The maturing pension fund market in Mexico is creating opportunity for local investors and international financial firms alike. In a regulatory initiative by The National Commission for the Pension System (CONSAR) that reflects worldwide trends in the liberalization of developing market pensions, Mexican funded pensions, known as Afores, can now invest up to 20% of their assets with international managers.

Afores manage over $140 billion in pension investments across 48 million accounts. Some 58% of assets are presently deployed to Mexican government debt, down from 83% as recently as 2005. By distributing their investment allocations more broadly, Afores seek to reduce risk concentration and home country bias while gaining access to global investment opportunities. For international asset managers, the new Afore rules open up a potential market worth in excess of $25 billion.

Increased Diversification
Mexico’s Afores came into operation in 1997, with fully 100% of their initial $4 billion in assets allocated to local government bonds. In 2005, CONSAR created five tiers of pension fund risk allocations, ranging from conservative (5% equities) for older workers, to risk-engaging strategies (40% equities) for young workers with multidecade investment horizons. In 2011, Afores began deploying assets to real-estate securities that resemble Real Estate Investment Trusts (REITs) seen in the

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United States and to Mexican private equity and infrastructure projects.

Over the years, Afores have steadily diversified, deploying a smaller proportion of assets to government fixed income instruments. Today, some 20% of pension fund assets are allocated to equities. And these equity allocations have significantly internationalized. Equity allocations that were initially built on Mexican-to-international allocation ratios of 80/20% today display a markedly global, international-to-Mexican ratio of 69/37%. Afores presently are limited to a maximum 20% allocation to foreign investment across all asset classes. They are also prohibited from investing in hedge funds and international private equity. While investment in commodities is still prohibited, authorization for this investment class is expected soon.

**Strategic Priorities**

Mexican pension regulators have identified as a strategic priority the diversification of local pension funds into global bonds, equities, commodities and other securities that deliver higher-potential returns and risk. While Afores have returned an average inflation-adjusted nominal return of some 6.62% over the 15 years since their inception, many observers caution that those returns were in large measure derived from once-high yields on Mexican governments bonds that have been steadily reduced over time.

Risk management has also been a driver of the liberalization program. As the pool of Afores assets rose over the years, fund managers faced a dwindling array of local investment opportunities. This risk concentration inspired practitioners to pursue new strategies that could simultaneously diversify investment exposures and stimulate the development of a more sophisticated local financial services infrastructure. There is even evidence to suggest that the robust participation of Afores in Mexican markets created a “floor” for local investments that allowed Mexican equity markets to recover from the 2008–2009 market dislocation at a faster rate than did stock markets in the U.S., Latin America or in Emerging Markets as a whole.

Over the long term, Mexican Afores may achieve diverse global asset allocations in line with those of rising investment funds in Norway, the Middle East and Southeast Asia and of pensions, foundations and endowments in the most sophisticated investment markets of North America and Europe.

**Riding a Regional Trend**

The transformation of Mexico’s Afores is at the forefront of a wide-ranging trend toward the expansion of defined contribution pensions and pooled investing throughout Latin America. After several years of government fiscal discipline and robust economic growth driven by commodity exports to Asia and the self-reinforcing expansion of the middle class, the pooled investment industry in Latin America is booming.

Mutual funds in Latin America totaled more than $1 trillion in 2012 and are expected to reach $1.8 trillion by 2016. Defined contribution pension funds in Chile, Mexico, Colombia and Peru that managed $344 billion as of 2011 are expected to top $650 billion by 2016.

Mexico’s decision to liberalize Afores allocations is in line with policies undertaken in Chile, one of the first Latin American economies to encourage pensions to engage equities and international investments. In Chile, fund managers may allocate up to 80% of their assets offshore. For Latin American pension funds in aggregate, international allocation is expected to rise from 28% of assets under management in 2011 to 39% by 2015.

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**Four Key Drivers of Reform**

Mexico’s pension system is being transformed by four key trends:

1. **Reduced Investment Restrictions**
   As the Afores asset pool has grown, investment regulation has liberalized, allowing for increased diversification across asset classes, instruments, companies and countries.

2. **More Sophisticated Asset Allocation**
   With larger, more complex portfolios and increasing participation by global investors, Afores management has shifted from a risk-reporting to a risk-assessment approach.

3. **Pension Fund Engagement in Boards of Invested Companies**
   As Afores have increased their ownership of the Mexican stock market from 2% to 6%-8%, fund managers have increasingly participated in corporate boards in an effort to safeguard investors interests.

