

AUDITING THE INVESTMENT PROCESS OF THE GENERAL PENSION FUND

JULY 2019



General Audit Chamber
Algemene Rekenkamer



This document is an English translation of the original Dutch language report entitled: "*Audit naar het beleggingsproces van het Algemeen Pension Sint Maarten*". In the event of textual contradictions or any other differences, the original Dutch text will prevail.

July 2019

General Audit Chamber, Juancho Yrausquin Blvd #10, unit 4 & 5.

PREFACE

The board of the General Audit Chamber approved the conduct of an investigation into the investment process at the General Pension Fund St. Maarten (APS).

Pension funds invest in order to keep pensions affordable. In the long run, this allows a better return on investment as compared to putting money in a savings account. But which process is used exactly, and are participant's premiums invested responsibly? This report presents the results of our audit about the investment process and answers the question whether APS acts in line with its investment policy and principles.

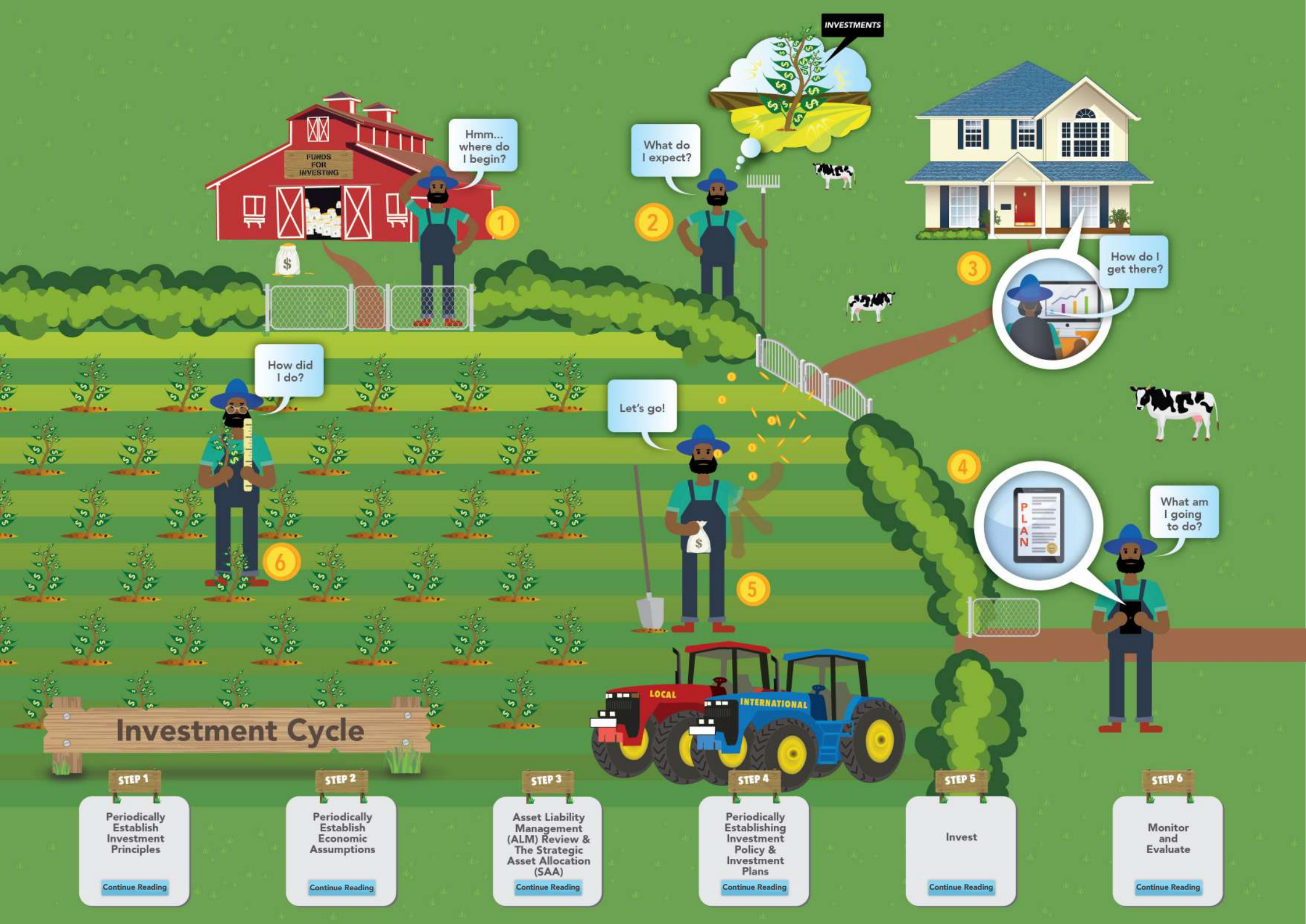
To introduce this complex process in a manner that is accessible, we present the process in the form of an infographic. The analogy of a farm is used to visually depict the process of investing. The infographic supports the narrative of our audit report.

