Account and Financial Management Journal e-ISSN: 2456-3374
Volume 3 Issue 05 May- 2018, (Page No.-1553-1558)
DOI:10.31142/afmj/v3i5.04, I.F. - 4.614

Long Term Objective of Kosovo Pension Saving Trust Investments

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Abstract: After the 2007-2008 crisis financial markets have enjoyed a long period of recovery with some short term stress periods along the way. In the face of this sustained appreciation of financial assets (bonds and equities) a correction was long overdue. This correction has just happened this year in late January – early February of 2018. The latest turmoil in financial markets is not to be compared with the 2008 financial crisis, since the banking system is liquid and big corporations are well balanced with strong balance sheets. Much of the correction is believed to have already occurred, and while in the coming weeks there might be an additional small decline to close the correction, the performance is expected to stabilize and return to positive territory for the year. These expectations are based on the fact that international institutions are emphasizing that developed economies are showing macro-economic stability.

Key words: Pension, Correction, Pension Fund, strategic investments, diversification

ACRONYMS

ASSEMBLY - Assembly of the Republic of Kosovo
CBK- Central Bank of the Republic of Kosovo
Government – Government of the Republic of Kosovo
GDP-Gross Domestic Product (as published by the Kosovo Agency of Statistics)
IFRS- International Financial Reporting Standards
KAS- Kosovo Agency of Statistics
KPST- Kosovo Pension Savings Trust
OECD- Organization for Economic Cooperation and Development
PWP- Phased Withdrawal Program (of pension savings)
SIP- Statement of Investment Principles
IPG-Investment Policy Guideline
US- United States
EU- European Union

GLOSSARY OF TERMS

EQUITY- Financial instrument that provides ownership in a company, depending on the size of investment.

NOTES OR BONDS - Financial instrument issued by governments or corporations with a designated maturity limit which usually pays a coupon based on a fixed or flexible interest.

MULTI-ASSETS - Investment funds that have in their composition a mix of securities from core asset classes (equities, bonds and cash).

INVESTMENT RISK- Implies the probability or likelihood of occurrence of losses relative to the expected return on any particular investment.

BENCHMARK- A standard reference level of comparing and analyzing the investment performance. KPST has set as benchmark
Kosovo's Consumer Price Index (CPI), otherwise referred to as the rate of inflation in Kosovo.

DEFINED CONTRIBUTION- In a defined contribution plan, fixed contributions are paid into an individual account by employer and employee. The contributions are then invested and the returns on the investment (positive or negative) are credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, usually through the purchase of an annuity which then provides a regular income.

Introduction

Since 2011, and particularly during 2016 and 2017, the increasingly asset allocation was in multi-asset and risk managed funds (47% in January 2018), in conjunction with objective to keep volatility at low levels, participate during uptrend markets and minimize the impact of downtrend markets. The latest turmoil in financial markets is not to be compared with the 2008 financial crisis, since the banking system is liquid and big corporations are well balanced with strong balance sheets.

Much of the correction is believed to have already occurred, and while in the coming weeks there might be an additional small decline to close the correction, the performance is expected to stabilize and return to positive territory for the year.

These expectations are based on the fact that international institutions are emphasizing that developed economies are showing macro-economic stability.

Regarding strategic investments allocations, KPST is currently invested in: 47% in multi-asset funds; b) 33% in equities (10% in risk-managed equities); c) 11% in bonds' and d) 9% in cash and money market instruments. (KPST Annual Report)

The Board believes that the current positioning of KPST (23% in directional equities and 77% in less risky and more protective instruments) is appropriate to navigate successfully and with prudence towards positive returns for the year.

Investment Policy Guideline (IPG) and Statement of Investment Principles (SIP)

In 2016 KPST adhered fully to the Statement of Investment Principles (SIP) and the Investment) set in 2014. The SIP is based on main long-term investment goal of KPST, which is: first to preserve and secondly to increase the contributors' capital in both nominal and real terms. The SIP sets the Consumer Price Index in Kosovo as a benchmark against which the performance of KPST investments is to be measured. The IPG, recognizing there ought to be a balance between contributors who are close to retirement and those who are not, calls for a policy which contains a reasonable and not excessive allocation to long-term instruments from which the expected return and volatility are higher, such as equities; this in turn should be combined with a greater allocation to investments with expected lower volatility and more stable returns than equities. With an increased emphasis on risk, the objective of the IPG is to offer more protection in downward markets, yet to reap the rewards when markets go upwards. This objective was met also in 2016 when oscillations were quite successfully subdued and protected the value of investments. The strategic allocation and its limits every quarter, the compliance of allocations with the limits for asset classes or the investment strategy adopted by open-end fund managers. Multi-asset funds mean funds that contain both equity and debt instruments of governments and global corporations such as e.g. bonds. When it comes to the investment strategy, risk managed funds set placements through derivatives (such as futures – agreements for executing financial instruments in the future with a redetermined date and price), in order to protect from markets going into an unwanted direction. Funds with risk targeting determine a risk level (target) for the volatility of the investment portfolio and on regular basis reallocate assets to restore the expected volatility to that established level of risk. At the same time, through careful analysis, KPST investments were verified if they meet all the provisions of the Law on Pension Funds of Kosovo. The current investment policy is based on a combination of:

