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The First Ross Goobey Lecture. By Alastair Ross
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INVESTMENT PRACTICE - FULL CIRCLE?

THE FIRST ROSS GOOBEY LECTURE

Given by Alastair Ross Goobey on 27th October 2005 at the Cass Business School to mark the foundation of the Pensions Archive Trust.

The late George Ross Goobey made his family name forever synonymous with the development of modern investment practice. As manager of the Imperial Tobacco Pension Fund in the 1950s he was a pioneer in pension funds investing predominantly in equities. Indeed, he is credited with fathering the "cult of the equity". Interest in his activities has recently been re-awakened by the depositing, with the newly-formed Pensions Archive Trust, of a quantity of his private papers. As George Ross Goobey's writings were never widely or comprehensively published, there is a serious gap in the understanding of several important developments in this field.

On 27 October 2005, George's son, Alastair Ross Goobey, who is eminent in the investment field in his own right, looked at the way investment policy and practice has developed over the decades since his father first came to prominence, arguing that things had, perhaps, come full circle. Following his presentation, Alastair Ross Goobey was joined by Alan Herbert, Chairman of the Pensions Archive Trust, who described the aims and progress of the Pensions Archive.

1. You can well imagine the honour and pleasure I feel to have been asked to give this inaugural lecture in my Father's name to mark the foundation of the Pension Archive. It is a highly appropriate time for the archive to be set up. Many of the debates we are having in the pension world have echoes from the discussions that surrounded the move into equities at the beginning of the 1950s with which my father's name became so identified. Those who ignore the lessons of history are destined to repeat its mistakes, and I have a horrible feeling that too many people are being blinded by science, rather than accepting the blindingly obvious.
2. Let us look back at the situation as it was fifty years or so ago. Final salary pension schemes were immature. As my father's papers to his Trustees point out, one of the great strengths of the scheme for which they were responsible was that they were unlikely to have to realise any assets in a hurry to meet outgoing liabilities. Volatility of asset prices could be their friend, not their enemy. That is certainly not the case today, with so many final salary schemes highly mature, and closed to new entrants. In 1950 there was no obligation at all to have a set level of assets, (or any at all), to meet the pension promise, and certainly no dynamisation of pensions, let alone deferred pensions. Transfers to other schemes were a rarity, since most employees expected to stay with the same employer all their lives. All these improvements to final salary schemes have come in the past thirty years, at considerable cost, and may well have been part of reason for the demise of the golden goose. My generation, (and I reach 60 in just over a month's time) has been blessed. We have not had to participate in a world war, and we have lived through an unprecedented

time of growing wealth and pension provision. A time that has abruptly come to an end in the case of pensions.

3. The fact that my father lived to the age of 86, and my dear mother is still going strong at the age of 94 illustrates one major problem more graphically than any other. Increased longevity is something we should all be happy to experience, but it is a burden on final salary pension schemes that was simply not envisaged when they were set up. One of the most shocking experiences of my time at Hermes was when the BT Pension Scheme was told that, between December 1992 and December 1998 the estimate of the life expectancy of a male member of the Scheme retiring at 60 had risen by three years. The BT Scheme, being one of the largest, did not depend on actuarial tables for this information, but on a study of its own membership. There is no doubt that the 1992 figure was already too low, and the actuary was handicapped by less than perfect record keeping. It is also true that the 1998 estimate might have included some pre-emptive further improvements in experience. Nevertheless, no scheme could face such an improvement in longevity with equanimity. Pension funds were set up originally on the basis that the employer might have to support ex-employees for a few years after retirement, not decades. The cost of doing the latter is huge, and cannot currently be hedged.
4. The Pensions Act of 1995, for which I will bear my share of responsibility as a member of the Goode Committee that created it, introduced the concept of a funding level to back the pension promise. The MFR was not of our making, but it did represent an attempt to ensure that the cupboard was not bare when things went wrong with the employing sponsor. It was put on the statute book at least partly in response to the Maxwell scandal, where the assets of the pension schemes of the Maxwell group were spirited away, leaving the members bereft of the benefits to which they reasonably thought they were entitled.
5. If you add the tax change introduced in Gordon Brown's first budget in July 1997 to this list of changes and the well-intentioned improvements in benefits, then we can understand why the provision of final salary pension schemes has become highly costly to the sponsor. For many it is also too high a risk in terms in volatility of liability.
6. First, however, let us look back at the position of a pension fund, and its manager, in the early 1950s. The conventional wisdom then was that the assets of a final salary pension fund should most closely match the liability underwritten. The late 1940s had been the era of cheap money, and had followed a decade of the Depression and strict price controls and rationing during the War. The idea that inflation might become a problem was not in most people's minds. The majority of the actuarial profession, in learned papers, recommended that bonds should be the asset of choice. Since there was no obligation to increase pensions, let alone deferred pensions, to reflect rising price levels, there was some logic to this stance. However, since bond yields were so low, it was an expensive business to achieve this match.
7. A pension fund was not then subject to analysis on the basis with which we have become so familiar. The investment performance of the scheme was not measured on its quarterly time-weighted rate of return. This measure did not really come in until the early 1970s. I remember its introduction when I was a junior member of the investment department at what was then Kleinwort Benson at the time. The trustees of pension schemes saw the role of the scheme as part of rather paternalistic welfare provision, and its cost was not overwhelming, since life expectancy post retirement was limited. The scheme was immature, and net contributions were running at a high level relative to the existing assets. There was no prospect of having to meet current

