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REVIEWS

The Stock Market. By CLIFF PRATTEN (Cambridge University Press, 1993) £27.95

Although J. M. Keynes' theories on investment were developed during the 1930s, his writings have influenced thought on the way the investment market operates up to the present time. This book clearly explains Keynes' ideas and develops these further.

Figures showing that equities (including reinvestment of dividends) outperformed other main categories of investment by a substantial margin are included. This is particularly true for the period between 1960 and 1990. The conclusion is reached that equities were undervalued over a long period and that this could be due to the retention of a 'risk margin' and also because it was (and is) necessary to retain a proportion of funds in readily realisable assets. It is also argued that investors failed to foresee that equities would provide better returns than alternative forms of investment between 1960 and 1990.

From 1923 J. M. Keynes was Chairman of the National Mutual Life Company, and in his report in 1928 he said that Mutual was pioneering the inclusion of ordinary shares in its portfolio, and in 1927 the proportion rose to 18% of its investment fund.

In today's conditions this seems to be a remarkably low proportion, and equities now occupy the most significant part of the investment of life companies and pension funds. I would argue that the steady increase in the volume of investment going into equities could also be a significant factor in the increasing 'costs' of shares and hence the emerging yield.

The book is also of interest because it examines possible reasons for the considerable volatility of equity prices in recent years, and also discusses and develops Keynes' ideals for this.

Cliff Pratten acknowledges the problem that actuaries have when it is necessary to advise on suitable investments to match emerging liabilities. The flexibility provided by bonus systems had led to a much higher equity content in the investment portfolio of the life assurance companies. The recognition of the higher yield pattern for equities over the past few decades has also led to a higher proportion of pension fund money being invested in equities.

The book contains an interesting chapter based on completed questionnaires of the procedures leading to the allocation of investments by various institutions, including insurance companies.

In summary the book has the primary objective of commenting on, and the development of, Keynes' theories, and will be of interest to many actuaries.

R. W. SCADDEN

Better Pensions for All. By BRYN DAVIES (Institute for Public Policy Research, 1993) £7.50

Bryn Davies sets himself the ambitious objective of outlining how to provide adequate pensions for all in a report of just over 100 pages. On the plus side, his starting point is the political vision that it is possible for a society as wealthy as ours to provide adequate pensions for all. As he points out, a common problem in discussing pensions policy is that all too often a concentration on means can obscure the ultimate objective of the policy. *Better Pensions for All* is packed with ideas, many of them good, but some idiosyncratic to say the least. The style is more that of a manifesto than a report, and many of the counter-arguments to its proposals are obvious by their absence—but enough of the carping, READ THIS BOOK!

We begin by looking at what pensions are for and an analysis of the savings approach, typified by personal pensions, versus the approach of solidarity between generations, typified by the State scheme. The political vision is particularly clear here. As Bryn Davies points out, whatever approach we adopt, today's pensioners must always consume goods and services produced by today's workers. Therefore, arguments that the pay-as-you-go state scheme is fundamentally inferior to funded private provision are political dogma rather than sound reasoning.

We move on to look at the strengths and weaknesses of the main types of pension provision in the

U.K. In this chapter an unevenness in the arguments becomes apparent. To my mind, there is an over-emphasis on the problems of money-purchase arrangements—which we are told unions continue to regard with suspicion—and little discussion of how these can be addressed. We also learn that 'the State scheme is fair as between contributors', whereas only five pages earlier we learnt that 'providing different benefits for men and women is an example of unfairness.'

Next we look at 'the gaps in the patchwork' of pension provision in the U.K. and how these might be filled by improvements to the present three-tier system and by the introduction of industry pension schemes discussed later on. Following on from this, there is a discussion of the future for state provision. Bryn Davies makes the familiar arguments for the need to increase the level of the basic state pension and to restore the link to national average earnings. The plea for simplification of the state earnings related pension will strike a chord with most readers, although the proposed solution, conversion to a national personal pension scheme will raise some eyebrows.

Chapter five discusses the future for occupational provision with spirited arguments in favour of greater member control, a better deal for early leavers, better protection against the effects of inflation and addressing the other inequalities of final-salary schemes. Once subversive stuff, most of this is taken as read post-Maxwell and post-White Paper.

Finally, in Chapter six, Bryn Davies discusses his ideas for industry pensions—industry-wide with-profits targeted money-purchase schemes. Few will argue with the need to find a way to help lower paid workers and those who work for small employers or in part-time employment to increase their pension provision—some of my colleagues will even applaud the targeted money-purchase concept—but with-profits, surely that went out when I was in short trousers?

In summary, it is refreshing to read a strong defence of a pluralistic approach to pensions—the vision is there—it is packed with ideas, but do not expect to agree with them all.

