance fee. In the case of a performance fee, taking a loss is painful and the temptation is greater to influence the valuation. As a result, the chance of a major change in the valuation at a later date is greater, especially in turbulent market conditions.

STRENGTHENING THE CURRENT VALUATION PROCESS

Market standards may evolve increasingly toward independent valuations, such as how real estate is already valuated. In the case of large portfolios, valuation agents can be appointed to oversee the valuations of the independent appraisers and monitor the consistency among them on a portfolio level. This may help in neutralizing biases, which may either arise or be perceived to exist in cases where portfolio managers are rewarded on the basis of the performance of the portfolio. A second simpler solution could be the establishment of pricing committees, whose role is to independently determine the valuation methodology (and therefore also the assumptions).

The benefit of working with an independent external valuation agent is that it neutralizes the process between various stakeholders. They are providing the service to manage different asset managers, thereby optimizing their valuation process by experience and continuously developing best practices. This independent valuation process has become increasingly mechanical and systematic in the United States over the last 10 years for real estate. The use of independent valuation managers has also created a level of trust within the financial system in which valuations are rarely discussed or disputed; as of this writing, there are no known (legal) disputes on valuation.

The disadvantage of this trend is that less specific knowledge of portfolio managers about positions in the portfolio is used. This drawback could be addressed by continuously investing in this process to ensure that in-depth knowledge is accessed and the accuracy of the process is monitored. Daily valuation in the U.S. market is a continuous process executed by an independent external valuation agent. The valuation agent is using three levels of inputs: (1) concrete feedback from the asset management team, (2) market inputs, i.e. evolution of comparable values, and (3) model analysis overlay management. Every (expected) change within the portfolio must be real-time communicated by the portfolio management team to the appointed independent valuation manager. An important success factor for this process has been the material increase in discipline to report any change in the portfolio real time to the independent valuation agency. The quality of this process can thereafter be tested on a quarterly basis.

REVIEWING REQUIRED VALUATION FREQUENCY

For many alternative investments, the frequency of valuation is once a month. For the U.S. real estate market, it is already common to produce daily valuations; for other asset classes, such as private equity and private debt, this is still a work in progress. There is a trend in the United States to use a more model-based approach for these asset classes in which elements such as duration and sectoral approach are taken into account. The use of technology and data collection is increasingly having an impact on the valuation of private equity and private debt.

Due to the increased automation of valuations, as well as improved governance and increased intensity of communication between all involved stakeholders, even daily valuation for illiquid investments is becoming increasingly possible, albeit it with additional assumptions.[9]

The decision on required frequency of valuations is especially important if a pension fund implements an FPR, because participants and/or lifecycle fund managers will have the opportunity to adjust the portfolio at a fixed frequency. With delayed valuations, this may provide potential room for arbitrage for participants by choosing a good entry or exit time. If there is a desire to increase the frequency of the valuation to monthly or even daily for example due to more frequent rebalancing between age cohorts, it is would be good to discuss this with asset managers well ahead of the transition process. Mechanisms could be designed to mitigate the risks by implementing a solid governance in the form of notification periods and queuing mechanisms.

4 https://www.dnb.nl/voor-de-sector/open-boek-toezicht/sectoren/verzekeraars/balans-en-kapitaal-pilaar-1/good-practice-waardering-hypotheekleningen-solvency-ii/

5 https://www.inrev.org/

6 https://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202022.pdf

7 https://elfainvestors.com/wp-content/uploads/2022/02/ELFA-Diligence-Technical-Guide-for-Valuation-of-Private-Debt-Investments-1.pdf

8 https://www.linklaters.com/en/insights/publications/aifm/valuation

9 For example, with mortgages, intra-month mortgage readings are less accurate, which means that often month-end positions are used but with an updated discount curve.

IMPORTANT ACTIONS AHEAD OF THE PENSION FUND TRANSITION

As discussed previously, it is especially important to establish solid governance of the valuation methodologies used before the transition date. Is the method of valuation and governance of the valuation process well analyzed in the most recent ODD, and do these meet current market standards? If that is not the case, it is worth considering having the valuation carried out in parallel by an external independent party and agree upon a decision-making process around the leading valuation. This, of course, may create a situation where the valuation of the independent party must be used from now on in order to support a smooth transition process and not cause a valuation shock post-transition.