pension liabilities from the sale of assets at inconvenient times. In this fund, as in so many others of the time, investment was carried out in-house.

8. It was into this environment that my father moved to Bristol in 1948 to become the manager of the Imperial Tobacco pension fund. The fund was, as were most of its peers, overwhelmingly invested in bonds and preference shares. By 1950 these investments were showing book losses as the era of Dalton had gone, and long-term interest rates had crept higher. Father simply observed that equity shares as a whole were on a higher current yield than bonds. For a fund to earn less in equities than bonds there had to be a realistic possibility that dividends would be slashed, and permanently. He concluded that this was not a likely outcome. Looking back through history, and building on work that had been done by the actuary of the Legal & General, H.E Raynes in 1927 and 1937, it was apparent that, over long periods, dividends grew at least as fast as nominal GDP (although, not being an economist, I never heard him use that expression). Having convinced himself that buying a diversified portfolio of equities was going to provide better returns than bonds, and despite the apparent 'mismatch', he then had to convince his Trustees of the case. The papers that I was able to find in the rusty filing cabinets that still sit in the garage of our family home in Somerset date from the early 1950s, and I very much regret that no earlier ones seem to have survived. The change in the Imperial Tobacco fund's assets started earlier, certainly before 1950, and I hope that someone will be given access to the Trustee minutes of that period to confirm that. The critical element was to persuade Sir James Grigg, the Chairman of the Trustees. P.J. Grigg had been a minister in the wartime government, and responded favourably to the enthusiastic advocacy of this youngish actuary (father was 36 when he moved to Bristol).
9. The next obstacle was the realisation of substantial book losses on the bonds that the scheme held. Again, Grigg understood that the losses existed, whether they were realised or not. He could also see that income on the scheme would be improved if the assets were switched. As the papers indicate, much of the discussion was about the investment of cash-flow, since that was the pressing issue, rather than the switch of existing assets.
10. All this is well-known, and I leave it to others to analyse the history of the Imperial Tobacco pension fund. What I want to do now is to draw attention to the fact that some of the same arguments that were being discussed over 50 years ago are being recycled, and to try to separate out where I agree and disagree with the analysis.
11. The typical final salary pension scheme in the UK is now highly mature. Most of them are now closed to new members, although the effect of that on the overall maturity of a scheme will take some time to have its effect. The number of active members is usually overwhelmed by those in receipt of a pension, and deferred pensioners. Until recently the net cash flow of the average pension scheme was around nil, with the net outflow from pensions in payment and transfers being just about matched by the much lower level of contributions on behalf of active members plus the investment income on the assets. The removal by Gordon Brown of GBP 5 billion a year of tax credits from the income of pension schemes is still not recognised as one of the most damaging actions leading to the imminent demise of the final salary scheme. It is all very well for Ed Balls to point out that corporation tax was reduced at the same time, but I understand that there was no actuarial advice taken on the consequences for pension scheme valuations. The reduction in cash inflow to the pension schemes was a real cost, (the BT Scheme suffered by more than GBP 100m a year) and, with dividends growing strongly over recent years, the net cost must be much higher today.

