Equity investment by a pension fund makes no difference to a company's value. Trustees should learn from this, avoid unnecessary risk and instead provide scheme members with a secure future. John Shuttleworth

SAFE, NOT SORRY

One of the City's best-kept secrets was finally leaked last October. Known only to a few, between the spring of 2000 and July 2001, the Boots pension fund had quietly transformed its equity/bond split from a conventional 75/25 to a purist's 0/100.

Boots had two motives, both laudable: to improve the security of its employees' pensions, and to reduce its shareholders' risk. The technical analysis was impeccable: a business's liabilities (here, to pay pensions stretching out decades ahead) should be hedged with investments with similar characteristics (here, long bonds).

Media comment has focused on whether other pension funds will follow suit. It seems inevitable that the huge equity content in UK pension funds' portfolios will gradually fall. The wags will no doubt say that this decremental risk-reduction will not be unlike the 12-step process of Alcoholics Anonymous. Indeed, an immediate fall seems unlikely.

Quit while you're ahead

And with good reason. The Boots trustees landed on their feet and crystallised a surplus. Other trustees are now nursing deficits as a result of the significant decoupling of equity and bond markets since the top of the bull market in March 2000. In gambling parlance, the Boots trustees quit while they were ahead. It is not at all obvious that Boots would have done what it did had there been a deficit. Arguably what was most noteworthy was what didn't happen – over the fortnight spanning the leaking of the news, Boots' share price hardly moved.

So we now know the answer to what the theorists have long contended – equity investment by a pension fund makes no difference to the value of the business. According to the investment textbooks, any investment that does not match each future year's pension outgo is the same as trying to improve your household's finances by stopping your fire insurance. To be sure, your cash flow is better – until your house burns down.

This failure to add to shareholder value is a galling thought for those who make a living out of pension fund investment. And for company management and trustees, the sobering conclusion seems to be that the best strategy is one of masterly inactivity. Complex equity/bond portfolios merely soak up management time.

One can only speculate about how other trustees will respond to Boots' black and white analysis. A more useful line of inquiry is why, back in the spring of 2000 when many pension funds had healthy surpluses, few other trustees had on their agenda the possibility of crystallising their surplus. How was the plot lost? The reasons are numerous and complex:

- Most trustee boards lack in-depth investment expertise – the key criticism of the Treasury-sponsored Myners inquiry.
- Investment consultants, overly concerned about their own business risk, rarely put forward ideas that UK pension fund trustees are not embracing already. Remember: the action Boots took was instigated from within (by its corporate finance department, not its consultants).
- Most trustees simply do not understand the degree of risk-taking in their investment portfolios. Again, the Myners inquiry says this dereliction has to change. By all means, take a risk – but only if you know how much.
- Trusteeship in this country is a part-time activity, performed in the main by amateurs. From genesis to implementation, a decision can take months, and on occasion years, to implement.
- Self-delusion – everyone wants their free lunch. The bull market had gone on for so long that equities had begun to look risk-free and all trustees had concluded they were financial geniuses. The bell rang in the spring of 2000, but it was not heard until much later.

It often comes as a surprise to the British to learn that the continentals want little to do with our private sector pension system. And those who doubt this caution need look no further than the awkward reality that the pension funds of this country's insolvent companies are almost always insolvent themselves.

Trustees too easily forget that the distinguishing characteristic of insolvent companies is that they have no money. They need to think far more carefully about how crucial the company's well-being is to their pension fund's solvency. The man in the street does not expect to be exposed to double jeopardy – his job and his pension.

Shared interests

In short, trustees' charmed life has drawn to a sudden close. The next generation of trustees will be more accountable to their different stakeholders and, where they choose to take risk, will have to clearly articulate why. Stakeholders will demand nothing less. Sadly, it may yet need a court case to demonstrate that some trustees' investment strategies are, in financial terms, bordering on the reckless.

Boots executed a bravura full-frontal assault on the many vested interests surrounding the pension fund honeypot. And it was wonderful to watch! The big surprise is that, counter-intuitively, the interests of members and shareholders have turned out to be one and the same. People will chew on this paradox for a long time.

