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DEVELOPMENT OF KOSOVO PENSION SAVING TRUST FUND

Ymer Havolli[1]
University of Prishtina, Kosovo
Corresponding author: Email: ymer.havolli@uni-pr.edu

Ruzhdi Morina
Kosovo Pension Saving Trust
Email: ruzhdimorina@yahoo.com

Abstract

Pension system in Kosovo has experienced various developments in the last three decades. These changes have been driven by both, political and economic developments. The political developments were most important, especially that the previous system failed due to the lack of access to the fund in the post-war Kosovo. The newly established system in post-war Kosovo continues its operations with principles of modern pension fund, savings-based. KPST was established by Law in December 2001 as a not-for-profit institution. As such, the sole objective of KPST is to serve only the best interests of its contributors. KPST is funded in a similar way as are all defined contribution pension funds i.e. by charging fees on assets under management (pension assets). KPST is funded in a similar way as are all defined contribution pension funds i.e. by charging fees on assets under management (pension assets). Throughout this discussion paper, the implications of the crisis, management, asset management issues and most importantly, investment strategy are discussed and some potential solutions to these problems are proposed in order to increase the flexibility of the fund to improve performance in times of crisis.

Keywords: Pension, Pension Fund, Public Pension Funds, Investments, Public Debt

1. Introduction

Kosovo Pension Savings Trust (KPST) has been established by the Kosovo’s parliament in December 2001 and became operational as of August of 2002. It was established as an independent public institution based on defined pension contributions model which means that each contributor has its own account and upon retirement, they would receive pension repayments based on their original contributions (KPST, 2013). As all other financial institutions

[1] The views expressed in this policy paper are those of the author and do not necessarily present the views of the institutions where the author works.

in Kosovo, the fund is also supervised by the Central Bank of the Republic of Kosovo. The fund has various responsibilities, but is mostly administrative in the context of accounts management and the process of procurement for the asset managers. These mandatory duties of the fund result in a focus for long-term returns on the contributions. It should be pointed out that the fund is not licensed as asset manager and in this context, it may not decide on its own on where to invest the contributions. Until recently, there were extensive limitations as per countries the contributions could be invested. This limitation was especially emphasized for the country of contributors, Kosovo, since the law designed by UNMIK, allowed only 5% of total contributions does be invested in one entity. This was not a major deadlock for the fund, since until recently the instruments the contributions could be invested were very limited in Kosovo (i.e. only bank deposits). Since 2012, there is an additional investment option for the fund given that the Government of the Republic of Kosovo has started issuing T-Bills.

Pension systems have changed drastically in transition countries as the political changes took place during the stage of transition of their economic and political systems. Most of the transition countries have switched from the well-known system of pay-as-you go to the system which is based contribution based. In many of these countries, the contribution base was used to soften the transition process which hit hardest the contributors who went in retirement (Congiano *et al.* 1998), however, it is likely that it smoothed the transition process. It should be pointed that the growth of the pension funds have been substantial up to the point that they are often considered to be dominating the financial markets but also affecting the national accounts positions of both developed and developing countries (Gordon, 2000).

Kosovo was one of the countries which started the transition process among the latest, however, its contribution base has never been used for none of the purposes, such as its original purpose of repaying the retirees, or as the other transition countries have used to, to smooth the transition process. The contributions of the Kosovan employees for the period earlier than late 1990s have been transferred during the war to Serbia and yet a decade and a half after the war, they have not been paid to the contributors who paid into the system. "In general terms, the effect of pension fund reform on savings depends on many characteristics of the reform and the economy. To name a few: (a) the financing of the transition towards a new pension system; (b) the extent of crowding out voluntary savings by mandatory savings; (c) the strength of intergenerational transfer motives; and (d) redistribution effects between groups with different marginal saving rates and/or borrowing constraints.11 More specifically, pension fund reform accelerates the process of capital market development. Through this channel, pension fund reform helps to improve the screening and monitoring of new projects and to diversify systemic risk, and therefore enable individuals to participate in more investment projects, increasing the rate of investment of the economy (Singh, 1996).

On the other hand, the reforms in the pension systems of the transition countries have been followed by various problems, amongst the first and last, the transition from the previous pay-as-you-go system to that of fully funded mandatory pension system, which is known as pillar II. The case of Kosovo in this context has been unique given that it did not inherit any system or any funds for retirement age. In contrary, it had to establish the system from the begging and at the same time, introduce policy options which would be in line with social environment. In this context the Self-Governing Institutions of Kosovo and the United Nations Mission in Kosovo (UNMIK), designed policies which would result in the mixed-three pillar pension system of Kosovo.

The first pillar was funded by Government, the second was the mandatory system established in 2002 and the third was the voluntary system also established in 2002. The existence of the first pillar has been possible in Kosovo given its demographic characteristics and the fact that its population is amongst the youngest in Europe. However, this has been challenging for a social balance given that the monthly instalments for the pensioners have been relatively low. This low level was induced by the lack of information on the contributors. As a result, the government paid these low amounts to every person in the country above the retirement age, that is 65 and over. The payment amounts grew for some categories over time however despite the growth it is yet barely ¼ of the average salary in the country, lower than half of the average salary in the country, which is estimated to be around 300 Euros per month in private sector (AKB, 2011). However, this system is not expected to experience significant changes over the years. It is likely that the first pillar will grow, however, at a very slow rate.