12. Trustees are obliged, and will continue to be obliged, to have a certain level of assets to match the pension promise, and the strength of that funding will determine how much they will have to contribute to the Pension Protection Fund, the fall-back scheme that the Goode Committee rejected on the grounds of moral hazard (with good reason it seems to me). Under current accounting standards, the level of under- or over-funding will be a number published in the annual report and accounts. FRS 17, and its successor in international accounting standards, changes the sponsor's appetite for risk. Investment returns are measured on a quarterly basis, and most funds outsource the management of the assets. Longevity continues to be a challenge.
13. I accept therefore that things are certainly different today from what they were 50 years ago. Indeed, I was a trustee of a pension scheme where, in the late 1990s, we had good reason to doubt the strength of the sponsor, and switched a substantial percentage of the scheme's assets into bonds to protect the members from potential disaster. So I am not sticking my head in the sand. But I believe the advocates of a wholesale switch into bonds at any cost are not seeing the wood for the trees.
14. John Ralfe, who was instrumental in the Boots pension scheme switching most of its assets into bonds in the late 1990s, recently wrote: 'A pension scheme should hold matching bonds to back pensions already being paid. Does anyone disagree with that?'¹ My response is that it all depends. It depends on the strength of the sponsor, and its appetite for risk, and, most importantly, the *cost*, including the opportunity cost, of immunising the scheme in this way. What I can agree with completely is that such a strategy is the lowest risk for a scheme and its members, but it might be a far more expensive option than is necessary. Deferred and current pensions are now subject to a lower level of Limited Price Indexation, and buying index-linked bonds overcompensates for this liability, offering protection against inflation at much higher levels. Conventional bonds, at current yields, provide a real return against the 3% inflation level. However, such is the pressure on funds to make such a match that, to my mind, the pricing structure of both has become artificially high. It is unarguable that, for most schemes, to buy assets that would meet the liability for pensions in payment, or deferred pensions, would involve a huge additional cash injection that the sponsor may or may not have. The proponents of such a change suggest that it is economically sensible for the sponsor to borrow the money at the corporate level, receiving tax relief on the interest, and inject the cash raised into their pension scheme. The scheme would then immunise itself by buying the bonds.
15. While I absolutely understand the logic of this I would suggest that we are being dominated by taking too short-term a view of the liability. The alternative is, of course, that the pension scheme earns a higher level of return over the average life of its liabilities, and that can be achieved through equity investment. The financial economists throw their hands up in horror, and point out that, for many companies, this is tantamount to a commercial company becoming an investment business. The cliché is that British Airways is a pension fund with a small airline business attached. It is only because we are measuring long-term liabilities on a very short-term timescale that this has become a problem. Even the most mature of the large final salary schemes probably has an average life of its pension liabilities in the high teens in years. With recent attempts to correct the underfunding, even cash flow is now positive in many schemes. Is it really a high risk strategy to invest in equities over a twenty-year period?

¹ John Ralfe: 'Talking Head' FTfm, September 2005.

16. I think this is where the fundamental disagreement occurs. If you believe that longer-term returns on equities will not be superior to those on bonds, then, of course, buying equities will be a foolish strategy. Although I do not equate volatility with risk, no trustee would invest in an asset that was both more volatile and no more productive in return. It has been suggested that the risk of equities not providing such superior returns does not decline over the longer periods. The evidence for this is that the investment banks would not quote an attractive price for a 'put' option on the stock market. That is bunkum. The reason for the lack of such an instrument at an attractive price is that the provider of it has to mark it to market at all times. In other words the writer of the option must reflect short-term volatility in the pricing, not the longer-term likely outcome.
17. All the evidence is that equities do indeed provide superior returns over the longer term, and the longer the term, the more certain is the outcome. Elroy Dimson, Paul Marsh and Mike Staunton at the London Business School have analysed this thoroughly, both in their book *Triumph of the Optimists*² and in the annual Global Investment Returns Yearbook published with ABN-AMRO. In every market they analysed equities have provided higher real returns than bonds over the long term. What is more relevant in this context is that there has been only one 20-year period since 1900 over which equities in the UK have not provided a real return (1900-1920). In most decades returns have been positive in real terms too. It would be rather odd if this was not the case, since otherwise the whole of the Capital Asset Pricing Model theory would be overturned, and capitalism itself made a nonsense of. If equity risk is not rewarded, why would anyone invest in equity at all?
18. Critics of these simple observations of the past will say, as Chou En Lai was reported to comment about the outcome of the French Revolution, 'it's too soon to tell', in that we are dealing with relatively few independent 20-year observations since 1900. But that is not central to my case. While I accept entirely the proposal that the purchase of bonds may well be the optimal solution to the maturing of pension funds, the timing of such purchases is critical. In the same way that it is not always right to buy equities, it is not always right to buy bonds, even in pursuit of a strategic objective. If we take the situation in March 2003, this illustrates the point. At the time, there was no suggestion from the financial economists that this might not be the best time to carry out their strategy. Yet, on 12th March 2003 the current yield on the FTSE All-Share Index rose above the yield on 10-year government bonds, for the first time since the end of the 1950s. If I may allow myself a little boast. I appeared on Radio 4's Today programme on the morning of 13th March, and said that this was the best opportunity for buying equities for a generation. The FTSE 100 index had closed the previous night below 3,400. (Ironically part of the sharp fall on 12th March had been caused by an insurance company carrying out a switch out of equities into bonds, reportedly under some pressure from the regulator). Today it is around 5,200. Should Trustees, or the sponsor company, ignore such opportunities?
19. So my plea is the one I have always made about investment. Buy low – sell high, not the other way round. Trustees have too often abdicated the question of what is known as tactical asset allocation, and merely followed the herd. Why is this? Part of the problem has been the outsourcing of investment management. As someone who has managed two in-house pension funds (Courtaulds and BT) as well as having worked for the outsourced investment management industry, and now as a 'sponsor' of substantial funds such as The Wellcome Trust, I have no doubt which is the