a) asset classes - i.e. financial instruments of direct investments as well as those of indirect investments held through open-end funds; and

b) investment strategy adopted by individual open-end funds. Each combination of asset classes and strategies has minimum and maximum of investments allowed in them. It should be emphasized that KPST is using all legal options and financial potential of Kosovo for investing pension funds, and currently there are only two options: investing in Treasury securities and bank deposits.

Table.1. The combination and allocation of asset classes (year 2016)

Asset class	Strategy	Actual Allocation	Limits
Cash/Kosova T-Bills-Depozits	Interest bearing	4,7%	1%-12%
Kosova T- bonds	Interest bearing	3,4%	0%-9%
Debt Instruments	Directional	6.80%	6%-25%
Multi Assets	Managed/Targeted risk, Apsolute Return	41%	21%-45%
Equities	Dividend	4,1%	2%-8%
Equities	Managed/Targeted risk, Apsolute Return	12%	7%-13%
Equities	Directional	27,9%	25%-35%

Source; Annual Report, 2016, Kosova Pension Saving Trust (KPST)

Multi-asset funds mean funds that contain both equity and debt instruments of governments and global corporations such as e.g. bonds. When it comes to the investment strategy, risk managed funds set placements through derivatives (such as futures – agreements for executing financial instruments in the future with a predetermined date and price), in order to protect from markets going into an unwanted direction.

The combination of asset classes and strategies has minimum and maximum of investments allowed in them. It should be emphasized that KPST is using all legal options and financial potential of Kosovo for investing pension funds, and currently there are only two options:

1. Investing in Treasury
2. Securities and bank deposits.

The table below shows the combination of asset classes and respective strategies, actual allocations as of December 31, 2017 as well as respective limits in force on that day as set by the Governing Board. Absolute return funds aim to select stocks and debt instruments with the perceived greatest potential to generate positive returns, under the general belief that the lower volatility of debt instruments will itself

counterbalance the volatility of stocks and reduce the overall risk.
Funds with a dividend investment strategy select in their portfolio only stocks of corporations with regular and stable dividend payments. The "Interest income" is supposed to include direct placements in interest-bearing instruments, such as term deposits and Kosovo debt securities.

Table.2. The combination and allocation of asset classes (year 2017)

Asset class	Strategy	Actual Allocation	Limits
Cash/Kosovo T-Bills-Deposits	Interests bearing	8.70%	1%-12%
Kosovo T- bonds	Interests bearing	3.30%	0%-9%
Debt Instruments	Directional	6.70%	4%-25%
Multi Assets	Managed/Targeted risk, Absolute Return	48.00%	25%-55%
Equities	Dividend	2.00%	0%-8%
Equities	Managed/Targeted risk, Absolute Return	8.90%	7%-13%
Equities	Directional	22.40%	20%-35%

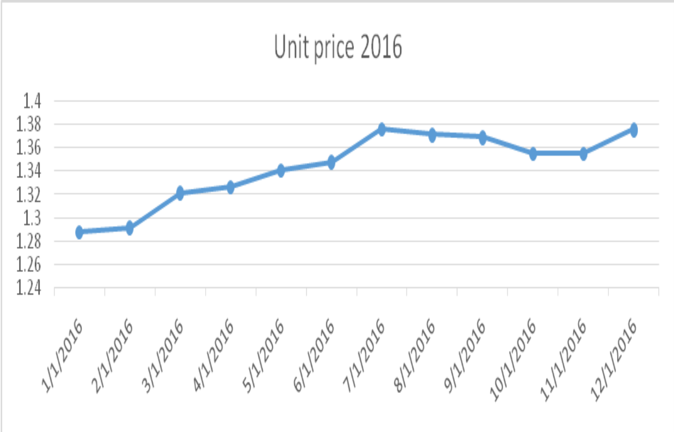
Source; Annual Report, 2017, Kosovo Pension Saving Trust (KPST