On the other hand given its continuous growth and its relatively large accumulated contributions (however average per person is still too low), it is the second pillar that matters. This is especially having in mind that it is a modern system based on personalized accounts for each contributor. Therefore, the repayment also depends on the size of the contributions throughout years. In this context, throughout this paper, the focus will be paid on the second pillar especially that this pillar is only administered by a single institution and as of end-2012; it manages a substantial amount of contributions which exceed 20% of Kosovo's GDP.

Despite the newly introduced and modern pension system introduced in Kosovo over 14 years ago, much as other developing economies who have substantial savings in their pension system, this system is facing many questions and challenges on the final benefit that contributors and the economy is getting from this system. With regard to contributors, so far, the Kosovo's experience has not been bad, however, it could have been better if there was a proper decision making in timely manner. On the other hand, the benefits that the country's economy is getting are heavily debatable. Of course, it is always easily argued that the benefit is if the value of the contribution increases, however, countries such as Kosovo which are lacking behind in macroeconomic context and are converging at a slow pace, could have benefited more if instruments for investment of the fund existed in the country. Nevertheless, the primary focus of this research paper is in elaborating ways on how to fulfil best the first challenge, that is, increasing the value of the contributions through investing the fund into existing instruments in both, local and international markets.

The structure of this paper is organized as following: Section 2 discusses on the KPST Investments post-war second pillar pension system in Kosovo which includes the performance analysis during its existence. It emphasizes the performance during the 2007-2009 crises and the problems fund faced during this period. Next, section 3 discusses the current investment strategy, followed by analysis of some potential investments strategies which would reflect the country's demographic structure. Section 5 provides the conclusive remarks and prospects for the future.

2. KPST Investments

The assets shall only be invested in accordance with the provisions of the Law of Kosovo Pension Saving Trust. The main objective of investments of contributions is to maximize returns and in order to maximize returns on investments solely for the benefit of participants and beneficiaries. In this process of investments according to the law, management and the Board should take in to consideration:

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

From a theoretical point of view, more liquid (less expensive) stock markets increase incentives to invest in long-duration projects, because investors can more easily sell their stake before the project matures (Levine and Zervos, 1998). Therefore, good investment projects with long duration can be undertaken increasing economic growth. Moreover, because of economies of scale there may be a virtuous circle in the relationship between transaction costs, liquidity and volatility, in that they can be presumed to reinforce each other. In addition, it is possible to expect that new institutions be created to handle increased transaction volumes, such as new electronic security trading systems, more competition among alternative markets, centralized custody deposits, and others alike (Walker and Lefort, 2002).

To meet its investment objective, the strategy is established as such so thatthe investment returns should outperform inflation. Using an inflation benchmark is crucial to keep the focus on protecting the real value of contributions.

3. Investments in Any Single Issuer

According to the KPS law "The maximum proportion of total Pension Assets that may be invested in the assets of any single issuer, including in this calculation assets of Affiliated Entities, is five percent (5%) for stocks, ten percent (10%) for AA and above rated bonds, and up to thirty percent (30%) of the total assets may be invested in Government Securities of Kosovo".[2]

Table 1. Issuers with more than 1% of KPST assets

Issuer	KPST Assets	Total Allocation	Contributors
1. US Treasury [a]	€137.0m	10.80%	BNY Mellon: 51.3% AXA GILB: 30.1% Nordea SRF: 16.2% Schroders: 1.4% AXA OI: 1.0%
2. Kosovo Treasury [b]	€84.4m	6.70%	Direct: 100.0%
3. UK Treasury [a]	€23.4m	1.80%	AXA GILB: 100.0%
4. Australian Treasury[a]	€16.8m	1.30%	BNY Mellon: 95.2% AXA GILB: 4.8%
5. Microsoft Corp	€13.9m	1.10%	BNY Mellon: 45.7% Vanguard: 32.2% KBI: 15.9% Pictet: 6.2%
6. Johnson & Johnson	€12.6m	1.00%	Nordea SRF: 34.2% Vanguard: 25.5% Nordea GSEF: 21.6% Pictet: 13.2% KBI: 5.5%

Note: a: Debt instruments rated AA and above; b: Government securities of Kosovo.
Source: KPST (2016)

The top allocation was that in US Treasuries with 10.8%. As the rating for US treasuries is AA or above, this is not within the 10% legal limit.

Second were investments in Kosovo Treasuries with 6.7%, making Kosovo Treasury the only other issuer with more than 5% of KPST assets directly or indirectly invested in them. This is well below the 30% allowance for investments in government securities of Kosovo (Table 1).

KPST investments were NOT within limits provided by article 9.9 of the Law on account of exceeding investments in a single issuer. An action is needed within 180 days to bring investments in US Treasuries below 10% of assets.This means, that for the time being no new investments into: Nordea SRF, Schroder's, BNY Mellon, AXA-GILB or AXA-OI can take place.

"The maximum proportion of the securities of any single issuer, including its Affiliated Entities, which may be held by KPST, is five percent (5%) for stocks and thirty percent (30%) for bonds. No such limitation shall apply for Government Securities of Kosovo"[3].