Ronald C. Halman

Chairman, General Audit Chamber

CONTENTS

INFOGRAPHIC	
1 OUR AUDIT.....	1
1.1 Basis for the audit.....	1
1.2 Audit questions	1
1.3 Methodology	1
1.4 Reading Guide	1
2 HOW DOES APS INVEST?	2
2.1 Step 1: Periodically establish investment principles	2
2.2 Step 2: Periodically establish economic assumptions	3
2.3 Step 3: Asset Liability Management (ALM) study and Strategic asset allocation (SAA)	3
2.4 Step 4: Periodically establishing investment policy and investment plans	4
2.5 Step 5: Invest.....	4
2.6 Step 6: Monitor and evaluate.....	5
3 OTHER FINDINGS	7
3.1 Changing the pension system.....	7
3.2 The international investment portfolio	7
3.2.1 <i>Restructuring the international portfolio</i>	7
4 OPINION AND RECOMMENDATIONS	9
5 RESPONSE FROM APS' BOARD	10
5.1 Response from the Board of APS	10
ANNEX 1	11
Section A: APS' reaction on underperformance regarding the international portfolio	11
Section B: APS' reaction: nuance of the underperformance of the international portfolio	11
Section C: APS' reaction to restructuring of the international portfolio	11



INVESTMENTS



Hmm... where do I begin?

What do I expect?

2



How do I get there?

How did I do?

Let's go!

4



What am I going to do?



Investment Cycle

STEP 1

Periodically Establish Investment Principles

[Continue Reading](#)

STEP 2

Periodically Establish Economic Assumptions

[Continue Reading](#)

STEP 3

Asset Liability Management (ALM) Review & The Strategic Asset Allocation (SAA)

[Continue Reading](#)

STEP 4

Periodically Establishing Investment Policy & Investment Plans

[Continue Reading](#)

STEP 5

Invest

[Continue Reading](#)

STEP 6

Monitor and Evaluate

[Continue Reading](#)



1 OUR AUDIT

1.1 Basis for the audit

APS manages the pensions of government employees.¹ Besides collection of premiums, investment² forms the basis for all payments. Adequate control of the investment process is of great importance in this regard.

Insight into the process and management of APS' investments is the objective of this investigation.³

1.2 Audit questions

We answer the following questions in this report:

1. Does the investment policy and process guarantee that APS invests in accordance with its investment principles?
2. Did APS act in accordance with its internal investment policy and principles during fiscal year 2017, and in the period from January to June 2018?

1.3 Methodology

Our investigation focused on:

- establishment of investment convictions;
- the structure of the administrative organization/internal control measures of the investment process;
- the link between the various phases of the investment cycle;
- the correlation between actual investment and the investment policies/principles.

We consulted an expert in asset management of pension funds for this investigation.

1.4 Reading Guide

The report is organized as follows:

- Chapter 2: a review of the investment process- and management, including our findings, and per step in the cycle, the reaction of APS;
- Chapter 3: additional findings, namely the investment risks related to pension reform, and the performance of the international investments;
- Chapter 4: our opinion and recommendations;
- Chapter 5: response of APS' board.

¹ Article 4 of the Pension Ordinance public servants, which includes employees in government service, teachers and employees of government-related organizations of St. Maarten.

