

Pension Notes

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Diversification of pension fund investments: the Dominican experience



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Executive Summary

Pension fund (PF) investments have had a significant impact on economic development and job creation in the countries of the region where individually funded systems have been incorporated, generating a virtuous circle to improve the returns of workers' funds.

The FIAP 2022 seminar addressed the successful experience of the Dominican Republic in creating local investment instruments, which sets a good example for other countries in the region. Five panelists reviewed the main aspects of the Dominican experience:

Yamil Isaías – Pioneer Investment Funds:

The investments made by Pioneer alone, with the contribution of Pension Funds Administrators (AFP), have generated more than 6,000 direct and indirect jobs, with an additional 10,000 jobs projected in the next 2 to 3 years.

Corporate buildings in the city of Santo Domingo, a shopping center in Punta Cana and a network of bank branches were built. Moreover, the PFs own a more than 3.3 million square foot duty-free zone, generating 2,000 jobs. In the tourism sector, a hotel was opened in the locality of Miches and investments are being made in a hotel in the city of San Luis.

Raúl Hoyo – Altio

Investments that provide tangible benefits to people have been financed thanks to the PFs. The Coral Highway and renewable energy projects are proof of that.

The tourism sector employed 141 thousand people two decades ago, and currently employs 365 thousand people. At that time there was capacity for 3.3 million tourists, today this figure has risen to almost 7 million.

The Dominican Republic has changed completely in the last 20 years thanks to 3 key factors: macroeconomic stability, political stability and the stock market/AFPs.

Felipe Amador – Advanced Asset Management

Thanks to the AFPs, investments such as the following have been financed:

- In 2019, 100% of the shares of Grupo Bolin and Pan Pepín were purchased. After merging these companies, they were sold in 2021 at 1.7 times the investment, with almost 50% returns on annualized investment. More than 400 new direct jobs were created through this transaction.
- Five to six outpatient health centers were established in the Dominican Republic. This will generate 200 direct jobs and 1,000 indirect jobs.

- Investments were made in the expansion of Empresa Dominicana de Cales (DOCALSA). Operating costs and carbon emissions were reduced, achieving a return of 16.5% in dollars.

Elianne Vilchez – DR Stock Exchange

The PFs own 41% of the securities in the Dominican securities market. It is understandable that investment was initially channeled into sovereign debt while opportunities arose for the AFPs to invest more in the private sector and be able to better balance their portfolios.

When comparing the nominal return of the PFs with the weighted average lending rate of the system, an extraordinary performance of AFPs is observed. The next step to maintain those returns, energize the market and continue to grow the economy, is to develop instruments focused on environmental and social sustainability.

Andrés van der Horst – Fiduciaria Reservas

By way of example, some 70,000 homes or housing solutions in the country are planned through public trusts, financed by the AFPs. Great additional trust opportunities, like the Pedernales tourism hub, are evident.

Public trusts coexist in a transparent, sustainable manner, with strengthened governance. The government needs financial support in this area, and the PFs can contribute significantly.

Introduction

An investment lesson that is still valid is the old saying “Don’t put all your eggs in one basket,” because if you drop it, all the eggs will break. This advice is also valid for the PF investments.

Despite the above, if one analyzes the investment portfolios of the PFs in FIAP countries, especially in the smaller ones, we observe low diversification and a significant part of them concentrated in government assets. The PFs may naturally invest in government instruments, especially at the outset of pension systems, but it is essential to diversify investment portfolios over the years to reduce risk.

It is not easy to achieve the diversification of domestic investments if the capital market is not developed, or the required investment instruments are not available in the country. The panel “AFPs and pension funds in the Dominican securities market: Competitiveness and economic and social returns,” in the FIAP – ADAFP Seminar recently held in the Dominican Republic¹, addressed the successful domestic experience in creating investment instruments that have enabled greater diversification of the PFs, with a significant impact on economic development and job creation.

¹ Seminar held on October 6-7, 2022. See further details on this event [here](#).