[2] Republic of Kosovo, Law on Pension Funds of Kosovo, Article 9.9
[3] Republic of Kosovo Law on Pension Funds of Kosovo, Article 9.8

Table 2. KPST share of open-end funds

Investment fund	KPST Assets	Fund AUM	KPST share	Previous KPST share
AXA-OI [m]	€57.9m	€586.4m	9.90%	5.20%
BNY Mellon [m]	€206.4m	€3,013.7m	6.90%	6.50%
Vanguard [e]	€340.7m	€6,864.3m	4.90%	4.40%
AXA GILB [d]	€99.8m	€2,655.1m	3.80%	3.70%
Nordea GSEF [e]	€78.3m	€2,164.7m	3.60%	2.80%
Pictet [e]	€39.9m	€1,152.0m	3.50%	2.70%
KBI [e]	€64.2m	€2,600.0m	2.50%	2.70%
Nordea SRF [m]	€184.5m	€10,920.5m	1.70%	1.80%
Schroders [d]	€9.8m	€1,639.0m	0.60%	4.60%

Note: d: Debt/fixed income; e: Equities; m: Multi-asset
Source: KPST (2016)

As it is not possible to track and obtain the shares and debt in issue by any given issuer, the compliance of investments with Article 9.8 is confirmed using an indirect method. KPST does not own more than a 30% share in any of the fixed income or multi-asset open-end vehicles; it is therefore safe to assume that KPST can't be the creditor of more than 30% of the debt of any of the issuers. The outstanding debt of Kosovo Government Securities at quarter-end was €409.7m, making KPST the creditor of 20.6% of such debts. As per Article 9.8, no limits apply to Kosovo Treasuries.

KPST's share of funds containing equities is greater than 5% with AXA-OI at 9.9% and BNY Mellon 6.9% (7.2% and 5.3% respectively for the gross equity part their portfolios). Given that all the equity issuers in these funds are large corporations, KPST can't be the owner of more than 5% of shares of such issuers. It should be noted that the share of KPST in AXA-OI has increased most substantially, from 5.2% to 9.9%. This is the result of both: a) KPST investing an additional €30m during February 2016 in it; and b) around 8-10% of assets redeemed by other investors during the quarter (Table 2).

4. Diversification of Open-end Funds

In order to provide with the issuer diversification within open-end funds, the following table lists all the funds where, as at quarter-end, more than 5% of the portfolio was invested in securities of a single issuer.

Table 3. Issuers with higher than 5% allocation per open-end fund

	Asset class	Current Quarter	Previous Quarter
AXA-GILB			
US Treasury	Fixed income	41.30%	36.60%
UK Treasury	Fixed income	23.50%	28.20%
Italian Treasury	Fixed income	9.80%	7.50%
French Treasury	Fixed income	8.30%	8.70%
BNY Mellon			
US Treasury	Fixed income	34.10%	30.30%
Australian Treasury	Fixed income	7.70%	5.30%
Nordea SRF			
US Treasury	Fixed income	12.10%	17.30%
Nykredit	Fixed income	5.60%	6.20%
Schroders			
US Treasury	Fixed income	18.90%	9.70%

Source: KPST (2016)

The AXA-GILB portfolio has the most allocations to a single issuer which can be expected given the limited number of issuers of inflation-linked bonds; in this fund US treasuries held the first spot with more allocations to it, while UK treasuries retained their second spot. BNY Mellon's allocation to US Treasuries continues to be substantial given their increased allocation to cash and short-term bills. An increase was also apparent at their exposure to Australian Treasuries.Nordea SRF decreased the exposure to US treasuries from 17.3% to 12.1%. Exposure to US Treasuries was more than doubled by Schroders. Otherwise, these funds were well diversified. Vanguard, KBI, Nordea GSEF, AXA-OI, Pictet and Tobam had no placements of more than 5% in any single issuer, making them well diversified across issuers (Table 3).

5. KPST Investments in Debt Instruments

5.1. Investments by Rating

KPST investments in debt instruments and money markets according to their rating at the end of reporting period are given in Table 4. Figures do not include investments in deposits with local banks. It should be noted that at present there are no legal or regulatory restrictions as to the minimum acceptable rating of debt instruments held directly or indirectly through underlying holdings of open-end vehicles.

Overall assets invested in debt instruments decreased from 35.2% to 29.4%.Decreases were more apparent in the High and Upper medium categories, whereas increases were in the Prime (thanks to increases to US Treasuries) and Substantial risk categories only. As a percentage of debt instruments the Prime category increased from 30.1% to 42.5%, Kosovo treasuries increased from 20.7% to 22.6%, whereas the High category decreased the most from 29.4% to 22.9% followed by the Upper medium from 9.0% to 2.8%. In default investments (ranks 9 and 10) consisted of 0.00004% of pension assets (0.0014% of debt instruments), worth €524 on reporting date and remain insignificant in financial value.

Just under 100.0% of investments in debt securities, can be considered fairly safe (ranks 1-6). Investment grade securities (ranks 1-4, excluding Kosovo Treasuries) decreased to 74.7% primarily thanks to increases in the Substantial Risk category. Investments in Kosovo treasuries which, although not rated, as per the Law can be treated as belonging to the Prime category (KPST, 2016).

Table 4. KPST investments in debt instruments and money markets by rating

Rank	Category	Total assets	Debt instruments
1[a]	Prime	12.50%	42.50%
1[b]	Kosovo Treasuries	6.70%	22.60%
2	High	6.70%	22.90%
3	Upper medium	0.80%	2.80%
4	Lower medium	1.90%	6.40%
5	Speculative	0.40%	1.30%
6	Highly speculative	0.20%	0.80%
7	Substantial risk	0.19%	0.60%
8	Extremely speculative	-	-
9	In default with little recovery prospect	0.00%	0.00%
10	In default	0.00%	0.00%
	Total	29.40%	100.00%

Source: KPST (2016)

5.2. Investments by Public Debt

In terms of exposure to public debt, KPST investments held the debt from a limited number of countries and regions/provinces on reporting date, excluding affiliated entities. Overall, KPST assets directly or indirectly invested in public debt increased from 23.2% to 23.7% of KPST assets.

