Should pension funds invest in equities?

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Background

- The world has changed
- It's about to change more
- Financial Economics arguments have taught us a lot
- How do we advise clients in practice?

Strong company

- Pension fund liabilities are effectively company liabilities
  - extremely small chance of going bust
  - debt on employer changes: can't walk away
  - trust structure makes little difference

Equity / bond exposure

- Can hold equities in the pension fund
- Or:
  - switch equities to bonds in the pension fund
  - issue a corporate bond and buy back shares
  - overall equity/bond exposure is unchanged
- UBS paper September 2003

Second order issues

For bonds

- Tax
- Expenses
- Accounting / matching
- Surpluses and wasted capital
- PPF levies?

For equities

- Peer group performance (everyone else does)
- Expenses
- Accounting

Exposure to your own company's performance versus others
Company cost of borrowing (linked to default risk)

The other end of the spectrum

- Weak company / covenant
- Pension fund assets much larger than Company's NAV and market cap
- S75 Debt on Employer larger than Company's NAV and market cap
- Active members 10% of the liabilities
- Closed to new members

Implications

- Pension fund liabilities cannot be considered purely as company liabilities
- Everyone is affected by fund performance:
  - Company
  - Trustees
  - Shareholders
  - Members
- Potential for conflicts of interest

Why invest in equities?

"Investing in equities is the only way there's a chance the benefits will be paid in full"

restated:

"Moving to bond investment would show with certainty that the accrued benefits cannot be met from existing assets. To rectify this would require further cash from the employer, which may put the employer out of business."

Company perspective

- High equity / low contributions: company stays afloat
- Low equity / high contributions: company goes bust
- Pension scheme members are giving the company cheap finance
- If you go bust, it may not matter to the shareholders how big the S75 debt is
- May as well run the equity risk (one way bet)...
- …or wind up and compromise the debt?

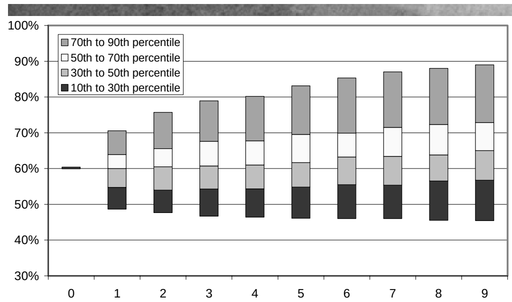
Trustee perspective

- Set investment strategy such that
  - Probability of success adequate
  - Probability of ruination low enough
- Will result in a combination of asset classes
- Or will be impossible
- Impact of PPF?
- Impact of “scheme specific funding”?
- Impact of anti-avoidance legislation?

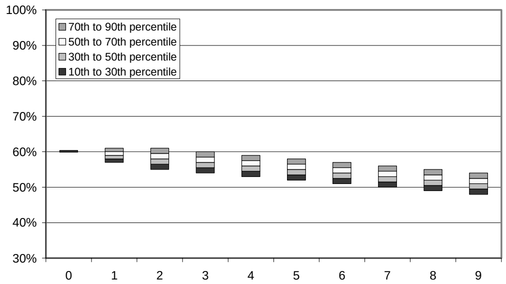
What if you invest all in bonds?

- You have locked in the buy-out deficit
- Benefit coverage for non-pensioners is reduced:
  - every time a pension increase is granted
  - every time somebody retires
- Trustees have to treat all members fairly
- Better to wind-up now?

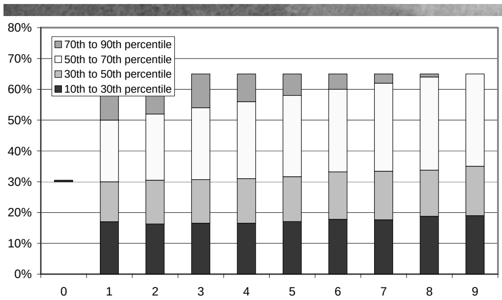
Average benefit coverage
High equity strategy



Average benefit coverage
High bond strategy



Benefit coverage for non-pensioners
High equity strategy



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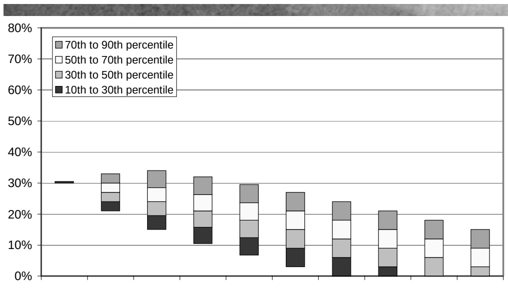

Practical way forward

- Most cases will be in between the two examples
  - Company and Trustees agree a process to manage the scheme's finances
  - Define timing of switch to bonds and changes to contributions
- Communication to members

Conclusion

- Strong companies – have fun advising on 2nd order issues
- Weak companies – go for it or give up now

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