The Dominican experience is a good example of domestic diversification of the PFs for other countries in the region. This note reviews the main aspects presented by each of the panelists.

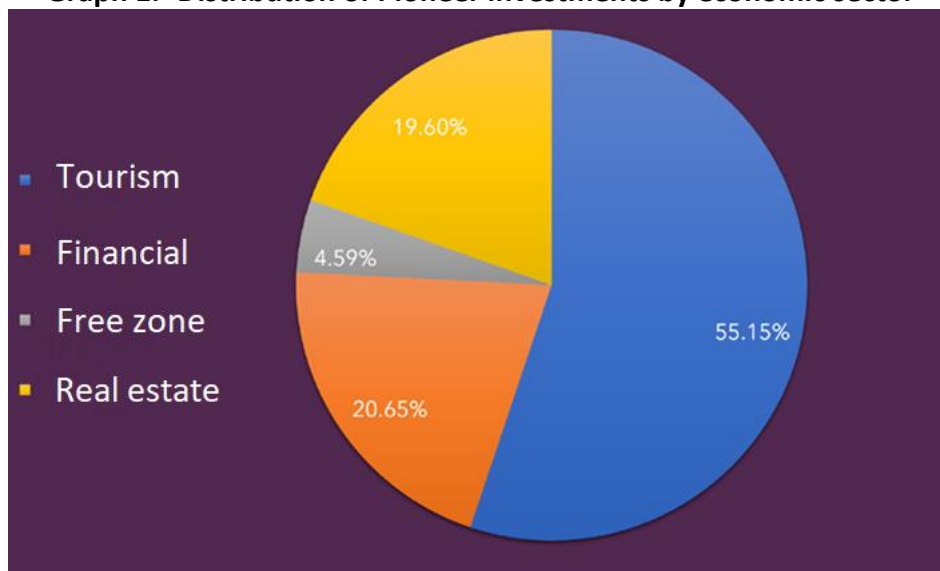
I. Investment funds: an opportunity for pension funds to impact the real economy

Presented by Yamil Isaías - Pioneer Investments Funds

The investment funds (IF) industry came to the market to diversify the PFs with investments in the real economy, in real and financial assets, whether banking or government debt.

Pioneer Investment Funds started in 2011 and in 2012 achieved the first approval of a fixed income fund, which was what existed at the time. In 2015, Pioneer began investing in assets, with the country's first real estate fund, in which the AFPs invested. In 2018, a company development fund was created, subsequently expanding to industries such as tourism and the free zone. In 2022, the first social impact fund was inaugurated, which not only measures financial returns», but also their impact. Today, Pioneer manages just over RD\$20 billion (approx. US\$362 million) in investments. This is a very institutional Investment Fund Manager (IFM), because the AFPs have trusted its management. Graph 1 shows the distribution of Pioneer's investments by economic sector, highlighting the tourism sector, with 55% of the portfolio.

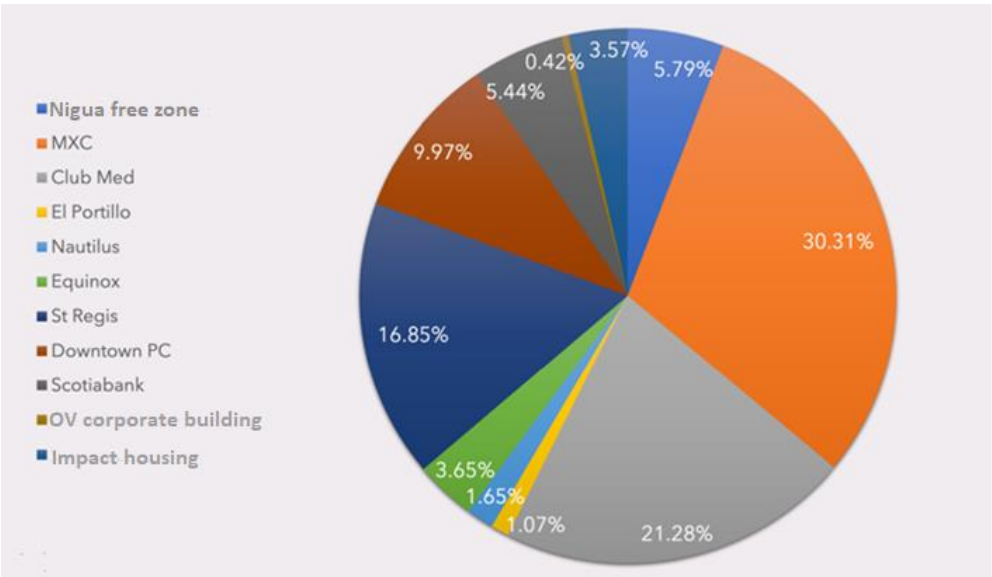
Graph 1.- Distribution of Pioneer investments by economic sector



