There's still a place for equities in pensions

Despite the short-term risks, shares offer an excellent hedge against inflation, in the long run minimising fund costs and maximising pension fund values. William MacDougall explains.

Global fears: pension funds have the luxury of time to recoup value

inflation for 20 or 30 years in setting wages and prices and therefore profits.

While equities might not give the day-to-day protection of index-linked gilts, they do give protection over a working life, with higher yields. Financial economics has produced many important insights into the workings of financial markets, but to do so it relies on simplifying assumptions, one of which stacks the cards against equities: the assumption that markets move in a "random walk".

This implies that there is no mean reversion. For example, when a market collapses irrationally in response to a health scare in Asia or a terrorist attack in New York, it is just as likely to fall further as to recover.

Yet there is considerable evidence of mean reversion and its corollary that the annualised real volatility of equities is lower for longer periods of time. A pension fund that can wait 25 years - and cash in any time between 20 and 30 years - can afford to take the short-term risk of equities and wait for valuations to return to the norm. They are paid a premium by those that cannot. This equity risk premium is genuine, although sometimes overstated. Once you take into account survivorship bias, and get a more representative period than often used, the historic advantage of equities is much reduced. My own guess would be 2 per cent a year over bonds, but that adds up to a lot of money over a working life.

I am a bond man by background and pension liabilities do not look like a bond to me. Their duration and annual magnitude are too uncertain. They vary with death rates, early retirement dates and staff turnover. They vary with real wages and inflation. They vary with the trade-off between what a company is required to pay and what it might decide to give for the sake of good staff relations. In fact, pension liabilities look rather like an equity.

Accounting standard FRS17 favours the case for bonds by using a fixed inflation assumption, although in theory it allows the use of one based on current market index-linked gilts (ILG).

Accountants usually take a rounded rate, 2 or 2.5 per cent, say, based roughly on the difference between ILG and conventional gilt yields, rather than the difference to several decimal places.

In fact, an unscrupulous accountant could produce almost any surplus or deficit on the pension fund you want by manipulating the FRS17 inflation assumption hidden in a footnote.

If you use a fixed inflation rate the liabilities look like a conventional bond. If you use a market rate to several decimal places, and add a variable "corporate yield spread" on the asset side, as the standard requires, then a corporate inflation-linked bond would be a better match. Equities are the next best matching asset and, given the small and illiquid nature of the corporate inflation-linked bond market, perhaps the only matching asset.

Another issue is the required credit quality. Some investors have legal, regulatory and other requirements to buy high-rated bonds: this extra demand depresses the yield on those bonds and increases the returns on lower-rated bonds. As a firm's pension liability is certainly weaker than an AAA promise, why back it with expensive higher-rated assets?

Some argue that it is best to look at pensions from the overall company standpoint - that there are tax advantages to holding bonds in the pension scheme, while the desired equity/bond balance overall can be better achieved by adjusting the gearing of the parent company. The argument usually and wrongly assumes that the liabilities are bond-like.

Moreover, the liability for UK companies is indirect. Instead of owning the assets, the firm has an obligation to fund an independent trust, which must have its own assets to cover the liabilities. It makes for clearer thinking if the very complicated sets of liabilities and assets are thought of together.

What these arguments imply is that a pension fund cannot match its liabilities by buying conventional and inflation-linked bonds, or anything else for that matter. The worst it can do is to pay someone else to take them on, by buying very expensive deferred insurance annuities. The best it can do, and the way to maximise shareholder value, is to try to minimise the pension cost in the long run, in part by holding equities.

William MacDougall is an independent investment and pensions consultant. Until March 2000 he was chief investment officer of TRW's £8bn UK pension scheme.