ANTHONY LOWE

Money, Credit and Asset Prices. By GORDON PEPPER (St. Martin's Press, 1994) £40.00

The publication of this book in the first quarter of 1994 was timely, coinciding with worldwide falls in capital markets. A popular explanation for the falls was that highly geared speculators, such as the so-called hedge funds, became distressed sellers as a result of margin calls on positions which had been financed largely by credit. One of the insights of the book is that, when such liquidity-driven transactions dominate, causality in markets is reversed: the falls in price are a cause of further deterioration in sentiment and further distressed selling, rather than changes in economic expectations leading to a change in prices. If I may paraphrase this in terms familiar to actuaries, the point being made is that liabilities can be important to investment decisions in the short term as well as in the long term, if the liabilities in question are urgent in nature. This may appear to be a straightforward point, but it is an insight sadly lacking from the vast literature of the last three decades on the subject of market efficiency. The author does not seek to rubbish this literature, but he does argue that its failure to account for liquidity-driven transactions makes it 'correct but incomplete'.

The book is organised in three parts. The first ten chapters (Part I) are mainly a distillation of the author's experience of how markets work. Chapters 11 to 14 (Part II) consist of reprints of papers written in previous decades (including one to the Institute) which illustrate how the theories in Part I were developed. Finally, chapters 15 to 18 (Part III) elaborate on the themes developed in earlier chapters.

The author justifies the inclusion of historical papers in unrevised form in Part II on the grounds that theories advanced before an event takes place have more credibility than ex-post rationalisations. The effect for the reader is that, on an initial reading, the book seems rather disjointed; but on closer study the inclusion of the historical papers does indeed enhance the credibility of the view of markets advanced in Part I.

The elaboration in Part III is partly further historical detail, and partly an application of a monetary economist's perspective to fields such as foreign exchange and stock market regulation.

It is emphasised that the book is not a manual for forecasting market movements, but rather an aid to understanding how markets work. One of the main themes is the importance of monetary disequilibria within the financial system, particularly for forecasting the movement in the equity market over a horizon of one to two years. For this timescale the book presents a time series analysis of the years 1967–1989, which suggests that fundamentals, such as earnings and dividends, have very little role to play in forecasting equity market movements; they become dominant only over horizons of around five years or more. In the short run, financial forces (as measured by the behaviour of the gilt market) are found to be far more important than fundamentals. For this reviewer, the distinctiveness of this view is illustrated by the fact that, if one accepts it, one can disregard a great deal of the market commentary emanating from brokers' equity strategists, on the grounds that its focus on fundamentals largely misses the point.

A second main theme is that monetary disequilbria in the United Kingdom were, to a large extent, cyclical and predictable by monetary economists in the 1960s and 1970s. With an open economy and the modern ease of international capital flows, this predictability has now been lost.

Another theme is the influence of crowd psychology on the behaviour of markets. In recent years other economists, for instance R. J. Shiller in his book *Market Volatility* (MIT Press, 1989), have stressed crowd psychology as an explanation for variations in capital market prices, but have provided little information on how they would measure or predict psychological phenomena. The author attributes crowd psychology to disequilibria of financial forces: an excess of funds available for investment creates a bullish psychology, and conversely a persistence of distressed selling motivated by a need to raise funds is conducive to bearishness.

The author notes that, if one accepts the view that monetary forces are dominant in the short term, an investment manager who is assessed on an annual basis should concentrate on financial forces, and pay little attention to fundamentals. He suggests that this is an important explanation of the common disagreements between the City and industry concerning 'short termism'.

The book offers no easy answers for investors, indeed it acknowledges that there is very little evidence that any type of investment transactions can make one a persistent winner in the long term. Possible exceptions are transactions where a clear 'losing' counterparty who is transacting for non-investment reasons (e.g. distressed selling) can be identified. However, some investors may not feel able to take advantage of such opportunities. For example, pension funds and other investors with liabilities related to long-term real factors may consider that allowing investment policy to be dictated by financial forces is too risky, and may prefer to base their decisions solely on the need to obtain a match for their liabilities. It appears to this reviewer that a closed final salary pension fund—motivated by considerations of long-term matching of pensions in payment rather than short-term investment return—would be a prime candidate for the role of 'loser' in a transaction with an astute follower of financial forces! Indeed, the book identifies life assurance companies writing without-profit business as one of the sources of such opportunities in the 1960s and 1970s. The reason for this was that, at the bottom of the business cycle, the actuary of a without-profit fund would still wish to retain long gilts, while an astute follower of financial forces would be selling gilts in anticipation of a rise in interest rates.

Events have moved on since the 1960s and 1970s, and the forecasting and exploitation of monetary imbalances is now greatly complicated by the increased scale of international capital flows, which the book starts to address only in the penultimate chapter. In this sense the book is more an explanation of how markets worked then rather than how they work now. Another structural change, not discussed in the book, is the development of increasingly complex derivative instruments, which greatly complicate the connection between availability of credit and the investment positions which can be financed. The author acknowledges that the analysis of monetary aggregates now needs to be carried out on a global scale, but in this area the book is limited to highlighting the difficulties of analysis rather than providing solutions. Perhaps that is a task for the next generation of market analysts, although it must be said that the focus of much current research seems to be more on the non-linear statistical properties of individual price series rather than on a broad range of macroeconomic aggregates. For this reason, the book is a timely reminder of the value of a broad monetary approach to our understanding of capital markets.

R. G. THOMAS