Table 5. KPST investments in public debt

Treasury	KPST allocation	Difference from previous quarter
United States Treasury	10.80%	0.90%
Kosovo Treasury	6.70%	-0.60%
UK Treasury	1.80%	-0.30%
Australian Treasury	1.30%	0.50%
Italian Treasury	0.80%	0.20%
French Treasury	0.70%	-0.10%
New Zealand Treasury	0.50%	0.10%
German Treasury	0.20%	-0.10%
Spanish Treasury	0.20%	-0.10%
New South Wales - Australia	0.20%	0.10%
Victoria - Australia	0.20%	-
Canadian Treasury	0.20%	-
Japan Treasury	0.07%	-
Swedish Treasury	0.06%	-
Netherlands Treasury	0.04%	-
Belgian Treasury	0.01%	-0.10%
Norway Treasury	0.00%	0.00%
Total	23.70%	0.50%

Source: KPST (2016)

The biggest increases were in US Treasuries with an additional 0.9% of KPST assets allocated to it. The largest drop in allocation was in Kosovo Treasuries with 0.6% fewer (Table 5). The Law provides for no limits in relation to investments in public or corporate debt as such; the information is provided only with the aim of understanding if securities from a treasury in trouble are, directly or indirectly, held.

6. Correlation of KPST Open-End Vehicles

Presented below is the correlation of daily performances for the 90 calendar days up to reporting date (excluding weekends) between open-end funds (and KPST itself).The south-west side of the table displays correlations between respective entities, whilst the north-east side of the table displays differences in correlation compared to the previous quarter. Note that absolute differences are shown, i.e. a negative correlation becoming more negative was shown as an increased correlation, albeit it is an increased negative correlation (KPST, 2016).

The quarter displayed a decreased correlation between KPST and most funds, with the exception of Schroders and marginally KBI, Vanguard and AXA OI. The most significant decorrelation occurred with BNY Mellon and Nordea-SRF. KPST correlations remaining above 0.7 were with Vanguard, NOGSE and AXA-OI.Given the turmoil of Q1, correlations generally decreased between investment funds themselves. Only three correlations were in excess of 0.7: a) AXA-OI with Vanguard; and b) Nordea GSE with KBI and Nordea SRF.

Table 6 provides the performance correlation between open-end funds in the portfolio of KPST. The correlation between open-end funds and KPST itself is also provided. Data consist of daily performances for 90 calendar days up to March 31, 2016.

Table 6. Correlation of daily performance between open-end vehicles (and KPST)

	VG	NOGSE	TOBAM	KBI	PICTET	BNY	NOSRF	AXA-OI	SCH	AXA-IL	KPST
NOGSE	0.53										
TOBAM	0.05	0.28									
KBI	0.39	0.71	0.53								
PICTET	0.07	0.29	0.69	0.70							
BNY	0.36	0.40	0.06	0.20	-0.04						
NOSRF	0.37	0.72	0.42	0.59	0.39	0.44					
AXA-OI	0.82	0.56	0.19	0.55	0.15	0.35	0.40				
SCH	0.14	0.38	0.34	0.48	0.47	-0.07	0.20	0.18			
AXA-IL	-0.19	-0.15	0.03	-0.05	0.05	-0.22	-0.01	-0.15	0.25		
KPST	0.91	0.76	0.30	0.68	0.34	0.47	0.63	0.84	0.66	-0.13	
	EQ-D[a]	EQ-R		EQ-I		MA-R			FI-D		

Notes: Explanation and abbreviations: EQ-D (Equities; Directional), EQ-R (Equities; Risk + Absolute Return), EQ-I (Equities; Income), MA-R (Multi-asset; Risk + Absolute Return), FI-D (Fixed income; Directional)
Source: KPST (2016)

Correlations between open-end funds in excess of ±0.7 are highlighted by KPST. Such cases include: a) Vanguardvs AXA-OI with 0.82 - VG has only equities in portfolio whereas AXA-OI, albeit a multi-asset fund, had more than 75% of the portfolio invested in equities; b) Nordea GSE vs. Nordea SRF with 0.72 – Nordea SRF includes Nordea GSE for the equities in its multi-asset portfolio; and c) Nordea GSE and KBI with 0.71 – where these funds tend to go after the universe of good value dividend-paying stocks.

The performance of KPST was most highly correlated to Vanguard (0.91) primarily due to weight of Vanguard in the portfolio of KPST oscillating between 26-27%. AXA-OI although much lower in weight (4-5%) being highly correlated to Vanguard is also highly correlated to KPST (0.84).

7. The Performance of Kosovo Pension Saving Trust

In the early days of Kosovo Pension Saving Trust (KPST) (2003), investments were made in money market funds. Interest rates were favorable at the time and with this strategy of placement it was aimed to preserve purchasing power of money and the growing confidence of the participants in this new pension scheme. At the later stage, since it was aimed for higher returns and the risk tolerance was increased, in 2004 investment policy had changed which allowed for 50% allocation in money market funds and 50% in shares, with the latter being realized through passive fund shares of global corporations (Vanguard).

In 2006 there were also investments in European and global security markets with the aim of neutralizing the risk associated with shares (amounting to 60% allocation).During the 2008 financial crisis, the price of the unit fell by 30%, time during which KPST was without the Board and the decision making for investments was impossible. In 2009 the Board was appointed and a new policy strategy was in place, limiting the allocations in shares at 40% and the remaining in money market funds.