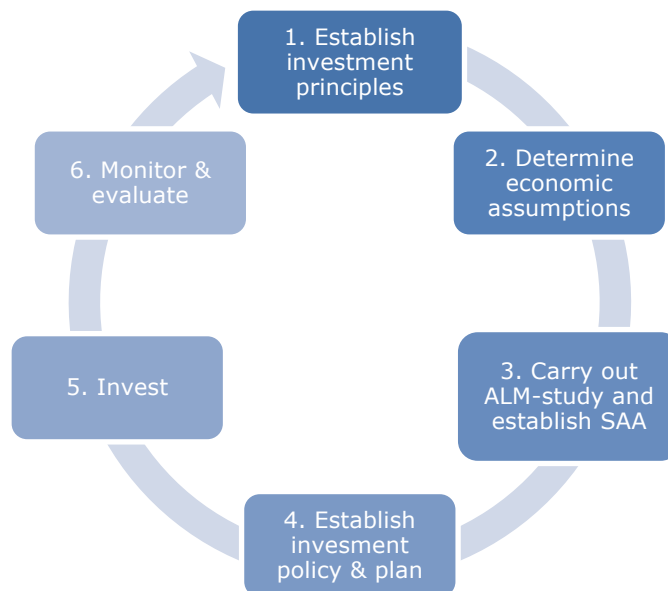
² Investing is committing money for long or short periods of time to achieve financial benefit.

³ Article 26 of the National Ordinance APS: the fund is subject to review by the General Audit Chamber.

2 HOW DOES APS INVEST?

APS collects pension premiums that the fund subsequently invests. Investing, along with collection of pension premiums, is necessary to ensure that APS can pay the promised/expected future pensions. It is important that the process of investment and the management thereof are properly structured and carefully executed. It is appropriate to follow an investment cycle. Figure 1 shows an investment cycle that is also used by APS.⁴ The terminology used in the figure is explained later in this report.

Figure 1: Cycle of investment



2.1 Step 1: Periodically establish investment principles

The cycle starts with the establishment of investment principles of the fund. These principles are assumptions about the functioning of markets and how these markets can be used to earn money.

What are our findings regarding the establishment of investment principles at the time of our investigation?

The investment principles were established in 2011.

Newly drafted investment principles of 2016 were not yet formally established by APS' board during our investigation but have been used since 2017.

⁴ Based inter alia on: A. Slager, F. Lute, J. Overmeer, J. Schreur, (eds.), *Managing pension assets*, 2015; De Nederlandse Bank, *The new FTK (Financial review framework): relationship of the important changes*, 2015, and pension experience.

What is the status of establishing the investment principles?

According to APS, the investment policy is amended based on changes to the principles. In its response, APS states that the board approved the 2018 investment plan.⁵ Investment principles drafted in 2016 are part of the 2017 and 2018 investment plan. As such, the investment principles drafted in 2016 are formally established and approved by the board.

2.2 Step 2: Periodically establish economic assumptions

APS' economic assumptions in 2011 are; a minimum yield of 5.5% on total investments.⁶ An annual average long-term yield of between 3% and 6% is assumed for local investments, and for international investment, a long-term return of between 7% and 11%, is expected.⁷

What are our findings regarding economic assumptions at the time of our investigation?

The assumptions are based on an estimate of the yields for the period 2011 up to and including 2015. Thereafter, the fund did not carry out a review.

Specifically, the sharp decline of international interest yields was most likely the cause of reduced expectations.

What is the situation of the economic assumptions?

The assumptions about the anticipated yield were 'valid' until the end of 2015, though remained in use until the end of 2018. APS reports that this has been corrected after the update and approval of the investment policy in January 2019. This means that the anticipated yield is changed.⁸

2.3 Step 3: Asset Liability Management (ALM) study and Strategic asset allocation (SAA)

The objective of an Asset Liability Management review (ALM-study) is to provide insight into the relationship between expected proceeds from investments and the associated risks. The ALM-study normally analyzes a fund's entire financial strategy. The study can be used to recommend changes that can lead to improvement of the coverage ratio. As part of their response to our findings, APS states that the entire financial strategy of the fund will be (re)-analyzed after the pension reform is approved by Parliament.⁹

The results of the ALM-study are used to institute a strategic asset allocation (hereafter: SAA).¹⁰ The SAA uses a risk profile that suits the objectives and assumptions of the fund. To remain up to date, the SAA should be reviewed at least every three years, or even more

⁵ APS-board meeting of Augustus 20, 2018.