This statement of Investment Principles is based on the long - term objective of KPST investments that is: first to maintain and secondly to increase the equity of the contributors, in nominal and real terms. It The Declaration has established the Kosovo Consumer Price Index as a benchmark against which investment performance will be measured of KPST.
The Investment Policy Guide (IPG), acknowledging it should have a balance between contributors who are close to retirement and those who are not, call for a policy that contains a mass reasonable but not excessive allocation to long-term assets which are expected to be higher return and volatility, such as shares; of combined with a larger investment allocation from which it is expected lower volatility and more stable returns than shares.
With this emphasis on risk, the Investment Policy Guide (IPG) goal is to provide the protection when the markets are down but still to reap rewards when markets grow. This objective was also met for 2017, when markets were generally in strong growth rates, even the KPST's investment portfolio, albeit conservative, brought one solid growth above 6% of unit price. At the same time, through careful analysis, it is verified whether KPST investments fully meet all the provisions of Law on Pension Funds of Kosovo.

Performance

KPST marked another year of positive annual investment returns. Gross returns (including cash at CBK and other income) where €64.6m – equivalent to a gross performance of 4.88% (2016). The gross performance less (investment and operating) fees charged on the fund resulted in a net performance of KPST - and unit price increase - of 4.4% for the year.

Fig.1. Unit Price,2016

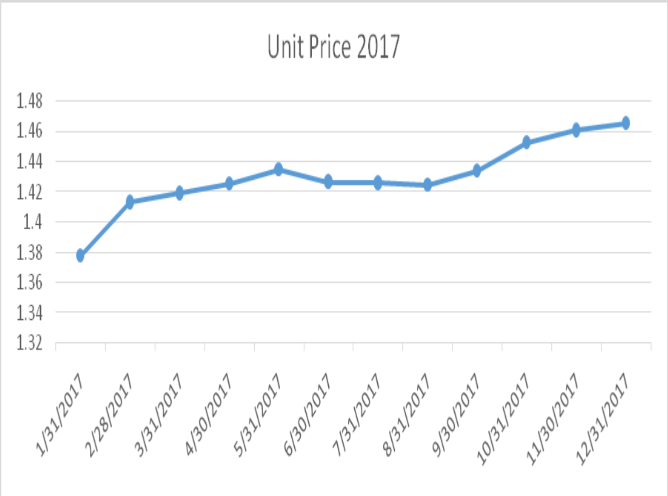


Source: Data base of KPST,2016

This positive result was achieved in a year dominated mostly by political events. Brexit as well as the presidential elections in the US contributed to a high market volatility. However, the weak economic indicators in China and the falling oil prices were economic factors that played a negative impact on keeping markets under constant pressure during the first half of the year. But once these indicators changed path, along with a growth in corporate earnings, improvement of labor market in the US and EU, solid global economic growth and the fading effect of political risk, pushed the markets towards a rapid growth (especially) in the last quarter of the year.(Annual Report, 2017)
Except from the external environment, the KPST investment strategy in force, proved viable and effective by providing a combination of stability and returns through investment balance and diversification.
KPST's investment performance for 2017 was at a record level in terms of nominal value, with a gross return of € 102.6 million - equivalent to a gross performance of 6.8%(2017). By deducting the fees charged (for investments and operations) it turns out that the net performance and the unit price increase was 6.5% for the year. This was a year of strong growth in the financial markets, especially of the

stock market. The most important global stockpiles captured historic records in a double-digit growth year. This growth was based on (generally) very good indicators of economic growth and declining unemployment in the US, the EU and important Asian countries, but also by a favorable investment environment, where fiscal facilities continued to be in place for 2017 Apart from the movement of markets, the investment strategy and the tactical allocation by the Governing Board were significant, thus enabling the harvest of highly satisfactory returns from investments. This despite the fact that KPST has an investment portfolio that maximally maintains the balance between risk and potential gain. Thanks to these factors, this was also the year with the lowest volatility of the investment portfolio of KPST.