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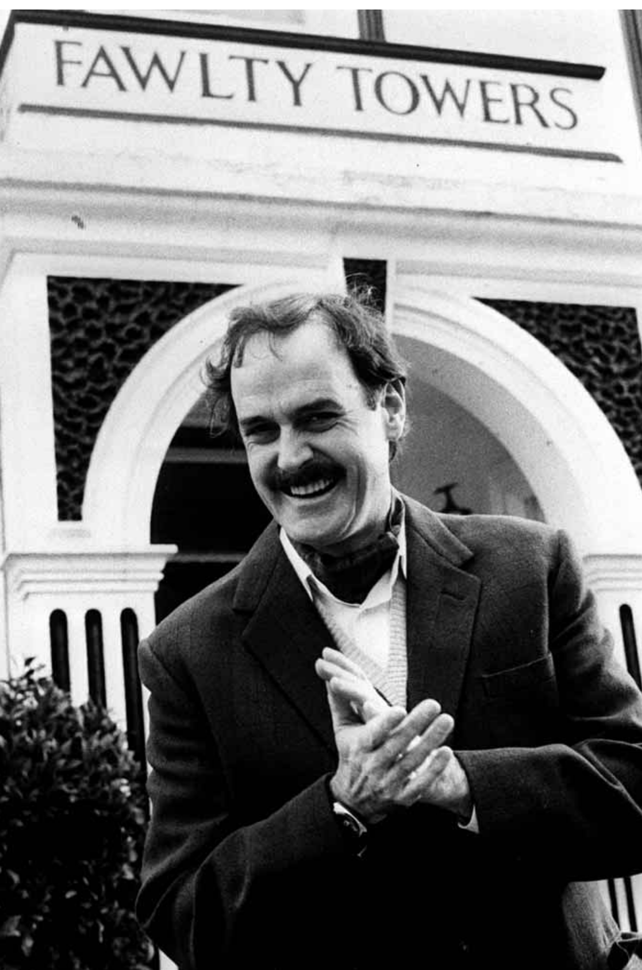

DON'T MENTION THE GERMANS

The UK is still not taking the necessary action to safeguard pension funds. It's time we followed the example of others, says John Shuttleworth

After the debacle of the minimum funding requirement, the British are getting a second chance at solving the pension security problem. And it looks as if they will squander it. The British are in a fix. Almost always, the pension funds of insolvent companies in this country are themselves insolvent. The MFR was a Heath-Robinson contraption designed to do something about this. It fell over for numerous technical reasons but, fundamentally, it had to go because it did not deliver – the employees of an insolvent company with a 100% MFR funded scheme receive only 60p to 70p in the pound.

Every other country that has looked at the pension security problem has found the same answer. First, companies should stand by pension promises that they have voluntarily entered into. Only in the UK can an employer unilaterally substitute something of lesser value. Second, some insurance system should ensure that pensions are paid in full in the event of the employer's insolvency. This is what happens in Germany, Sweden and the US – tried and tested for 25 years.

Perversely, Whitehall is resisting on both counts. It has backtracked on a March 2001 statement that 'companies must meet in full the accrued entitlements of scheme members', now asserting that this 'could be unsustainable for many UK companies'. When you stop and think about it, this is really quite odd. Would Parliament allow the same behaviour by people who overspend on their credit card? It seems that the normal laws of credit do not apply to Latin American economies or UK companies' pension promises.

The insurance approach used in other countries is casually dismissed in the worst sort of half-baked Whitehall conceptualising. It is asserted that pension fund investment choices would become 'distortionary' (not a feature the Americans would recognise in their allegedly 'distorted' pension plans).

Instead, pension schemes are to have a 'long-term scheme-specific funding standard' (whatever this gobbledegook might mean). And putting beyond doubt the suspicion that Whitehall makes it up as it goes along, the government has binned an earlier idea of making good deficits within 'a relatively short period of time, say three years'. The talk is now of 10 years.

Cover-up

Fundamentally, the British need to decide what level of consumer protection should be given to individuals' pensions. There are precedents. Insurance company products are covered. And, in a strange example of the prioritisation of what is important in life, the British public is protected against the insolvency of travel operators. Yet pension funds are covered only against fraud – something that happens rarely.