In 2010 Board considered the need for inclusion of multi-asset funds in the investment portfolio of KPST, especially those with risk management as a component, realized through futures and options contracts, but also though risk balancing by asset class. In addition, regarding shares, in 2003 a decision for its diversification was taken, hence, the investment not to be undertaken only in indexed global stocks but also in active managed funds of two types: dividend-paying value equities and in shares with risk management. Therefore, placements in money stock that where without risk management over the years where reduced from 60% to 40% of the portfolio, of which 14% with lower risk compared to value of risk management and

26% that bears all the risk of stock markets. At the same time, the inclusion of multi-asset funds with risk management increased continuously reaching to 36% of the allocation in June 2016. The main aim of the new policy was to stabilize investment performance, aiming at one hand to benefit as much from growing markets and on the other hand absorb less from declining markets.

In addition, it was intended that the selected funds during this time not to be correlated with one another and or with exiting funds in portfolio. This was done with the aim of efficient diversification and at the same time reducing the likelihood of over-diversification or duplication of placements. Thus, in June 2016 the average correlation of the performance of funds committed was +0.28; while the average correlation of the performance of funds against KPST was +0.55. These diversification and the policies pursued during the period January 2011 – June 2016 have significantly reduced the volatility of investments in KPST portfolio. The variance (60 month performance) was at the level of 9.3% and the current level is at 4.9% or 47% lower. Moreover, over 36 month (until June 2016), time during which the stock markets have been declining, KPST have absorbed only 40% of these falls while when these markets where growing, KPST have absorbed 70% of this increase.

Until 30th of June 2016, performance over the latest 36 months was 18.2% net (after taxes attributable to fund) implying a annualized performance of KPST at 5.7%.Over the same period, the consumer price index in Kosovo, set in 2012 as a benchmark for KPST performance, fell by 0.3% (-0.1% annualized) (Table 7).

Table 7. Annualized performance of Kosovo Pension Saving Trust (KPST) since inception (Aug 2002)

	TIME SPANS				
	1Y	**2Y**	**3Y**	**5Y**	**Since inception (Aug 2002)**
Annualized performance	1.39%	3.87%	5.72%	4.92%	2.17%

Source: KPST (2015)

Investments in Kosovo reach a record high of €96 million. A year of positive investment returns for KPST whilst the main global indexes were stuck in negative territory. Net performance for the year was 2.3% with assets under management increasing by 13.0% (KPST, 2015).

8. The Unit Price of Kosovo Pension Savings Fund

Upon its establishment, the unit price was the same as the contribution. That is a 1 Euro contribution was equal to 1 that is the value of the unit. As presented in Figure 1, the unit price for the year 2002 was most of the time at 1, meaning that one Euro of contribution would be returned to the contributor at the same amount. This figure also presents the period when the contribution level was relatively low, hence the exposure in the foreign market of Kosovo's pension system.

From 2005 until middle of the year 2008, the unit price increased substantially contributing also to the faster increase of the assets managed by the fund. This was also enforced by new contributions, but the value of the assets increased by nearly 27 percent. This performance started to weaken over the course of 2008, decreasing by nearly 10 percent until the first quarter of 2008, when the initial problems of the global financial crisis started to emerge.

As presented in Figure 1, indicate specific developments which led to the financial crisis of 2008-2009. In August 2006, the European Central Bank, following the developments in the financial system in the USA released a statement that investors are underestimating the risks. This statement was followed with a decrease of over 2 percent in KPST within one month. However, this decrease was very short-lived despite the concerns of drying liquidity in the inter-bank market (on June 2007). As Wachtel (1999) points out, pension systems require deep and liquid financial markets to absorb savings flows and allocate them efficiently. During this period, it was exactly what pension funds can hardly tolerate, a drying liquidity. However, during this period, it was exactly when the first concerns for interbank lending appeared but contrary to the general expectations, the unit price reached its peak at 1.265. This relatively high unit price decrease with the beginning of 2008 at a significant level, however, it remained in positive-returns territory until the filed bankruptcy by Lehman Brothers in September 2008. After Lehman's collapse in September 2008, the unit price of KPST decreased by 8.2 percent in October 2008. The month after, this drop continued at a faster pace by another 12 percent drop reaching a value of 0.86 Euro for every 1.00 Euro of contribution. This trend of drop in the unit price continued at a relatively fast pace until March 2009 when the unit price of KPST reached the bottom level experienced at 0.797.