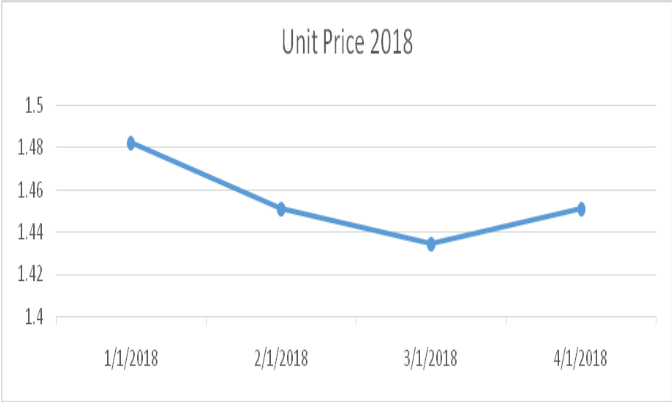
Graf.2. Unit Price, 2017



Source: Data base of KPST,2017

Out of 12 investment funds engaged this year, only one of them closed the performance from negative investment (-0.19%). This fund belongs to the cash market and is exclusively intended to provide maximum protection in the financial market. The 11 other investment funds had a positive return on investment. They were led by the extremely positive performance of the Vanguard GSIF share fund of + 16.7%. In this way, this fund contributed 56.7% to KPST's total gross performance, while it had an average annual allocation of 23.7%. Vanguard GSIF was the best year of all funds in the ratio between the average allocation and the return on investments. All other investment funds (including investments in Kosovo) contributed 43.3% to the KPST's overall performance, with the most distinguished three multi-asset funds: Nordea SRF (with an average allocation of 15.6% and with a contribution of 10.0%), BNP Paribas PDD (with an average allocation of 5.3% and a contribution of 7.8%), and Schroders GDG (with an average allocation of 5.1% and a contribution of 6.2%). Investments in Kosovo (Treasury and Deposit) generated € 2.0 million (or 1.9%) of gross returns for the year of € 102.6 million. This was achieved by having an average combined allocation of 7.3% of the funds. (Annual Report 2017)

Graf.3. Unit Price 2018



Source: Data base of KPST,2016

After the 2007-2008 crisis financial markets have enjoyed a long period of recovery with some short term stress periods along the way. In the face of this sustained appreciation of financial assets (bonds and equities) a correction was long overdue.

The last correction has just happened this year in late January – early February 2018th . February 2018 was very shocking with the rapid decline in markets. Fall was up to 10%. KPST had a good diversification in which case the decline was smaller compared to other funds. So KPST assets falling down -7.5up to -8% in two critical days. In the past two months, the fall of KPST sets by January to the end of April was -1.1. Our reactions within KPST were also stressful, but we decided not to panic and react by the emotions, and all we had decided as a board was not to sell under the pressure of fear what will be tomorrow. Certainly the prices were scary, but our orientation was on long-term investments.

According to S & P Dow Jones Indices, the Standard & Poor's 500 index, the broad gauge of stocks, ended February down 3.9%, its first monthly loss since March 2017, which left it just shy of an 11-month streak in 1958. The fall was also the largest monthly decline since January 2016, when investors came back from stocks due to concerns that China's economy was in danger of a major contraction (Adam Shell,2018).

This February was a turbulent period, which saw the return of wild price swings for stocks after a long period of calm. The volatility - including two days in which the Dow Jones industrial average suffered record points drops of more than 1,000 points - was set in motion by fears that borrowing costs would spike more than expected this year, threatening to slow growth for the economy and stocks (Adam Shell, 2018). Market corrections are natural, and they're going to happen. What we don't know is when, how severe they might be, and how long they're going to last. This isn't a time to panic, and keep in mind that investing and emotions don't mix well. However, times like these can serve as a good reminder to check in on your investments to make sure they are aligned with your short- and long-term goals(BY JJ KINAHAN, 2018).

Objectives - Diversification of the Investments

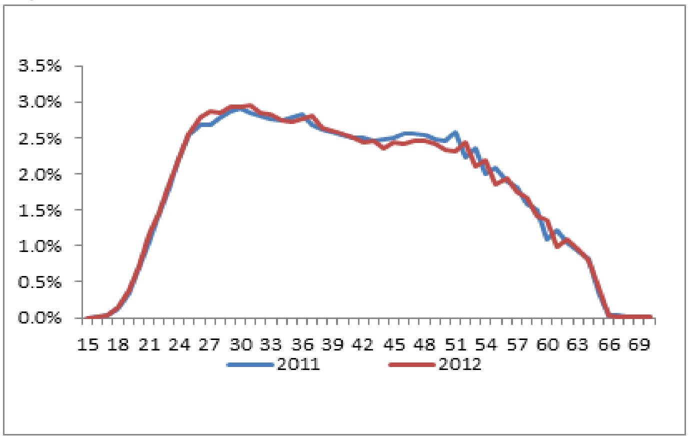
Regarding strategic investments allocations, KPST is currently invested in: 47% in multi-asset funds; b) 33% in equities (10% in risk-managed equities); c) 11% in bonds' and d) 9% in cash and money market instruments.