Source: The author.

Graph 2 shows the distribution of wealth based on the different real assets, highlighting the tourism, real estate and free zone sectors.

Graph 2.- Distribution of Pioneer's equity by asset type

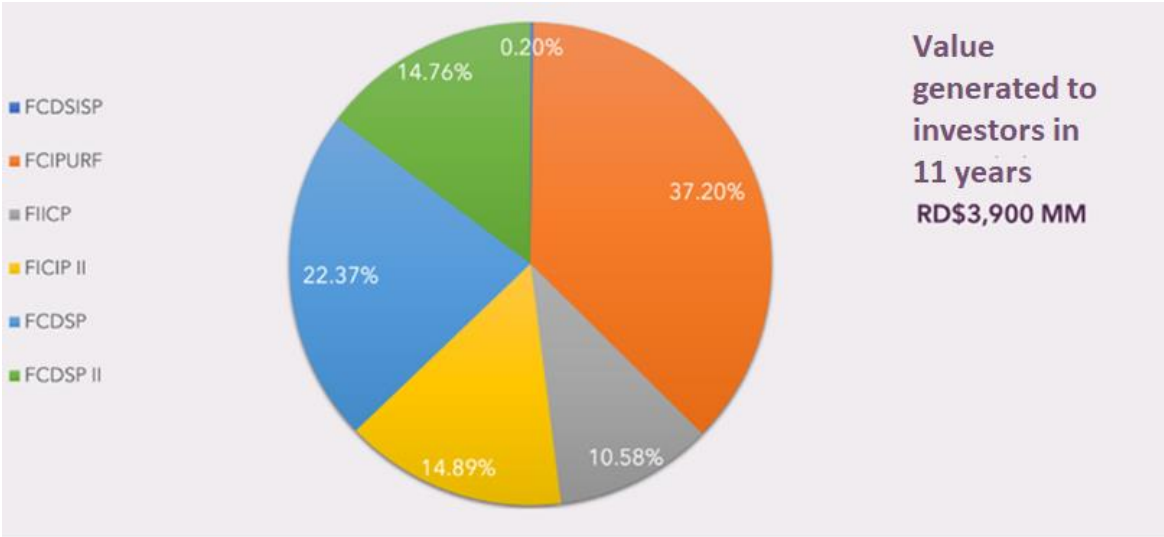


Source: The author.

The impact of these investments on the economy and employment in the Dominican Republic has been very significant. The investments made by Pioneer alone have generated more than 6,000 direct and indirect jobs. Almost 10,000 additional jobs are projected in the pipeline being constructed in the next 24 to 36 months, all with the contribution of the AFPs.

Graph 3 shows the value generated by each of the IFs managed by Pioneer in the last 11 years, amounting to a total of RD\$3.9 billion (approx. US\$71 million), in returns on instruments and distribution of earnings on rent and revaluation of assets.

Graph 3.- Distribution by fund of the accrued value



Source: The author

The PFs invested in real assets for the first time through a real estate fund, and Pioneer's intention was always to experiment and revolutionize, applying strategies to investments in the real economy. In the real estate sector, we have corporate buildings in the City of Santo Domingo with world-class tenants, such as the German, Dutch and Italian embassies. Likewise, we own the main shopping center in the Punta Cana area, a corporate building next to the airport, and we have also initiated a network of bank branches, seeking not only rental payment but also to purchase assets to protect the capital belonging to Dominican pensioners. Thus, when we liquidate those investments, they can generate capital gain and grow their assets.