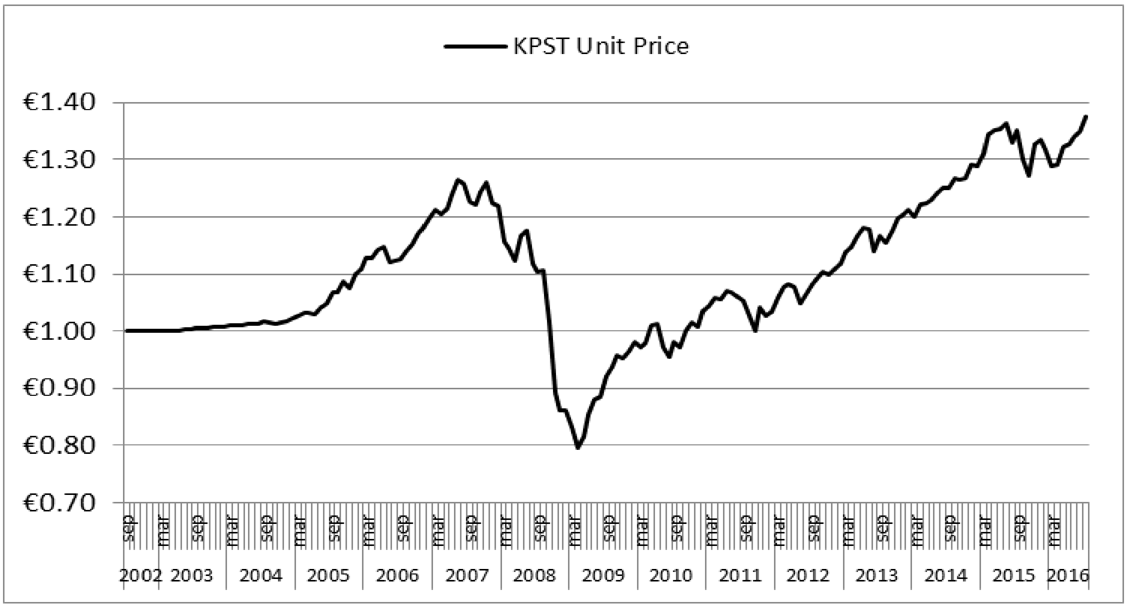

Figure 1. The unit price of Kosovo pension savings fund
Source: KPST (2016)

One of the main problems in this continuous drop in the unit price was the inability of KPST to react on time. This was due to the lack of governing board of the KPST which is the decision making body for investments and withdrawals of their assets. The KPST was actually without the decision making board for a period of nearly a year. So, there was enough time to realize that the crisis is about to begin, however, the decision making institution was not functional, hence, the unit price was continuously going down. In April 2009, the new board of KPST was appointed by the Parliament of Kosovo and the unit price when the new board was appointed was 0.814, nearly 20 percent lower than the amount of contribution. The decision of the board was to act passively which is against what most of the pension funds do in such cases. The literature finds that the behavior of many pension funds around the world is the so-called contrarian behavior which means that when stocks go down, the funds sell them to get rid of their "mistakes" (Lakonishok *et al*, 1991). In this context the KPST decision was to keep these investments in the stock markets until the price recuperates. It was another 12 months after the new board was appointed that unit price returned to 1 Euro.

9. Investment Strategies

The original investment strategy of 60/40 in favor of equities was designed in mind with the average age of participants-which is under 40 years old- thus giving plenty of time to recuperate any loses. However, 2008 market movements and shocks have led to a more conservative strategy for the foreseeable future.

Figures 2 and 3 show that the performance of KPST is slightly below those of main equity indices Dow Jones Industrial and S&P500, respectively; which is in line with the investment strategy approved by the successive Governing Boards of KPST, to have as much of the upside of equity markets but with less volatility.

The investment strategy in force at Q1-2016 was to invest: a) 1-12% in cash and money markets; b) 10-34 in fixed income instruments and/or mutual funds; c) 23-45% in multi-asset mutual funds; and d) 35-57% in pure equity mutual funds (KPST, 2016).

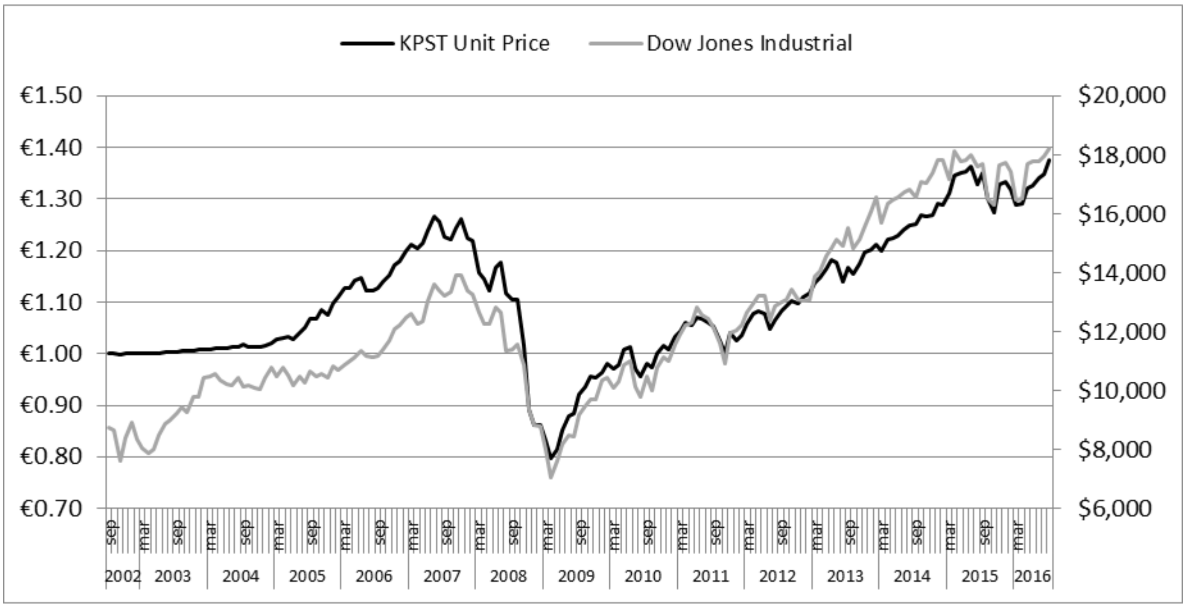

Figure 2. Market movements approximated by Dow Jones Industrial index
Source: KPST (2016)