⁶ In their reaction of May 10, 2019, APS indicates that the minimal yield of 5.5% must be reevaluated. Additionally, APS will have to consider the amended actuarial interest that is annually reviewed.

⁷ APS' most recent actuarial and technical memorandum dated September 28, 2015, refers to a period of five years.

⁸ APS stated the following in their response of May 10, 2019: the anticipated yields have decreased over the short life span of the fund. These reduced anticipated yields have been acknowledged by APS and were expressed through numerous asset reallocations within the international portfolios.

⁹ Reaction of APS dated May 10, 2019, based on our findings at the time of our investigation.

¹⁰ An example of a SAA is: 10% cash, 30% bonds and 60% equity (shares).

frequently when the fund or the financial markets experience major change. APS conducted an ALM-study in 2014.¹¹

What is the position of the ALM-study?

In 2016, the strategic investment plan was changed based on the 2014.¹² As a result, the investment portfolios were restructured in 2016/2017, according to APS. In addition, APS states that these changes were minor, remained within the strategic allocation margins, and were individually approved by APS' board. Furthermore, the board also approved the SAA and/or all changes within the international investment portfolio.¹³

2.4 Step 4: Periodically establishing investment policy and investment plans

The SAA forms the basis of the investment policy. In turn, the policy ensures that the fund's resources are responsibly used. The policy must include an up-to-date assessment of the ambitions and objectives of the fund.

The investment plan is a translation of the policy for the short-term (usually one year). The plan specifies the objectives for the coming year.

Since 2011, the economy has changed, global interest rates have declined sharply, more historic data and analyses about proceeds are available, and the fund introduced several changes (example: new insight regarding the investment principles and the SAA). APS adopts an investment plan every year in consideration of up-to-date circumstances.

What is the status of the investment policy and -plan?

In their reaction of May 10, 2019, APS reports that the strategic investment policy was changed in 2016 based on the 2014 ALM-study. The new investment policy was approved by the board in January 2019.

According to APS, the 2016 investment principles are part of the approved 2018 investment plan.¹⁴ The Strategic Asset Allocation is an integral element of the investment policy.

2.5 Step 5: Invest

Investments commit money for longer or shorter periods of time, to derive financial benefit in the future. When the pension fund outsources the implementation (i.e. investing), the fund can engage an external party (fiduciary manager).¹⁵

The total investment portfolio (local and international) as of June 2018, is ANG 617 million.¹⁶

¹¹ APS' policy is to conduct an ALM-study or continuity analysis every three years. Source: Actuarial and technical memorandum, dated September 28, 2016.

¹² According to APS' reaction of May 10, 2019: 2017 investment plan, page 16, chapter 4, under (re)evaluation investment policies & portfolio restructuring.

¹³ According to APS' reaction of May 10, 2019: approval by the board by means of signed Letters of Authorization (LOA's).

¹⁴ APS: see 2018 Investment plan, version 5, page 22.

¹⁵ Fiduciary manager: responsible for policy execution of an investment portfolio.

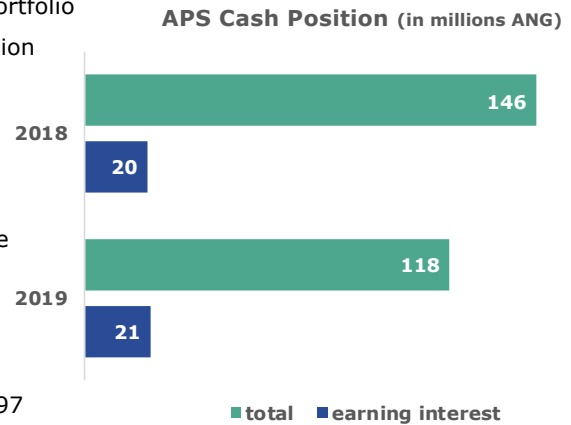
¹⁶ Total Investment Portfolio report of June 2018.