Due to the pandemic, the investment in logistics to generate exports in countries close to the US, put the Dominican Republic's free zones in a very interesting position. That is why we fully own a more than 3.3 million square foot free zone with more than 30 warehouses, that currently provides for 2,000 jobs. Less than a year ago we bought additional land to triple the size of the free zone and potentially add another 6,000 jobs. There we have a tenant in the medical sector that produced and exported masks during the pandemic. Today we have 100% occupancy and demand for more than 50% of the future project.

In 2018, we made the first investment in the tourism sector and opened a new tourism destination called Miches, one hour from Punta Cana. This investment opened the first hotel in the area, which is the only one currently operating. This would not have been possible if the government had not invested in the infrastructure to access that new tourist destination. That is why we assumed the Chair of an association working with the community of Miches, which today signed an agreement with the government to provide the community and the hotel sector with a new water pipeline, security, environmental management and a waste management area. All this was done through an investment made by an IF supported by the AFPs, making Miches the new tourist destination in the Dominican Republic. We are also investing in a hotel in San Luis to diversify the luxury hotel offer.

Finally, there is the social impact fund. We have started investing in social housing that meets environmental sustainability parameters, investing in favor of the community in nurseries, parks, and health projects. The idea is to continue growing. We now have investments in projects with high quality partners. One of them is the project with about 500 units in Santiago. We will also develop 500 more homes in Punta Cana and we are projecting 6,000 homes in the next 18 months, all through this fund, thinking about Dominican pensioners and generating the impact that our country deserves.

II A testimony on how the investment of pension funds improves road infrastructure

Presentation by Raúl Hoyo - ALTIO

I will tell you a personal anecdote related to the growth of the Dominican Republic in the last 20 years, which coincides with the years in which the stock market and the AFPs have existed.

I returned to the country in the year 2000, after studying in the United States. At that time, I got involved in a family business, a mechanical workshop. I remember that I loved to get involved in new projects. I worked very hard and on Saturdays at approximately 07:00 PM, I left Santo Domingo

in my car and arrived in Boca Chica at about 11:00 PM, because it was impossible to drive to Punta Cana at the time.

22 years ago, the Coral Highway did not exist and it is a reality today, because the PFs bought the government bonds that enabled that highway to be built.

Yesterday morning, I drove from my home in Santo Domingo to Punta Cana, returned in the evening, and slept at home. I woke up this morning and here I am talking to you. I will take the same road home and be with my children at 06:00 this evening. This is a good example of how people benefit from infrastructure investment.

Furthermore, I can tell you that we have not had to worry about electricity in these two days in Punta Cana, not like 20 years ago, when we would most probably have experienced several power outages. From 2003 to date, the electricity grid has grown from 3,300 to 5,200 megabytes, and possibly more importantly, in 2003 there was no renewable energy in the Dominican Republic apart from hydroelectric plants. It was basically *fuel oil* and coal, with natural gas starting to emerge. Today, 26% of power in the Dominican Republic is renewable, This has been achieved thanks to the investments of the PFs in IFs. PECASA was the first direct investment of the PFs in shares of a renewable energy company, through the ALTIO IF.

141 thousand people were employed in tourism two decades ago. 365 thousand people are employed in tourism today. At that time there were 3.3 million tourists per year. There are almost 7 million tourists per year today.

Finally, there were only 53 free zones in the great crisis of 2003, when China began to be a world power. Today there are 80 free zones that employ 200,000 people.

In other words, the Dominican Republic has changed completely in the last 20 years and there were three key factors in my opinion: macroeconomic stability, political stability, the stock market and the AFPs. It's a three-legged stool; you take off one of the legs and the country wouldn't be where it is today.