If you liken pension schemes to a fire service, a single fire engine for the whole country, available to put out fires in all pension schemes, is the basis for the US and German model. A single fire engine, without wheels, that takes a year to get on the road, is what the British have at the moment. One fire engine for each pension scheme – the fiscal equivalent of every pension scheme being amply funded against even the remotest outcome. This cannot be the optimum use of UK plc's shareholders' funds. No sensible business denies itself the use of insurance. This is the nub of the problem – pension promises are only as strong or as weak as UK industry itself. Business uses insurance because it makes business more efficient.

In the last 10 years we have had two major government-sponsored reports that address the pension security problem. The real oddity in both was the paucity of reference to non-UK practice: five pages in the 1993 post-Maxwell report and two pages in Paul Myners' report last year. It is a case of don't mention the Germans – or the Swedes or the Americans or the Canadians. In all these countries, insurance makes good deficits.

How much would an insurance solution cost? Overseas experience suggests about one-fifth of what the British spend on house contents insurance. This is hardly lavish – pensions are, for most people, either their biggest or second biggest financial asset, and are therefore a prime determinant of one's quality of life.

Whitehall whitewash

Since Whitehall is in a minority, one needs to look for a motive. A number spring to mind: the Treasury was undoubtedly humiliated by the MFR debacle and is wary of getting it wrong a second time. Hence the attraction of deregulation – it becomes someone else's problem. Any form of insurance is likely to lead to a reduction in UK pension funds' chunky equity holdings. The Treasury wants to inculcate an equity culture in the country's savers. Whitehall does not have the appetite to construct a quasi-government insurance system along the lines of those found abroad.

It is just possible that Whitehall is right and the rest of the world is wrong. If so, the Treasury is in for a busy time as other countries come here to study the British way before returning home to unwind their own arrangements. More probably the next few years will see the British, true to form, muddling through.

This is a debate that will not go away. People do not want double jeopardy – losing both their job and their pension. Brussels has made it clear that it wants all EU pension funds to have sufficient money to pay pensions at all times. Either Whitehall will introduce change voluntarily, or Brussels will do it for them.

John Shuttleworth is an actuarial partner at PricewaterhouseCoopers

No pay, no gain

The UK spend on state pensions is half the EU average, there is no clear strategy and the poor are losing out. The government should follow the examples of our EU counterparts, says John Shuttleworth

It is almost axiomatic that when the bureaucracy touches pensions, the result is legislation of bewildering complexity. This is what will happen in April when the state earnings-related pension scheme (SERPS) is rebranded the state second pension (S2P). And a year from now, the new 'pensions credit' will means-test the state pension. The sometimes weird, but always fiendish detail is probably fully understood only by a handful of civil servants – who will quickly forget it when they rotate to the next department of state.

The British have not had a pension strategy since the 1950s – hence the jibes that the government makes it up as it goes along. As with our railways, policymakers seem bedevilled by chronic indecision. This is slightly unfair – in the last few years, there has been a clear policy intent to retarget the state pension at the lower paid.

There is undeniable logic to what the government is doing – it is surely a proper role of government to deliver a defined benefit pension to people who have a low risk tolerance. The unpredictability of defined contribution makes it unsuitable for the poor. Dickens put it more elegantly: 'Annual income £20, annual expenditure £19 19/6d, the result happiness. Annual income £20, annual expenditure £20 0/6d, the result misery.'

British cheapskate

The government is keen to boast of the UK's low spend on state pensions. It is already the lowest in the European Union (half the EU average, at just 5% of GDP). In spite of our adverse demographics, we are the only member state where the spend is expected to fall over the next few decades. Some boast!

Like families that only reluctantly mention the miser amongst them, the continentals rarely refer to the British cheapskate approach to pensions. And with good reason – we have failed to make cheap labour costs a competitive advantage. Yet this failure is easy to explain. To be sure, our spend on state pensions is half the EU average, but all that is happening is that the half of the UK workforce who are not in tax-subsidised occupational pension schemes are losing out. On pensions as a whole, public and private together, we spend roughly the EU average.

There are potentially profound societal implications of this division into haves and have-nots. Worryingly, it always seems to be the next government's problem. Suppose we did have a grand design. What would it look like? The 'to fund or not to fund' debate is a sideshow. But do not underestimate the politics – supporters of funding often seem more motivated by a desire to build huge piles of investments than how to deliver a no-frills state pension in the most efficient way.