In the event that market conditions during the transition are very volatile (for instance, as the result of a financial crisis), the creation of an additional temporary buffer could be considered. The size of the buffer could be estimated for the expected delayed decline in the value of illiquid investments on the basis of the decline that has already occurred in liquid investments. The disadvantage here is that the decline in illiquid investments is sometimes difficult to predict. The temporary sharp declines in liquid markets during the COVID-19 crisis did not materialize in illiquid investments due to the temporary nature of the crisis.[10]

Should a change be made in the allocation of the portfolio as a result of the implementation of the WTP, it is important to consider that the valuations of alternatives are not equal to a transaction price. They are best estimates. Hence, changes in the portfolio post-WTP can result in a negative impact on the coverage ratio. An option would be to make the change in the portfolio pre-transition instead of post-transition, as this gives a better insight into the actual coverage ratio of the fund. In addition, this would ensure that the transaction costs related to the required changes are allocated to the entire population of the pension fund as opposed to groups that have either a higher or lower exposure to the alternatives.

Finally, it is good to think about a procedure in case valuations of investments turn out to be incorrect at the transition moment. While it does not occur frequently, valuations may be revised. The impact in general may be limited, but it is good to have an agreed-upon procedure in place to ease discussions and facilitate independent handling.

KEY ROLES FOR THE BOARD AND INVESTMENT TEAM

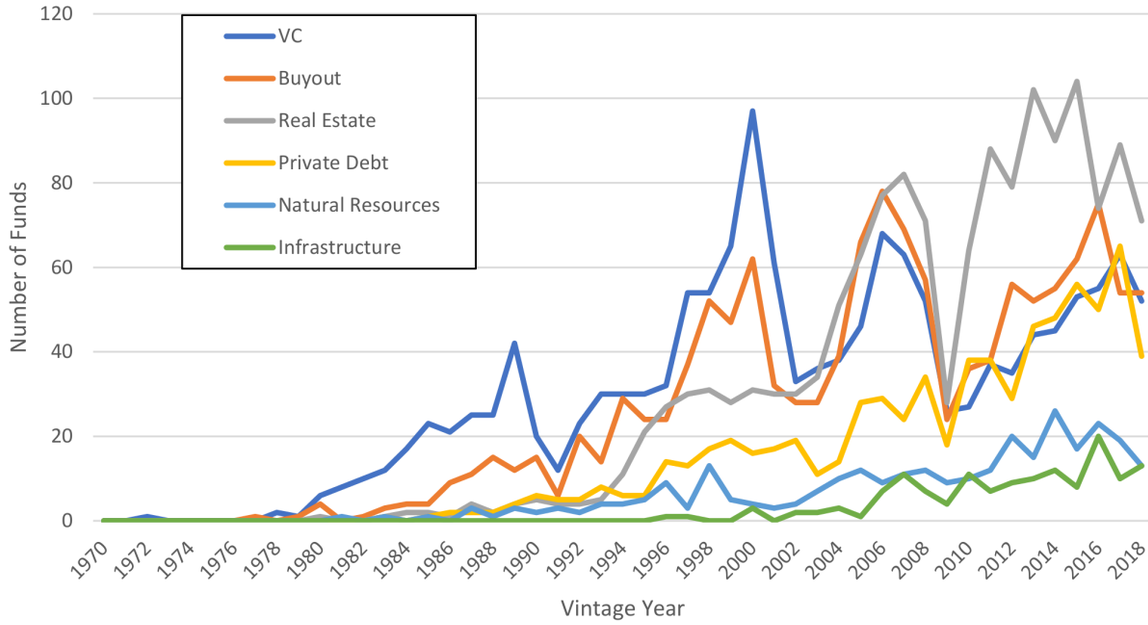
Alternatives offer an attractive way to enhance the risk-return profile of a portfolio. The markets are showing a strong growth in both the number of asset classes as well as the number of providers.

This implies that institutional investors must develop a solid governance model to manage these asset classes and their asset manager within their portfolio effectively both during and after the transition to the new pension regulation.