² Dimson E, Marsh P, Staunton M: *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press, 2002

superior model. Which takes me back to the Imperial Tobacco Pension Fund. I can see no way in which the switch that Imperial undertook in the 1950s could have been achieved if it had not been managed in-house. Indeed, the long-term performance of that fund, which ignored the league tables for decades, was made possible only because it was run in-house. The confidence that trustees can build up with their in-house staff, whom they will meet perhaps monthly, is far superior to the 'what have you done for me lately?' confrontations with external managers we have all witnessed. Trustees have compounded their problems by appointing external managers at the peak of their relative performance against their peers, and firing them at the nadir of that performance. I know, I have been there! It is an expensive and wasteful process.

20. Of course, I recognise that it is difficult for moderately sized pension funds to recruit top class investment people, particularly in the hedge-fund world where investment managers have become so greedy. But by outsourcing all investment, trustees have lost the ability to think for themselves about strategic investment issues. How many of them were prepared to accept that equities in the late 1990s were over-valued, and exposure to them should be reduced? Unfortunately trustees, sponsors and, to be fair, investment managers, were obsessed with what everyone else was doing. At Hermes my colleagues and I were lucky enough to be able to persuade the BT Trustees that buying half the fourth largest property investment company in May 2000 was a better bet than simply maintaining our current asset mix. No outsourced pension fund could have done this.
21. Another reason for this lack of independent action is the tyranny of the benchmark. Funds have three mutually incompatible targets, sometimes explicit, often merely implicit: to beat the benchmark, to beat the peer group (the sponsor takes a particular interest in this) and, since 1999 anyway, not to lose money. For fund managers, whether internal or external, cleaving to the benchmark is a low-risk option.
22. What would I recommend now? Despite everything I have said, for highly mature pension funds, and following the dramatic recovery in equities since March 2003, I support the view that trustees should be moving more of their assets into bonds. This may not be the perfect time to do so, and I prefer conventional bonds to index-linked, but it is certainly a better time than two-and-a-half years ago. For trustees with a weak sponsor, this switch will be quite compelling. The equity risk premium has fallen back again, and there is no obvious reason to be a buyer of the market. My point this evening is that trustees should make these judgements and not simply ignore relative valuations.
23. How would the Imperial fund have reacted in these circumstances? In early 1999, only a month or two before he died, the Imperial trustees decided to outsource all their investment management. This was a sad development for father, but he was consoled by the many newspaper references to him and his record in the post-war period. I like to think that he was still open-minded enough to have embraced the idea that bonds have a place in a highly mature fund. Indeed, I recall him saying in 1975 that buying Consols yielding 18% was a pretty attractive option for a pension fund.
24. In June that year, after father's death, one of his successors at Imperial, Will Mather, wrote a 'Lament on the Death of Imperial Investments' from which, with his permission, I will quote. It illustrates so many of the issues to which I have referred, and illustrates how dramatically the environment for pension fund managers has changed over 50 years.
25. 'Fear no more the profits warning

Nor the wretched broker's downgrade
Before us now a void is yawning
Shares we never more shall trade.
In-house managers all must
As chimney-sweepers, come to dust.

Fear no more the cold statistic
The WM performance table
To us each holding's something mystic
So hard to measure, sort and label.
In time the counters too are bound
To measure out their length in ground.

Fear no more – become quite free
Untroubled by the benchmark mystery
Rid your mind of the S-I-P
Consign the ALM to history.
E'en actuaries, I hear you chortle,
As George has proved, are not immortal.

Fear no more, there's naught to fear
The pressures may be just the same
But as for us, the end is near.
There are new managers to blame!
Whilst we to various ills will fall
The Fund itself outlives us all.'