It cannot be repeated enough that pre-funding the state pension does not magically make it more sustainable. No matter how cleverly the economic cake is cut, a country's economic production in any year is consumed by the people who are then alive. The issue is how different generations lay claim to each year's production. (And pre-funding does not even guarantee payment – as irate Argentinians have just discovered. To stop a run on the banks, their government has said it will unilaterally convert all bank deposits made by pension funds into government debt.)

An emerging model in many countries is a core defined benefit (DB) pension with individual defined contributions (DC) accounts on top. The Germans are the most recent to embrace this. From 2008, UK-style personal pensions will be available to which individuals can contribute a tax-deductible 4% of pay.

At the beginning of this decade, the Swedes introduced a state system that is genuinely innovative. Under its DB core, each Swede has an individual account to which 16% of their pay is credited each year. This account is revalued by wage inflation. Then there is a DC top-up, to which 2.5% of pay is paid.

The Swedes have been pragmatic about the design of their DC arrangement, constructing a sensible public/private partnership. Keen to avoid the high costs of administering individual DC accounts in the UK and other countries, the Swedes set up a publicly-owned clearing house. It negotiates charges with in excess of 80 investment managers, collects contributions, pays them to the managers, and maintains records.

In the UK, stakeholder pensions have been sniped at and labelled a flop – in the first eight months since their launch 'just' 570,000 were bought. The snipers miss two points. For the first time, the British have a long-term savings vehicle that is cheap. It is no exaggeration that, before stakeholder, commission and other costs more or less cancelled out the tax-relief. Second, there is a very good reason why the poor are not buying more pension provision – they have no money to save.

Not so simple

It is easy to argue that government's role in pension provision should be limited to providing a low quality pension and the creation of a savings environment in which people can reliably plan. But real life is not so simple. The reason for the periodic revisiting of UK public policy on pensions is that in the UK, much more than on the continent and in North America, the poor are excluded.

It must be a pretty good bet that, by the end of the decade, Whitehall will be back from the drawing board with a proposition that, just as everyone must pay taxes, each of us must contribute to an individual DC savings account.

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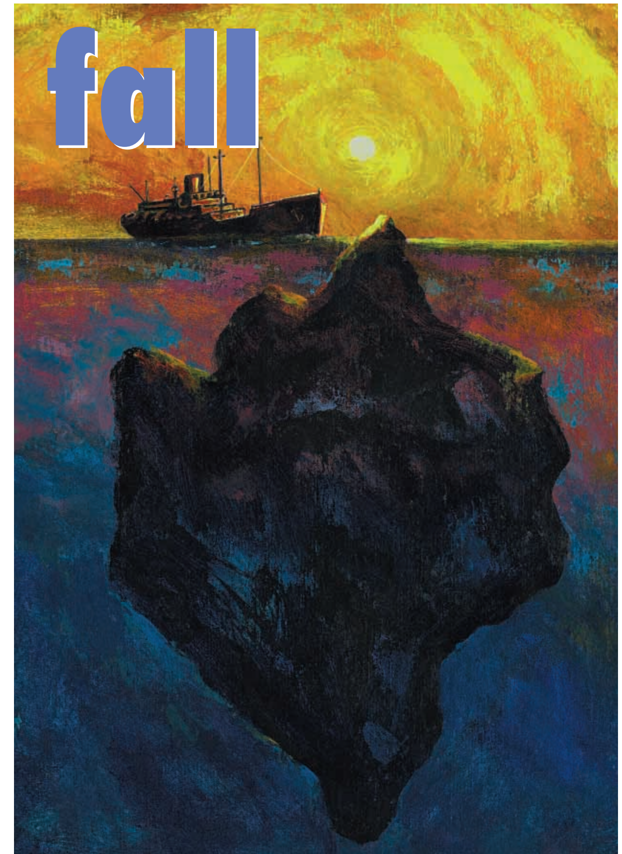
Heading for a fall



The risk involved with investment in equities increases over time. Too many trustees ignore this fact and put pension funds in jeopardy, says John Shuttleworth

There are many misconceptions in investment, but the mother of them all is surely the common belief that equities become less risky the longer you hold them. Exactly the reverse is so. Since any good book on finance tells you this, it is both puzzling and worrying that this popular myth endures. To be sure, the longer you hold equities, the more likely they are to outperform cash or bonds. But this analysis is only one dimension of a two-dimensional picture. What is missing is the size of the shortfall when equities underperform.

