Abstract

Optimal Design of Pension Funds in Emerging Markets

Vedat Akgiray
CARF – Boğaziçi University

The value of financial assets held by pension funds globally is more than half of the world's GDP. As such, the long-term financial performance of pension funds and their asset allocation practices are of utmost importance for global and local financial stability. G20 has defined financial stability as the *'Resilience of the financial system to unanticipated adverse shocks to enable the continued functioning of the financial intermediation process.'* Properly designed pension funds can easily absorb adverse price shocks and earn the associated risk premiums because they can diversify these risks over time.

Since a large portion of financial assets in emerging markets is held by "international" investors (for example, more than 65% of the floating value of BIST), these markets are more and differently exposed to systemic risks. Standard agent-based asset pricing models based on trading patterns in developed markets cannot fully explain the actual pricing processes in these markets. Therefore, this study argues that an optimal design of pension funds in emerging markets should consider:

- Not only the usual system architecture of allocating funds between debt and equity instruments in line with the natural purpose of maximizing long-term value,
- But also unpredictable adverse investment flows due to systemic events and their impact on asset values.

As a consequence of this recommendation, it is also argued that pension funds in emerging markets should place more weight in equities and equity-linked assets both for long-term performance and also for enhanced absorption capacity of adverse flows. Moreover, this policy will also incentivize national savings and marginalize the problem of current account deficits.