4. **Increased Impact of Afore Investment in the Mexican Economy**
   Long-term pension investment tends to have a stabilizing influence on volatile markets around the world. Perhaps more significantly, a steady flow of investment from Afores will tend to stimulate company growth and employment, generating yet more pension investment in a virtuous circle that generates multiplying effects across the Mexican economy.
**Fund Custody and Administration**

As Mexico’s Afores go global and engage new asset allocations, it is essential that they adhere to best practices in fund custody and administration. Global administrators can provide sophisticated “outflow capabilities” including global custody, the safekeeping of international assets and cross-border trade settlement. But at the same time, Mexican regulations require that these custodians have a local office, with a physical presence and staff, in order to serve as a local trustee.

International custodians that do not have local offices must form joint ventures with local sub-custodians in order to adhere to regulatory requirements. Global custody banks with substantial local presence and extensive history in the market are therefore able to offer the best of both worlds. Their combination of global and local capabilities allows for efficient international investment administration, enables oversight of multiple local and international asset managers, portfolio-wide risk management, periodic fund rebalancing and proactive portfolio maintenance and system upgrades from within a single operational and reporting platform.

**Benefits of Global Portfolio Allocation**

Liberalized investment allocation allows Mexican Afores to increase portfolio diversification and develop more sophisticated risk monitoring across asset classes, strategies and geographies, thereby optimizing returns for investors.

But to take maximum advantage, significant global expertise is required. While Mexican institutional investors and asset managers are clear industry leaders when it comes to Mexican securities, Afores looking for overseas investments will derive optimal benefit by collaborating with the world’s best global asset managers.

“The engagement of international asset managers will allow our investors to benefit from a wider range of global investment opportunities,” said Francisco Javier Orvañanos Márquez, Chief Investment Officer for Afore Banamex. “In addition, through the engagement of global partners, local Afores and Mexican investment professionals can gain expertise in many more asset classes and markets via skills transfer provisions that are spelled out in management contracts.”

The “internationalization” of Afores investment is expected to positively impact the costs efficiency of portfolio management in Mexico. While Afores currently have an average annual fee of over 1% of assets, many expect this expense ratio to diminish with increased competition from a more open investment market. Investment firms from the United States, United Kingdom, Italy, Colombia and an increasing list of other countries are today participating in the Afores market.

The benefits of efficiencies gained through the Afores’ more international orientation, in the context of the current regulated pension system, accrue to the ultimate owners of the investment assets – pensioners – in the form of transparency, portfolio efficiency and superior risk-adjusted returns.

Many industry observers believe that the liberalization and globalization of the Afores are only the beginning for an increasingly sophisticated Mexican financial culture that will eventually extend to mutual funds, insurance and a nascent alternative investment industry. The growing pools of Mexican pension assets, alongside robust volumes in other investment structures, are expected to have the secondary beneficial effect of enhancing liquidity in local capital markets, driving down the cost of capital and stimulating economic growth, employment and the creation of yet more pension savings.

Afore Banamex, Mexico’s largest pension fund management company with eight million clients and over $23 billion in assets under management, is the first local Afore to take advantage of the new regulatory regime and hire international managers. Securities and Fund Services (SFS) Banamex, was the first custodian/administrator to service these investments, through Citi OpenInvestor which provides global custody, administration and accounting.

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**Mexican Afores — Investments End August 2012**

Source: CONSAR

- **Mexican Government Debt**: 58%
- **Mexican Equities**: 7.5%
- **Global Equities**: 12.3%
- **Mexican Private Debt**: 16.7%
- **Alternatives**: 3.1%
- **International Debt**: 2.5%
About the Authors

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Mr. Garza is the Securities and Funds Services Business Head, responsible for Direct Custody and Clearing, Global Custody, MXN Peso Clearing, CLS Nostro Agent Services and Third-Party Clearing.

He joined Citi Mexico in 1994 holding multiple positions within Securities Services Operations and Client Services, and transferred to the Americas Regional Services Center in Tampa, FL in 1998 heading the Client Services Team for Mexico and other Latin America countries. In 2002 he joined the Product Management team in Mexico, heading Client Management, Product Management and Product Development.

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Javier is the Chief Investment Officer of Afore Banamex. He started his career at Banamex in 1996 and was appointed Chief Investment Officer in 2005. Afore Banamex is the largest mandatory pension fund in México with close to 25 billion USD in assets under management.

About Citi OpenInvestor™

Citi OpenInvestor is the investment services solution for today’s diversified investor that combines specialized expertise, comprehensive capabilities and the power of Citi’s global network to help clients meet performance objectives across asset classes, strategies and geographies. Citi OpenInvestor provides institutional, alternative and wealth managers with middle-office, fund services, custody, investing and financing solutions that are focused on their specific challenges and customized to their individual needs. For more information, visit openinvestor.transactionservices.citi.com

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