If you put the two dimensions together, the mathematics shows clearly that equities' risk increases, not decreases, the longer they are held. (Technically, you use the methodology of option pricing to calculate what an investment bank would charge to insure your equity portfolio against underperformance. Answer: the longer you need the insurance for, the more you get charged, reflecting the fact that the risk persists.) To be sure, the investor buying equities for the long haul has more time to recover from market collapses, but he also has more time to encounter them.

To reassure readers of the credentials of these assertions, I hasten to add that all are endorsed by the investment gurus – Bodie, Merton and Samuelson to name but three (and the last two are Nobel prize winners).

Not unreasonably, pension fund trustees in this country are not keen on this analysis – they point to the last century and the absence of any 20-year period in which UK or US equities did not outperform bonds. But this data is threadbare, to say the least. The last century contains just five independent 20-year periods. No statistician would draw anything but the flimsiest conclusion from five data points.

Advocates of the equities free lunch also conveniently forget Japan's travails, and that some stock markets have disappeared entirely (including those in Russia, Peru and Poland). Survivorship bias is the oldest pitfall of them all for the amateur statistician.

Ignorance is not bliss

Does this lack of knowledge among investors matter? Yes and no. In the case of private investors, you cannot legislate against ignorance. Fools will always be separated from their money. That said, we owe it to our children to give them a better education and grounding in the rudiments of investment. But in the case of pension fund trustees, it does matter because they invest other people's money. Paul Samuelson, arguably the pre-eminent economist of the second half of the 20th century, has described it as 'a blunder if not a crime' for a fiduciary trustee to believe that equities' risk decreases over time.

If you strip away the wrapping on a pension fund and look at its financial fundamentals, you find yourself looking at a hedge fund (to get technical, one that is short bonds and long equities). Pension fund trustees in this country simply do not get this. The terrible events of 2001 reminded us that the world remains a risky place. This is why equities probably outperform bonds. But this is a statement of no great insight. After all, junk bonds probably outperform gilts (but not certainly, and not all the time). Challenge: if you are one of the believers, why stop at the herd's 75% in equities; why not go all the way to 100%? Answer: if it were guaranteed that equities would outperform, their price would rise to eliminate the arbitrage opportunity.

This is not to say that trustees should not continue to invest in equities; rather, trustees need to work harder on their logic. This is that the sponsoring company's management asks them to run a heavy asset/liability mismatch. Trustees clearly cannot have a higher risk tolerance than the company, but they could have a lower one. More often than not, though, trustees conclude that the company's underwriting of the mismatch is good enough.

Lost plot

Yet events repeatedly prove this to be an optimistic conclusion – the pension funds of this country's insolvent companies are almost always themselves found to be insolvent. Trustees too often forget their job – to protect employees against double jeopardy (their job and their pension) – and try to second-guess what the company wants. And company management has a case to answer too: it can underestimate the virtues of a well-funded, safely invested pension fund if the day ever comes that the company downsizes.

I am sure that many trustees will challenge

If you strip away the wrapping on a pension fund and look at its financial fundamentals, you find yourself looking at a hedge fund

the thrust of this article. It has not been my intention to annoy. The hopelessly poignant thing is not trustees' naïve belief that the top has yet to come, but that so many trustees believe so vehemently that their efforts are well-intentioned.

The English have a fondness for amateurs and eccentrics. Both scare the continentals. My proposition is that amateurism is not good enough for pension fund members. Paul Myners, to his credit, confronted this last year and the law is shortly to be changed to put beyond doubt that decision-makers must be 'familiar with the issues'. The Treasury has said the current position is a 'matter for serious concern'. Let's hope trustees can make this step-change before the failure of a very large pension fund brings the debate into the courts. Somewhere along the way the plot got lost – pension funds are there to provide pensions. It's as simple as that.

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