

Going against the grain

Contrary to popular belief, equity investment by a pension fund does not add to shareholder value. John Shuttleworth explains why

How's this for a counter-intuitive proposition: equity investment by a pension fund makes no difference to the value of the business. Conventional wisdom has it that because equities should outperform bonds, the costs to the business are less. Not so.

The reasoning is basic Finance 101 stuff, requires fewer than 100 words and no mathematics. In financial terms, pensions are simply long-dated liabilities of the business; in other words, just another form of debt. A portfolio of equities and bonds is available as collateral to meet these liabilities. Changing its mix has no effect on the size of the liabilities, and hence none on shareholder value either. And employ the logic of *reductio ad absurdum*: no company would ever contemplate borrowing money to invest the proceeds on the stock market.

There is always merit in simplicity. Given that how the pension fund is invested makes no fundamental difference to shareholder value, why not opt for the easy life and match the liabilities as closely as possible? What should trustees make of this? It means trustees can properly leave shareholders to worry about themselves and instead focus on their own job – managing risk. To do this, trustees need to understand just two investment principles:

- pensions are bond-like. Intuitively, this looks plausible: both pensions and bonds have regular cash flows stretching many years into the future.

- equities do not hedge inflation. This is not a matter of opinion, but of empirical observation: history shows that equities have only a weak correlation with inflation. This is not the same thing at all as saying that equity returns are unaffected by inflation in the long run (which is probably a true statement). The very virtue of equities as an investment is their poor correlation with wage-linked pension liabilities.

It follows that, for an investor with pension liabilities, the lowest risk investment is long-dated bonds, specifically a mix of fixed and inflation-linked. Equities' risk-adjusted return is the same as that from a bond. And we know this for sure because, if it were not true, there would be players in the market raising 30-year money, investing the proceeds in equities, and watching from a beach in the Caribbean.

Deliberate mismatch

Pension fund trustees choose to deliberately mismatch their assets and their liabilities. They therefore rely on the company to underwrite this



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mismatch. Using option-pricing mathematics, a figure can be placed on the asset of the pension scheme represented by the company's underwriting – for a typical UK pension scheme it is in the order of 25% of its investments. Plainly, this is self-investment on a grand scale. Unfortunately for their members, trustees do not get this. This country's insolvent companies almost always have insolvent pension funds.

This asset of the pension fund is of course someone else's liability – here, the shareholders in the business. They underwrite the trustees' deliberate mismatching. To be sure, shareholders have an offsetting asset – the right to the surplus should the equities outperform. But, at the first order, these assets and liabilities equate and cancel out.

At the second order, shareholder value is arguably reduced by equity investment: first, by investment management costs; and second, by any gratuitous benefit improvements financed

out of ephemeral surplus (but not clawed back when there are deficits). In the 1990s, UK plc lost literally billions in this way.

Then there is an intriguing third heading. A company with a pension fund in deficit could issue debt, pay the proceeds into its pension fund, which then buys debt. This amounts to a mere accounting change that does not alter the business's financial fundamentals. But the tax man is the loser – to the extent of the tax-deductibility of the debt servicing. So why are there no takers of this free lunch? It is difficult not to be cynical – what hard-nosed finance director would issue debt with the avowed motive of 'to improve human capital'?

Kinky theory?

So corporate finance theory is unequivocal – shareholders should push company management to push trustees to hedge the business's pension liabilities with long bonds (with the possible exception of holding equities to the extent of any surplus). Many in company management will not like this conclusion. Too often executives erroneously assume that, since they create value in their core business in excess of costs, the same principles apply to asset management. You may say this is kinky theory. But we now have proof. Two years ago, Boots eyeballed the vested interest groups, sold all its equities, forfeited the equity risk premium, and yet its share price did not budge. QED.

This is not an article that could have been written as recently as a year ago without producing ridicule among trustees. The long bull market had made equities' outperformance of bonds appear a certainty. Not so. Life's only certainties are death, taxes and, in this country it would seem, at least one more financial mis-selling scandal.

A word of caution: this analysis has no application at all to how individuals should invest for their own retirement. Most individuals will properly conclude that it is worth risking equities' possible downside perchance to gain the probable outperformance. And good luck to them. ☛

This article draws heavily on various articles published by Professor Zvi Bodie of Boston University, but any errors are my own.

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