Institute of Policy Studies

IPS Working Papers No. 24: The Investment Risks in Singapore's Retirement Financing System

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The Institute of Policy Studies (IPS) and Towers Watson, a professional services firm, recently collaborated on IPS Working Papers No. 24: The Investment Risks in Singapore's Retirement Financing System. The paper was published on 12 December 2014 on the IPS website. A few weeks earlier on 19 November, the paper's authors, IPS Research Fellow Christopher Gee and Peter Ryan-Kane and Mark Whatley of Towers Watson, held a closed-door discussion (CDD) with some 40 academics and experts from the financial sector to discuss the initial draft of the paper. The session was chaired by Dr Lee Soo Ann, Senior Fellow at the Lee Kuan Yew School of Public Policy, and a separate media briefing was held after the CDD.

The paper continues IPS' work on retirement adequacy in light of Singapore's ageing population. It set out to document the fund flows through the Central Provident Fund (CPF) system and to evaluate the investment risks and opportunity costs faced by CPF members, as well as the risks borne by the government in investing those funds.

Major Findings

The authors concluded that CPF members are getting an attractive return from the CPF system, with the government essentially providing CPF members with a significantly higher and very stable return over the last two decades, while taking on the risk of significantly lower market rates especially in the low interest rate environment in recent times.

In the paper, the authors outlined some alternatives to how CPF monies are currently managed. CPF funds are invested in Special Singapore Government Securities, which pay interest at rates pegged to those payable to CPF members. The authors evaluated the 20-year expected returns and risks in other investment portfolios, comprising assets such as Singapore government bonds, global bonds, global equities, and a balanced portfolio consisting of 60% equities and 40% bonds. Compared to current CPF returns, they found that in nearly all scenarios, an investment portfolio made up of just Singapore government bonds or just global bonds would give lower returns, while a balanced portfolio yields comparatively similar returns to the CPF system, but has higher downside risk. While global equities yield higher returns — 95th percentile returns of 13.7% as compared to CPF's 7.2% — the downside risk is also significantly higher.

In real value, the authors estimated the value of $100 held in the CPF today to be $303 in 20 years' time. CPF account holders also have an annualised standard deviation of 1.4%, which refers to the amount of variation from the expected return. On the other hand, the annualised standard deviation for those who invested in global equities is 20%, the researchers said. This would mean a larger variance in returns between those in the higher and lower *percentiles.*

Fair Returns?

Dr Joelle Fong, Senior Lecturer at UniSIM College, SIM University, was the discussant at the CDD. She began by noting that the CPF mean return of 5.7% matched up very well against market rates, but whether or not these returns are "fair" is another question. She compared these returns to those offered by three Australian wealth management funds — AustralianSuper, AMP Super and Colonial First State — and highlighted their respective rates of return (ROR). While the CPF compared favourably to the five-year ROR of these funds (1.7–5.5%), it only represented the lower end to the average of the spectrum for the 10-year ROR of these funds, estimated at between 4.2–8.0%.

She suggested a study to better understand the risk preferences of CPF members, observing that international population studies done in France, the Netherlands, and the United States show that most retirees are risk-averse. She also noted that most CPF participants prefer default options, so even if an option with more risk was offered, this might mean that few would opt for a riskier investment profile.

She had a few suggestions for the CPF Board to consider. These included offering CPF members the option of a 60% equities and 40% bonds investment portfolio or life-cycle funds, which are investment funds that move from a position of higher risk to one of lower risk as the fund participant nears retirement. She also suggested having inflation-protected financial instruments, noting that while it is difficult to guarantee returns that could beat inflation each year, this is possible in a 10-year investment time-frame.

A member of the audience noted that a lot of the debate was on "fairness". Is the individual CPF member getting a fair return based on the money that is invested over such a long period of time? He expressed his opinion on the numbers presented, saying they demonstrated fairness in terms of risk-free rates and equity risk. The key question is the difference in opinion between individuals over what constitutes "fairness", and that is where the debate should take place, he said.

The CPF is a retirement fund and not just an investment fund, an audience member noted. He said that many people of his generation are asset-rich and cash-poor. "Changing and addressing the issue of returns today will only yield results in 30 to 40 years' time," he pointed out. The government has made many tweaks to Singapore's retirement fund, he said, highlighting especially the move from the pension system to the CPF one, saying it absolved the government of taking on "any risk".

During the discussion, it was pointed out that the key risk facing retirees is longevity risk, which makes "long-term inflation risk the key risk". A member of the audience said this means that not only do retirement funds need to beat market rates set by other investment funds, they also need to beat inflation, which erodes the savings of retirees, who often live much longer than they expect. An inflation-protected investment scheme is thus "appropriate", said a member of the audience, who noted that the Scandinavians and Australians have also employed this mechanism. However, despite these forecasted long-term returns looking plausible, it is "no easy job". "One has to be realistic about that risk as well", he said.

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