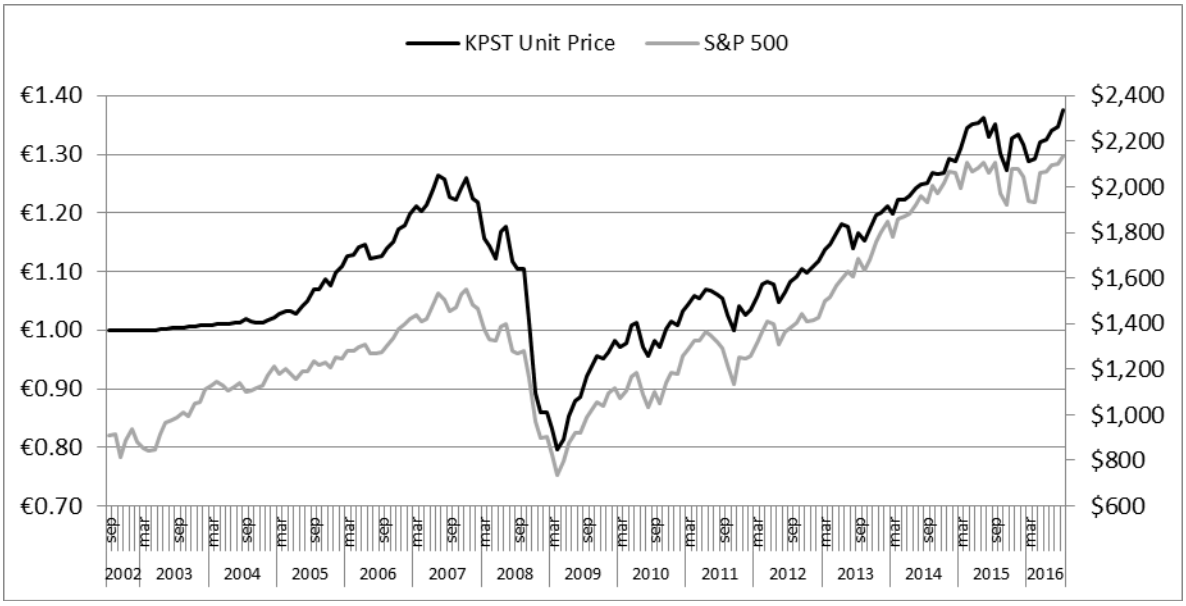

Figure 3. Market movements approximated by S&P 500 index
Source: KPST (2016)

Because of the market uncertainty and current market conditions, in September of 2009, the Board of directors has decided to re-arrange the investment strategy with 60% of funds invested in absolute return and fixed income whereas the remaining 40% will be invested in equities. It was determined by the Board that the fund cannot sustain another drop with a large exposure to equities, as it was during the financial crisis of 2008, and because of this it has decided to reduce the strategy in favor of the absolute return products.

As it was mentioned above during the height of financial crisis the KPST did not have a functioning Board-or an investment decision body, because the Parliament delayed the election of the Board for more than 10 months, from September 2008 until May 2009, which is the exact time when crisis hit the hardest. 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. KPST subscribes to Open-end instruments managed by specialized entities in order to invest in global financial markets. These entities have a 40% of assets invested in “Equities”. Investment Strategy of the KPST, gave its results over the years of post-crisis. This resulted in recuperation of the lost value and as of end 2012, the returns are nearly 8% compared to the initial value of contribution. KPST investment performance came mainly from the stock market, which contribute significantly to overall returns. Global stock market performance was mixed in the post-crisis period, especially having in mind the developments in the Eurozone with degraded rating of peripheral countries of Europe such as Greece, Italy, Portugal and Spain, and also the banking crisis of Ireland. The performance of U.S markets was generally better than the stagnated developments in Europe. However, KPST has benefited in this occasion through the concentration of its investments in the markets with very positive results. Positive performance in the U.S. came as a result of the lack of adverse events with great effect in the markets. Specifically, during the quarter there were some very positive news in the U.S. regarding economic growth, trade deficit and unemployment, thus affecting the confidence strengthening among investors and consumers. Although the current investment strategy has been successful and considered as a relatively conservative, there might be additional options for investments which may yield in a better responsibility of the fund towards its contributors.

10. Investing in the Domestic Economy: What Makes it Hard?

On the debate related to the investment strategy of KPST there were many alternatives discussed, among the investing the funds in the domestic economy which was more immune to the crisis given its limited exposure. However, investing the KPST into the domestic economy would be practically impossible due to the lack of instruments in the financial markets of Kosovo. As of 2015, there are currently only two main investment options for the domestic economy such as government T-Bills and deposits in domestic banking sector.

Related to the first investment option, that is T-Bills, it should be noted that this part of the financial market in the country is operational only since January 2012 while the offered amount by the Treasury Department was rather limited amounting at just over 70 million euros, which is 10% of the total assets of the KPST as of end 2012. Moreover, investing in the T-Bills represents a challenge for the KPST given that the KPST is not an asset manager, therefore, cannot be qualified as primary dealer. Instead, the KPST should invest its assets through licensed primary dealers which in this case are the commercial banks operating in the country. This makes even more difficult for the KPST to invest because banking system in Kosovo is over-liquid and hence, any bidding of the KPST through primary dealers (banks) is prone to secondary or delayed information on pricing of these instruments. This is a reason why the KPST should be licensed as primary dealer at least for the domestic transactions. Related to the second investment options, that is bank deposits, this is another case where KPST is limited given that this process should be based on tender and in a over-liquid banking system, it is unlikely that any bank will bid for funds available at the KPST and hence, makes it even harder to invest in domestic economy.