Important factors to take into account when deciding to add alternatives for Dutch pension funds are:

- The expectations with regard to risk and returns of the various asset classes. The risk-return profile of the various asset classes can be investigated by looking at the TVPI (total value paid-in capital multiple). The board and Investment Team must evaluate, along with an advisor, if the risk/return expectations are relevant.

Figure 6
The number of alternative funds has increased significantly in recent years. This figure shows the time series of the number of funds raised in vintage years from 1969 to 2018



Source: A.Korteweg and M. Westerfield, Asset Allocation with Private Equity, 2022 and Preqin

10 https://www.msci.com/documents/10199/32960175/Private-Real-Estate-Valuation-and-Sale-Price-Comparison 2021.pdf

- Evaluate the liquidity requirements due to for example collateral requirement, expected pension disbursements and in and outflows due to participant choices and rebalancing.
- The gap between valuation and transaction prices within predefined limits. Under the SPR, the board in particular should take into account the possible effects these might have on the realized returns of the various participant age cohorts.

As alternatives have proven to add material value over the long term, we believe it will be critical for investment committees to provide solid governance around these asset classes in preparation for the implementation of the new pension fund law in the Netherlands. This implies that institutional investors must develop a governance model to effectively manage these asset classes within their portfolio both during and after the transition to the new pension regulation.

In order to do this, we recommend reconfirming governance and setting key roles, responsibilities and activities for the management of the fund and its lifecycle funds. For the management three key roles can be distinguished: Fiduciary Manager, Portfolio manager and Pension Administrator. The role of a Liquidity Manager can be created alongside the Fiduciary Manager or fulfilled by the Fiduciary Manager.

The investment and e portfolio management team,will have to make decisions at various levels on the liquidity management in respect of among others:
- Alternative Asset class and related proxy buffer for this alternative asset class;
- Multi-asset portfolio;
- Positioning within Life Cycle Fund;

In the United States, delegated CIO's have developed management structures which already include alternative asset classes for DC schemes. This has been implemented in a cooperative model with advisors and in-house pension specialists.

Key considerations in the preparation for this transition will be (1) risk appetite and strategic target portfolio as well as (2) management of liquidity and (3) an independent, transparent and higher-frequency valuation process. We expect that the standard will move to at least a monthly valuation process for the alternative portfolio with shorter timelines for completion of the valuation.

Planning will commence by testing the risk appetite of the participants. This may well lead to either a defensive, more comparable, or more offensive risk profile. Even if the risk profile remains unchanged, it is expected that most investment portfolios will strive for higher returns with lower volatility as the compass for pension funds is moving from coverage ratios to returns. We expect pension funds will strive for stability in their annually reported returns, as it will have an impact on their capacity to directly provide for a pension and indexation for the real benefit of their stakeholders.

We have developed a scorecard that can be used as a reference in these discussions within investment committees on topics such as (1) release of the FTK buffer due to the change capital requirement regime, (2) complexity of valuation, (3) liquidity and (4) risk/return.

In the second column, the effect of the abolishment of the buffer requirement (FTK) is scored. All things equal, this creates more room to allocate to these asset classes. Infrastructure and private equity currently have a relative high buffer requirement.

In the third column, the complexity of valuations is scored. Model-based and external valuations are compared. Private equity is relatively complex due to the type of investments and lack of external valuations.

Concluding, being well prepared for the changes that are coming with the new pension legislation is strongly advised. Employers and pension funds must be well aware of not only the legislation but also the guidance drafted by regulators. It is still unclear what the significant post-transition impacts will be. Therefore, a good preparation of the knows and unknows is required, not only with regards to the liabilities, but also for investments portfolios. We recommend to review investment portfolios from a strategic perspective, complete an assessment on operations and reporting as well as a legal assessment on the overall set up.

Table 3
Scorecard for the key asset classes in the alternatives universe

Asset Class	Release of (FTK) Buffer Requirement	Complexity Valuation	Liquidity	Risk/Return Profile
Dutch Residential Mortgages	=	=	-	+
Infrastructure Equity	+++	-	--	++
Real Estate Equity	+	=	--	+
Real Estate Debt	=	=	--	+
Private Equity	+++	-	---	++
Private Credit	++	-	--	++

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