How are the local investments doing?

The local investment portfolio is carried out by APS. The Central Bank of Curaçao and St. Maarten demand that that at least 60% of the value of the total portfolio is invested locally (St. Maarten, Curaçao).

At the end of June 2018, the value of the local portfolio was ANG 369.1 million, of which ANG 146 million (40% of the total) reflects the balance at the bank (current account). APS earns interest on ANG 20 million.¹⁷

In reaction to our findings, APS states that these figures have changed.¹⁸ The total cash position of the fund as of January 1, 2019, is ANG 118 million, of which ANG 21 million (17.8%) is interest-bearing, and the remaining ANG 97 million does not earn interest (82.1%).



The fact that a large portion of the local portfolio does not, or not significantly, contribute to the desired yield of 5.5%, suggests that other parts of the portfolio must generate additional returns. The fund is attempting to pursue dual investment goals post-Hurricane Irma, specifically, keeping the pension affordable, and supporting the reconstruction efforts of St. Maarten through investment.¹⁹

What is the situation of the international investments?

The international investment portfolio has been outsourced to a fiduciary manager since inception of the fund.

At the time of our investigation in 2018, APS was using the investment policy established in 2011. In their May 10, 2019 response to our findings, APS states that the updated investment policy was approved by their board in January 2019.

2.6 Step 6: Monitor and evaluate

Monitoring investment results is very important. After all, results should correspond with the anticipated returns and objectives. Moreover, investment practice should be in line with the investment policy.

Deviations may require changes at various steps of the cycle. The entire cycle is evaluated every three years, or more frequently, if required.²⁰

¹⁷ See Total Investment report of December 2017 and June 2018.

¹⁸ Reaction from APS of May 10, 2019.

¹⁹ Minutes of the meeting with the director of APS, August 27-18, 2018 and minutes of the meeting with APS' chairman of Augustus 27, 2018.

²⁰ In their reaction dated May 10, 2019, APS states that it is not necessary to review all elements after three years.

How is the monitoring of the local portfolio going?

The board receives monthly summaries of the realized proceeds from the local investment portfolio.

The process and procedures regarding local investments are described in the document entitled "Process 004-Investments 20-12-12".²¹ Additionally, a series of documents from intake to decision-making of new investments, prove that there is a structured and verified process.

What is the status regarding monitoring the international investment portfolio?

The fiduciary manager provides a presentation to APS regarding the international portfolio every quarter.²² APS receives monthly, bias-free, third-party generated performance reports according to GIPS-standards.²³ Regular communication reports and due diligence also takes place on the international investment portfolios.²⁴ According to APS, communication is continuous.

During the annual meeting (due diligence meeting since 2018), specifically held for this purpose, discussion takes place with the fiduciary manager about, among others, the results and economic developments. APS adds that during the due diligence process, discussions are held with a selection of managers of all international strategies, and not solely with the fiduciary manager. Each strategy is handled separately. The general results and economic developments are not the only items discussed. APS states that they are constantly kept abreast of the status of the international portfolios.²⁵

The performance of the fiduciary manager was evaluated in 2016. The fund does not maintain a specific frequency schedule for conducting an evaluation.

How are evaluations going?

Evaluation of the entire investment cycle had not taken place at the time of our investigations. A number of phases of the investment cycle were evaluated by APS, such as the investment principles and the SAA. APS has included these in their investment policy of January 2019.²⁶

²¹ According to APS in their May 10, 2019 response.

²² Minutes of the meeting with the director of APS, August 27-18, 2018.

²³ The Global Investment Performance Standards' aim is to increase comparability of investment managers by standardizing the methodology that companies use to report investment performance.

²⁴ Idem.

²⁵ Idem

²⁶ According to APS in their May 10, 2019 response.