In short, the IFs have invested in duty free zones, tourism, roads / highways, energy, and business. Those are the keys to moving the economy and everything that has been achieved in the last 20 years is largely due to the PFs and the stock market.

III Three cases showing the impact of pension fund investment in industries.

Presentation by Felipe Amador - Advanced Asset Management

Advanced Asset Management started in 2017 with an initial fund of US\$50 million, aiming to gauge the Dominican Republic's capacity to develop private equity. This fund was backed by the PFs and more than 50 other professional investors.

After setting up the first fund, we realized that there is a pipeline. After having observed more than 750 companies, analyzed more than 200, submitted about 57 to a Committee and invested in 14, we have realized that there really is the potential to be able to take an equity position in many Dominican companies that are starting to seek regional expansion, as a way to channel the resources of PFs and other investors, to have highly diversified products not only in industry, but also in the region.

We want to continue building a fund portfolio, specifically in the area of alternative assets, and we have started a third fund focused mainly on logistics, warehousing and other industrial products.

I want to present three examples of investment inflows and outflows in companies.

Case 1:

We identified an opportunity in the merging of industries, since there are industries in our countries that are highly oligopolistic. With that in mind, we set about merging the industrial breadmaking sector of the Dominican Republic. The aim was to merge the most popular large brands that required investment and management. In 2019 we bought 100% of the shares of two companies in the sector, Grupo Bolin and Pan Pepín. We managed to significantly expand the market share (40% increase) by merging these companies, which enabled a successful sale in 2021 with an initial investment of US\$10 million. We sold it to an international and local consortium for approximately 1.7 times our investment and with almost 50% return on annualized investment. It is important to point out that this transaction created more than 400 new direct jobs, since, although the synergies generated certain savings at the employment level, the expansion in new production lines significantly increased employment in the company.

Case 2:

The current lack of investment by the government and the private sector in the health sector, to improve access to high-quality medical attention in high-density populations, allowed us to develop a business model to establish 5 to 6 outpatient centers in the Dominican Republic.

The construction of the first center began in 2021, with an investment of approximately US\$15 million, providing emergency care, outpatient care, diagnostic imaging, clinical laboratories, medical consultations, and telemedicine. Some 200 direct jobs and more than 1000 indirect jobs will be created. We forged an alliance with the Santa Fe de Bogotá hospital, one of the iconic hospitals in the region, to work together in launching this large chain, or network, of outpatient services in the Dominican Republic.

Case 3:

The last case is the investment in the expansion of Empresa Dominicana de Cales (DOCALSA) in the community of San Cristóbal. DOCALSA is the only large company in the area, and we saw the opportunity of doubling its capacity and reducing its operating costs. In the midst of the pandemic, we were able to install a 16-story oven that enabled the rapid growth of the business, multiplying

the EBITDA² by four in one and a half years. Carbon emissions were reduced using international environmental best practices (sustainability), and operating costs were reduced by 65%. We sold this investment through a traditional bank refinancing, achieving a return of 16.5% in dollars.

I want to conclude by pointing out that we feel very fortunate to have professional investors like the AFPs, who believed in a new business model in the Dominican Republic, allowing funds to be channeled to the real economy. In the last five years we have confirmed that there is significant leeway for continuing to support large and medium-sized companies in the Dominican Republic in their expansion plans. I also believe that the IFs are the ones destined to continue channeling the resources of professional investors and the PFs, which are seeking greater diversification.