The current positioning of KPST (23% in directional equities and 77% in less risky and more protective instruments) is appropriate to navigate successfully and with prudence towards positive returns for the year. Much of the correction is believed to have already occurred, and while in the coming weeks there might be an additional small decline to close the correction, the performance is expected to stabilize and return to positive territory for the year. The KPST is a long-term investor with the primary objective to ensure that assets are invested in a prudent manner consistent with the requirements of the Law. The goals of prudent investment for the portfolio are:

- The security of pension assets;
- Diversity of investment;
- Maximum return consistent with the security of pension assets; and
- The maintenance of adequate liquidity.

The most reasonable and long-term beneficial seems to be the creation of multiple portfolios based the current age of the contributors. This approach may result in a relatively controversial reaction by the general public however it is the structure of the contributors which may be a supporting argument for this approach. As presented, the largest part of active contributors belongs to relatively young age. (Annual Report 2017)

Figure 3. Percentages of active contributors by age



KPSF (2013): Annual Report 2013

Based on Figure 3, we can create four main sub-groups (or more if necessary) according to their age levels and long-terms prospects of the portfolios for each group. Let‟s discuss the share of sub-groups according to these splits:

a) 15-49,
b) 50-54,
c) 55-59,
d) 60+.

This separation provides some great insights on the structure of contributors and assets per each group and total assets for each portfolio of this multiple portfolio approach. In this case, the largest portfolio would be what was previously listed as a) the age group between 14-49, followed by portfolio b) 50-54, c) 55-59 and finally d) age 60 and over. (Havolli,2016)

This strategy might consume more resources for the KPST and the process of transition from the single portfolio system to the multiple should be a mid-term project, however, as noted by the management of the KPSF, this is viable option which could be gradually introduced.

There are further options to dividing age-groups, percentages of each age group for any investment instrument, but these of course, should be long-term value maximizing with the least risk for the contributors. This long-term value maximizing and minimizing the risk does necessarily require that higher share of the younger age-group (a) to be invested in equities, while as we move towards other older age groups (b,c and d), the investment in equities should gradually move towards zero for the last (d).(Havolli,2016)

The current strategy of the fund is that up to 40% of funds will be invested in equities, and up to 60% in absolute return instruments. With the current strategy the percentage of funds allocated to equity instruments remained the same, i.e. not exceeding 40% of total assets. This strategy aims to ensure that there is a balance between the interests of soon-to-retire contributors who have less tolerance for risk, and those whose retirement is more distant for whom implementing a relatively risky strategy may be appropriate. Balance takes into account these issues and reflects the fact that the Board still maintains a strategy based on the principle of prudent investment for potential returns from equity markets.

Absolute return instruments contain a mix of asset classes such as government or corporate bonds, stocks, futures, and cash instruments. Besides changing the strategy to invest up to 60% of funds in this category, additional Open-end vehicles were mandated to absorb new investments during the year in this category. The majority of instruments in this category are actively managed by the respective fund managers of the instrument; therefore they do not follow any particular index. KPSF subscribes to Open-end instruments managed by specialised entities in order to invest in global financial markets. These entities have a 40% of assets invested in "Equities".

Conclusions

The Statement of Investment Principles (SIP) should be based on main long-term investment goal of KPST, which is: first to preserve and secondly to increase the contributors' capital in both nominal and real terms.

The Investment Policy Guide (IPG), recognizing there ought to be a balance between contributors who are close to retirement and those who are not, calls for a policy which contains a reasonable and not excessive allocation to long-term instruments.

Investment Principles is based on the long - term objective of KPST investments that is: first to maintain and secondly to increase the equity of the contributors, in nominal and real terms.

Orientation during the February correction was not to panic and react by the emotions,

Market corrections are natural, and they're going to happen. Not to sell under the pressure of fear what will be tomorrow. Certainly the prices were scary, but our orientation was on long-term investments.

The most reasonable and long-term beneficial seems to be the creation of multiple portfolios based the current age of the contributors. This strategy aims to ensure that there is a balance between the interests of soon-to-retire contributors who have less tolerance for risk, and those whose retirement is more distant for whom implementing a relatively risky strategy may be appropriate.

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