3 OTHER FINDINGS

3.1 Changing the pension system

The Fund intends to have a new ALM-study carried out as soon as the legislation for the new pension ordinance is approved by Parliament.²⁷ According to APS, the change to the legislation is required in order to maintain the financial viability of pensions.²⁸

It is important that Parliament and APS consider the risks to pensions. For example, Hurricane Irma. After Irma, the Fund was concerned about the degree to which premiums could be collected,²⁹ but Irma's impact on the economy as a whole is both tangible and visible. In responding to our findings, APS states that as a result of Irma, the Fund's investment possibilities have increased. The impact of Irma on APS's investments (probable and existing) is, according to APS, multi-faceted and cannot be labeled as purely positive or purely negative.³⁰

Years ago, APS made calculations to determine how long the fund could remain operational in the event premiums would not be collected. We support such calculations and suggest that they be updated regularly.³¹

3.2 The international investment portfolio

In the period 2011 through 2017, the Fund mostly underperformed as compared to the SAA. For example, the realized yield on international investments in 2017 was 11.8%, while the yield according to the SAA is 15.4%.³² APS believes that prior to making this conclusion, consideration should be given to what is mentioned under section A of Annex 1 of this report.

The fiduciary manager indicates that the performance of the total investment portfolio should be evaluated over an entire market cycle.³³ The duration of an entire market cycle is very difficult to establish. As such, we find the argument to be insufficient to justify the underperformance. APS' feels a certain nuance is necessary.³⁴ APS position on this matter is listed in under section B of Annex 1.

3.2.1 Restructuring the international portfolio

In 2017, the Fund restructured the international investment portfolio to optimize the transparency of its management, its composition and its management costs. Despite reducing the number of investment strategies from 30 to 18,³⁵ we believe that the structure can be much simpler and more transparent. Currently, the portfolio mostly (70%) consists of active investment strategies.

²⁷ Approved minutes of the meeting between the General Audit Chamber and the Director of APS, August 27-28, 2018.

²⁸ *Financial Statements for the year ending December 2017*, General Pension Fund St. Maarten. For example: the retirement age will increase to 65 years, and the final salary scheme will be replaced by a average career salary scheme.

²⁹ Approved minutes of the meeting between the General Audit Chamber and the Director of APS, August 27-28, 2018.

³⁰ Management 's response of May 10, 2019.

³¹ Approved minutes of the meeting between the General Audit Chamber and the Director of APS, August 27-28, 2018. In its reaction of May 10, 2019, APS indicates such calculations are costly. Moreover, APS could execute these calculations after pension reform is approved in Parliament.

³² *Financial Statements for the year ended December 2017*, Algemeen Pensioenfonds St. Maarten, APS Total investment portfolio report December 2017 and Montley Investment presentation, Portfolio performance detail as of December 31, 2017, Kovack Securities/Kovack Advisors.

³³ This is the beginning of a rising market until the end of a declining market.

³⁴ APS response of May 10, 2019.

³⁵ As of September 20, 2018.

In our opinion, passive portfolio management is more in keeping with the investment principles of a passive investment policy.³⁶ This observation corresponds with the advice issued by Willis Towers Watson to APS, that the portfolio can be simplified and managed for a fraction of the cost.³⁷ APS' reaction on this matter can be found under section C of Annex 1.

³⁶ Unless it characterizes the market in question as inefficient.

³⁷ Risk Budgeting – Results, Willis Towers Watson, September 14, 2016.

4 OPINION AND RECOMMENDATIONS

Our investigation covered the period 2017 to June 2018. Our audit questions were:

1. Does the investment policy and -process guarantee that APS invests in accordance with its investment principles?
2. Did APS act in accordance with its internal investment policy and principles during fiscal year 2017, and in the period from January to June 2018?

It is our opinion that APS' investment process, in general, is in order. The Fund is familiar with all phases of the investment cycle and also follows the cycle.

The fact that important documents across the entire process have been approved and updated is in our opinion a positive development.

In terms of the ALM-study, one should have been conducted in 2017 (according to APS' policy).³⁸ APS indicates a new ALM-study will be carried out once the pension reform is approved by Parliament. We understand the costs and time required for the execution of such a study, and that an ALM-study will likely be necessary after approval of pension reform. However, approval by Parliament is not guaranteed, nor is the date on which approval will occur. Furthermore, an ALM-study can be carried out to review both the current and expected situation, thus providing insight into the effect of the changes. We advise APS to take this into account.