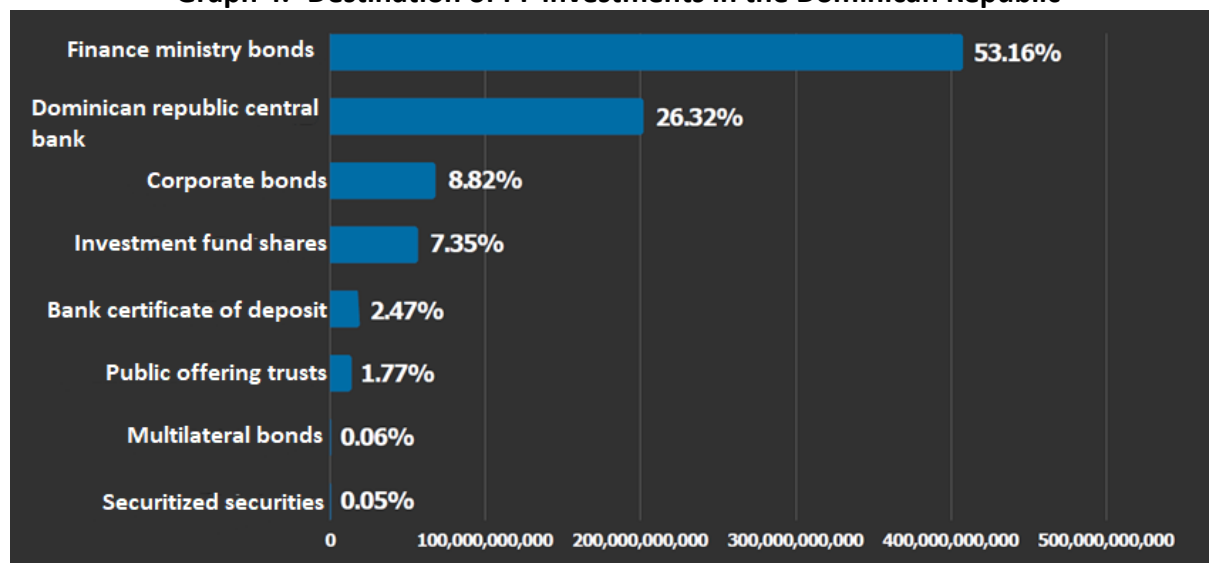
IV The Pension funds and the growth of the Dominican securities market

Presentation by Elianne Vilchez - DR Stock Exchange

The Dominican Republic is a small economy with an emerging market. The country has more than 10 million inhabitants, with a GDP above US\$93 billion, with a fairly stable exchange rate and a debt to GDP rate of close to 46%.

The PFs own 41% of the securities in the Dominican securities market. 86% of the PFs are invested in the DR and a significant part of them is invested in government instruments, as shown in Graph 4.

Graph 4.- Destination of PF investments in the Dominican Republic



Source: The author, based on the Pension Commission of the Dominican Republic (SIPEN).

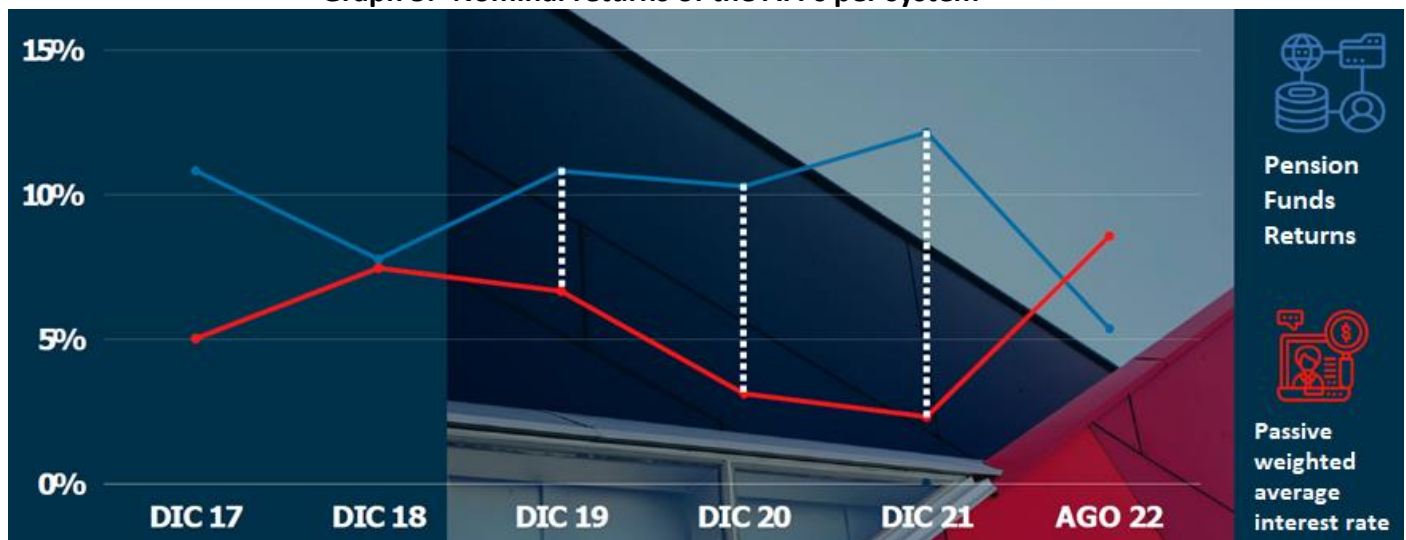
This concentration must be analyzed considering that the pension system has only been operating for 20 years, and for barely 10 years after the first law that allowed the establishment of IFs and public offering trusts.

