The inexplicable vitality of pension funds

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An analysis on Spanish pension funds between 1991 and 2007 shows a failure to achieve a return for investors due to factors such as high fees.

Despite promises of returns on pension plans, the fact is that with these investments, the loss column is outweighing the profits.

Yet, judging by the rate of investment in these plans, the lack of profits does not seem to bother the 10.4 million investors in Spain who, as of 2007, had assets worth 86.5 billion euros. This is the conclusion reached by IESE Prof. Pablo Fernández and research assistant Vicente J. Bermejo following their detailed analysis of the different fund categories and their results over the past 16 years.

Why do people keep paying high fees to managers who have proven to be less than efficient? How can there be such a high volume of investment when the returns are minimal? What makes the Spanish government continually endorse pension funds when, in many cases, investors have lost their tax write-off incentive? These are the kinds of questions raised in this study from IESE.

The analysis of the performance of pension funds in Spain in recent years reveals some figures that would make more than one investor think twice before putting money into such an investment. For instance, of the 1,597 funds that are five years old, only two had a higher profitability than the Madrid Stock Exchange Index. Also, over the past decade, the average return on those funds has been substantially lower than that earned from investing in a 10-year government bond.

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Size and profitability

The paper looks at the return on various funds, such as those of the individual and employee retirement systems, as well as fixed-income and equity funds.

Fernández points out that over the past five years, the highest profitability of the individual system came not from an equity fund but rather a mixed equity fund, with a notable difference in profits.

Also, funds in the employee system with the highest returns in the last three five-year periods were extremely small funds with very few contributions in 2007 - a characteristic that suggests a correlation between size and profitability in this type of investment.

With a high concentration in the individual and employee funds in 2007, Fernández confirms the correlation between size and profitability. In the case of the individual system, the 10 most profitable funds over the past five years accounted for just 2.7 percent of the equity, while the 10 most profitable funds from the employment system represented 0.1 percent of the assets.

Fees and senseless distribution

Few pension-fund managers are deserving of the fees that they charge their customers, generally ranging from 0.5 to 2 percent. Fernández considers that explicit fees - those paid by the investor that appear in the contract as costs related to management, deposit, subscription and reimbursement - are partly responsible for the meager returns seen by these funds.

Also sharing the blame is the distribution of the investment fund portfolio. Fernández was surprised to discover that, in 2007, 64.6 percent of equity was in fixed-income investments and liquid assets, and there were 123 funds with assets of nearly 6 billion euros in short-term fixed income.

Active management, unknown profits

The study also includes criticisms of what is known as "active management," in which the manager buys and sells frequently, making constant changes to the makeup of the portfolio.

Doing this makes it impossible to know if all the maneuvering has actually created value for investors. What is for certain is that stock market traders are obtaining profits thanks to the

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commissions they receive from their customers for all their purchase and sales transactions.

In light of this, the author recommends that fund managers inform participants of all the transactions being made, as well as the fees charged. They should also provide some information on the return that would have been obtained if the portfolio had stayed put.

Role of government

The government encourages people to invest their money in pension funds, giving tax preferences to these funds. But it does not take into account the poor results of these funds over the past five years.

Considering this inconsistency, Fernández suggests that the government should stop facilitating the indiscriminate investment in any and all pension funds. Instead, the government could recommend investing in a select few.

Fernández insists that the government should take responsibility for the losses suffered by the many contributors to the system. He cites cases in which investors even lost their tax deduction, which the government had given to them as an incentive for investing in pension funds of less than five years.

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