11. Risk Mitigation Strategies through Investment Options

Multiple portfolios are considered a good tool in risk mitigation for persons who are close to retiring. The overall investments strategy could remain the same, but individuals of certain age will be placed in less risky assets within that investment policy.

One of the debated investment strategies throughout years has been the multiple portfolio approach. There have been many options discussed on this approach, however, 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.

Based on Figure 4, 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:

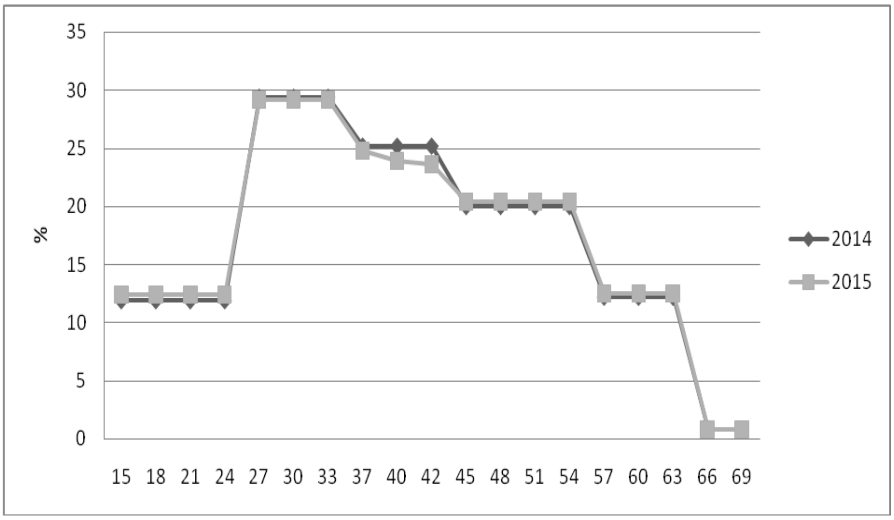

Figure 4. Percentages of active contributors by age

Source: KPST (2015)

In general there were no major changes in the participation of age groups as a percentage of active contributors. Close to 2/3 of active contributors (66.4%) were under the age of 45. In comparison with the previous year, with -0.4% the biggest fall was in 35-44 and 45- 54 age groups. The age groups 15-24 and 55-64, with 12.4% and 12.5% respectively, were the only ones with an increase (2014: 11.9% and 12.2%, respectively)[4]

[4] KPST, Annual Report 2015

Table 8. Sub-groups according to their age levels

Age	2014	2015
0-14	0%	0.0%
15-24	11.9%	12.6%
25-34	29.4%	29.6%
35-44	25.5%	24.0%
45-54	20.4%	20.1%
55-64	12.0%	12.9%
65+	0.8%	0.8%
	100.0%	100.0%

Source: KPST (2015)

In addition to the Table 8 and Table 9 are presented the age group classification with respective their contributions and assets starting from rage 15 and above. 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.

The table below shows that 4.7% of present account holders are 60+, they hold 7.2% of assets under management, with an average account balance of €3,092. While 4.7% of account holders might seem small, none-the-less it comes to nearly €60m in value of assets.

Table 9. The structure of contributors and assets per each group

Age group	Contributors	Assets	Average assets	Assets
15-49	78.6%	67.6%	€1,720	€544,318,628
50-54	9.5%	13.8%	€2,913	€111,387,420
55-59	7.2%	11.3%	€3,122	€91,066,412
60+	4.7%	7.2%	€3,092	€58,078,142

Source: KPST (2014, 2015)

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 KPST, 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).

In times of crisis this may be appropriate because those who are soon to be retired will be satisfied that their contributions are safe and for each euro of contribution, they at least, will get a euro or more. For other age groups, the problem of explaining that the losses are only a temporal phenomenon might be hard given the lack of general knowledge on the functions of financial and capital markets in the Kosovo's economy. Additionally, it might be particularly hard to manage the age groups which are on the edge of moving from one group (say c) to the other group (d). This is because if we wish to move a group which is slightly exposed to risk to a group which is not exposed to risk, it may lead to losses from the crisis due to slight exposure before the timing for shifting to the upper age group arrives. However, this can be managed with intermediate groups between each age group.

However, there might be dissatisfactions in times of economic progress, especially from the groups that we've assumed, had zero percent of their portfolio invested in equities since these groups might feel that their contributions are not being invested in high-return assets.

12. Conclusions

Pension systems around the world are developing relatively fast, often being the main drivers in financial market developments. Kosovo's system has also grown rapidly reaching in just 10 years at almost 20 percent of country's GDP. Similarly to many other pension systems Kosovo's pension system has been severely affected by the financial crisis of 2008-2009. But, the crisis effect was mitigated by the passive reaction of the KPST which waited the recuperation of the stock markets. However, this passive reaction was conditioned due to the lack of the board. In this context, it must be addressed this issue through legislative process in creating a mechanisms in the law that in case the Board mandate expires, that Board remains in place until the new Board is elected-thus avoiding the 2008-09 scenario. In case there is no Board in place, there should also be a mechanism for either management or CBK to take over the investment decisions. In addition, it has also been identified that technically there might an asymmetric information problem in KPST activity in the primary markets of Kosovo's government T-Bills, since the fund is not an asset manager. Being itself an asset manager would avoid any potential leak of information from the banks providing the bidding on behalf of the Fund. Further, there was a discussion for the newly debated multiple portfolios as a solution to the risk mitigating but certainly, considering the economic and demographic aspects of the country especially if this protects best those close to retirement.

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