² EBITDA is an accounting indicator of a company's profitability. It is calculated as income minus expenses, excluding financial expenses (taxes, interest, depreciation and amortization of the company).

It is reasonable for sovereign debt to have been the spearhead of investment in a young market that has been developing as the AFPs have been allowed to invest more in the private sector and better distribute and rebalance their portfolios.

Comparing the nominal returns of the PFs versus the weighted average interest rate of the system in recent years (Graph 5) evidences extraordinary AFP management. At the same time, a great opportunity presented itself in 2022 to create a derivatives market that would enable the AFPs to cushion eventual blows to their portfolios, often the product of external shocks.

Graph 5.- Nominal returns of the AFPs per system



Source: The autor based on SIPEN data.

The next step to maintain those returns, energize the market and continue to grow the economy, are instruments focusing on sustainability. Nothing can make more sense to the PFs, which have a long-term vocation, than instruments that guarantee not only environmental but social sustainability. This is something that is already happening today, but where there is still room to explore.

V. Trusts and pension funds

Presentation by Andrés van der Horst - Fiduciaria Reservas

Twenty years ago I was part of the team that negotiated the Free Trade Agreement with the United States and something similar happened to what is happening today, namely that despite the high technical sophistication of the AFPs in conjunction with the AIFs, from a returns, professionalization, etc. standpoint, there is a hazard that also existed when we negotiated the treaty, i.e. the matter of narrative and communicational legitimacy in a population that feels threatened.

That is why it is important to develop a narrative that shows the advantages of such management, which is impeccable from a professional and technical standpoint.

In a framework in which the Government has opted for public trusts and public-private partnerships and is looking for investors and non-traditional sources of financing, this provides a great opportunity.

We had a very rich experience a year ago in the process of renegotiating a Public Offering Trust, which was extremely successful since we achieved the longest placement ever made of fixed assets, 90% financed by the PFs. One must then explain how the roadways network of the Dominican Republic is being improved with the savings of the PFs.

Likewise, 60,000 to 70,000 homes or housing units are planned through public trusts, with the people who are going to acquire them being unaware that this financing comes from the PFs. So, the people who contribute to their pensions have to be informed that they have a financial benefit that is often difficult to explain, but they can also access a tangible benefit such as housing. It is not by chance that all governments have invested in infrastructure works since politics exists, because it is something that transcends time, with a direct and daily impact on people.

Today we see great opportunities for trusts that can change entire regions through IFs. The Pedernales public trust is the only solution that this region, which has lived on cattle and sugar cane, has had. We are convinced that the development of the Pedernales tourism hub will change the economic physiognomy of the south, a great opportunity resulting from the merging of workers savings through the PFs (with attractive returns) with government investment. That is something that will be evident when these tourists start arriving.

Projects in which the Government needs financial support and where the PFs can contribute significantly to the benefit of a more dynamic economy coexist in public trusts in a transparent, sustainable way, and with strengthened governance and the best prospects of the region, such as the Dominican Republic.

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Queries: International Federation of Pension Fund Administrators (FIAP).

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