

Business Europe/ *By William MacDougall*

Equities Still Beat Bonds

Fifty years ago, George Ross Goobey changed the face of the investing world. Until Ross Goobey came along, most everyone had taken it for granted that bonds—czarist railway loans for example—were a nice safe place to be. Accordingly, the proper place for the investments of widows and orphans, and pensions, was therefore bonds. Ross Goobey reversed this conventional wisdom, saying that equities had a higher yield and were a real asset, so they were the better place for your money. He moved Imperial Tobacco's pension scheme into equities.

Two years ago, drug-store chain Boots, under John Ralfe, reversed Ross Goobey's wisdom, and moved its entire pension scheme back from equities to bonds. While in the short term that decision looks brilliant, Mr. Ralfe has always insisted that the move was not taken on grounds of market timing, but rather on the basis that it was a more appropriate place for pension funds *in the long run*.

So who is right? The great fashion for equities that Ross Goobey started reached its peak about three years ago at the apex of the equity bull market, or rather just before the bubble burst. It was aided by actuarial methods that allowed pension funds to value the equities in their portfolios not on the basis of current market prices, but rather by the much smoother method of discounting future dividends. At least as important, accountants and equity analysts simply ignored pension deficits and surpluses in company accounts.

When I started managing pension-fund assets 17 years ago, I was told that equities were the most appropriate investment because they represented a claim on real, not nominal, assets; they protected against inflation. Bonds were thought to be attractive only for risk diversification. As the '90s developed and

inflation fell, that argument—though still valid—was forgotten.

Instead the dominant argument became that equities outperform, even that they always outperform. That view was always overstated. There was a form of survivorship bias built into this argument. In looking only at countries such as Britain and the U.S., which had had a good run, people ignored countries like Germany, where equity investors lost nearly everything twice in the last century and where, if you bought equities in 1960, you did not get your money back in real terms for 24 years. People forgot that even in the U.K. there were six periods in the 20th century when equities had had a negative real return over three years or more.

Yet just because the case was overstated, it does not follow that there was

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no case. There is an equity risk premium. You do get an extra return in the long run to compensate for short-term volatility. If you are saving for your retirement in two or three decades, you can afford to accept that volatility and earn that premium.

Behind the scenes there was a revolution going on in the thinking of the actuaries and accountants. Actuaries somehow convinced themselves that equities did not protect against inflation—not that inflation had gone away, but that equities did not protect you. Only an actuary, with the profession's typical lack of understanding of what is behind the numbers, could believe that profits, dividends, and equity prices would not eventually catch up with inflation.

Worse, the actuaries somehow convinced the accountants of this view, and the accountants in the U.K. produced a daft standard for valuing pension funds that wrongly treated pension liabilities as being fixed in nominal terms. Under FRS17 if you were to buy an asset that exactly matched your pension liabilities, then the standard would wrongly show volatility from year to year in your surplus or deficit. The standard pushes you away from truly matching assets.

Moreover the same accountants who delivered the daft U.K. standard are about to replace it with a European standard at least as bad. And worse still, the European standard will be enforced in the EU by law, not just convention.

While inflation has been low and stable in the U.K., it would be wrong to ignore inflation risks. The Bank of England

and other central banks are cutting interest rates at a time when they are forecasting inflation above their targets. They may be right to take risks with prices to improve growth, but they *are* taking risks with inflation, and therefore inflation is more likely than deflation. A rise in the inflation rate to 4% from 2% for 30 years is perfectly possible, and would be devastating for anyone whose savings were locked away in long-term fixed-interest bonds.

Furthermore, the actuaries are now introducing a quarterly measure—the “liability benchmark portfolio”—which defines any move away from Gilts as “risky”; when trustees see this, they will have trouble justifying any equity holdings.

The pressure is now very strong for pension funds to switch to bonds. Consultants who three years ago thought it sensible that a portfolio be 60% or 70% invested in equities now find that, after some equity prices have been cut in half, even 50% exposure is a bit risky. Many finance directors will not tolerate the balance-sheet volatility implied by new accountancy standards.

The U.K. government has just made things worse by lowering the required inflation-related pension cap to 2.5% from 5%. This is the maximum inflation protection required by law. The result of this change is, once again to make holding bonds in pension funds more attractive relative to stocks. While some schemes will chose to keep a higher cap, to keep some inflation protection, the government has removed any legal requirement to protect your pension against inflation, and thus reduced the need to hold equities as a hedge against inflation.

The result of these legal, accounting and actuarial changes is that company pension funds are likely to continue to move from equities to bonds. Another 10% to 30% of assets—£70 billion to £200 billion (\$110 billion to \$315 billion)—is likely to move in the next 12 months. Whatever merit this might have as a short-term bet, it is wrong on a long-term basis. Yet the train appears unstoppable. Regulators are compounding the problem with rules that favor bonds over equities, often without justification.

I found it amazing a few months ago that anyone would want long-term U.K. or U.S. government bonds yielding 4% or less. Even at today's rates, after the sell-off, the return is low and provides little compensation for inflation risk. My own long-term savings are in real assets, especially property and paintings. I will buy equities when they make their next big drop, after the pension funds sell.

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