Another important point is that we consider APS' investment policy complex and therefore costly. As indicated in Willis Towers Watson's report³⁹, the investment policy can be more cost effective. We question whether there is insufficient expertise within APS' organization in the field of international asset management. We therefore advise APS to be more critical of the performance of the fiduciary manager.

We end our opinion by stating that we experience the cooperation with APS as positive. We recommend that APS take a proactive approach for providing the General Audit Chamber with documents relevant to a specific investigation when these are updated and/or formally approved in support of the audit.

³⁸ Source: Actuarial and operational memorandum dated September 28, 2016.

³⁹ Risk Budgeting – Results. Willis Towers Watson, September 14, 2016.

5 RESPONSE FROM APS' BOARD

5.1 Response from the Board of APS

In their reaction, APS' board expressed their satisfaction with the findings of the General Audit Chamber and indicated their general agreement with the content of the report.

The Board states that they are considering carrying out a risk-budgeting study in the near term, given that an ALM-study is very costly, reason why it could only be carried out after pension reform.

In addition, APS' Board agrees that the cost of the fiduciary management can be evaluated. In anticipation of this, APS recently hired an experienced risk- and investment analyst to better monitor the Fund's international portfolio. Based on the results, APS will be able to determine what changes are required. According to APS, they are currently using an updated investment policy which is in the best interest of the management of APS's investment process.

ANNEX 1

Section A: APS' reaction on underperformance regarding the international portfolio

Based on the most recent monthly review of the March 31, 2019 performance, the 'net' *inception to Date return* of APS' international investment portfolio was +6.09% compared to +7.05% for the broad, general composite benchmark of a 70/30 allocation. This represents a difference of -0,96%. Over time, the weighted effect of the 60/40 allocations of the APS during the first two years of the fund will decrease when compared to the 70/30 allocation of December 31, 2018. The composite benchmark which yielded +12,41% up to December 31, 2017, was composed of 30% bonds and 70% equity, because that was the allocation as of that date, while APS' international investment portfolio for the first two years of the fund's existence was 40% bonds and 60% equity. This resulted in a slower upward trend due to a relatively high bond allocation in a bull market environment.

The SAA is not the historical compound benchmark. The SAA is clearly classified within the MIPS per asset class. There is no comparison of the SAA with APS' international investments because these cannot be compared. On the other hand, the historical compound benchmark is a broad and general reflection of the asset allocation of the portfolio that consists of globally recognized no-cost market-wide benchmark indices. Had APS placed 100% of their investments exchange traded funds (ETF's), with lower fees than the actively managed strategies used, the net profit of those ETF's would have been lower than the current actively managed portfolios. Investors cannot own benchmark indexes; the choices are therefore ETF products or actively managed strategies.

It is also important to recognize that APS' international investment portfolio is designed with more risk based on historical analysis, than the broad general benchmarks with which it is compared. During a bear market environment, APS' international portfolios are expected to lose less market value. Although there are no guarantees, the underperformance will be less if this happens.

Section B: APS' reaction: nuance of the underperformance of the international portfolio

APS believes that nuance is needed. The underperformance relative to the benchmark is based on multiple reasons/factors and not solely the consequence of the market cycle. In this regard, consider the differences between the composition of APS' portfolio vs the 2011-2018 benchmark, increases and reductions in allocations to non-US securities, or the changing allocation between larger and smaller capitalization companies, or, from value to growth, securities, etc. A market cycle can last 3-10 years, depending on economic conditions. Given that the composition of APS' international investment portfolios is designed to be more risk-averse, a bear market period needs to be included in the analysis. To date, APS has not experienced a bear market.

Section C: APS' reaction to restructuring of the international portfolio

A focus solely on expenses does not influence investment performance. The most important factor is the 'net' return after expenses. As of April 30, 2019, APS' current international portfolio is approximately 13.7% passive and 86.3% active. The costs associated with the management of APS' international portfolios have been consistently reduced by means of integration of passive investments with lower expenses and the reduction of active management expenses. The expectation is that the weighted percentage of APS' total international portfolio towards passive types of investment structures will increase after the next bear market, when most risks will have passed. When discussing the fees and expenses charged by Kovack, consideration must be given to the totality of services rendered by Kovack.



General Audit Chamber

Algemene Rekenkamer