ADDRESS

BY THE PRESIDENT

PETER EDWARD MOODY, F.I.A.

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I would have liked, as many of my predecessors have done, to produce an Address for you today which would retain its freshness and relevance as the years go by. Before I started composing I doubted my abilities in this respect and I must tell you that my fears were realized and that there is a pronounced air of topicality in what follows. I don't need to make a further apology for a theme that differs considerably from most of those of my predecessors, because I think you would expect me to talk about financial matters to do with capital markets, investments and the responsibilities of those who look after other people's money.

Recent events have shown that actuaries who control the fortunes of pension funds and insurance funds must inform themselves about the nature and quality of the asset backing for those funds and I have tried to direct my Address to those of you (and it must be most of you) who have already or will at some stage in your careers be in that position.

I am going to begin with some general comments on the capital market, a term which covers not only the Stock Exchange and the property market but a much wider field, and this leads me to develop several topical themes in greater detail. I then come closer to home in discussing the relative importance of capital and income in a life fund and to the analysis and assessment of asset portfolios. Finally, I have been unable to resist the temptation provided by a public forum of putting forward some views on the proper role of the institutional investor as a shareholder.

And so to some general comments on the capital market.

Our financial system is highly complex, is in a continual state of flux and is, to a large degree, a free and competitive market.

One can observe flows of funds in broad aggregates, between individuals as a group, industry, government, financial institutions and the overseas sector, but entities within these groups both demand funds from the market and supply funds to the market and millions of transactions take place between and within groups. So the position is complex and more so because, as a major trading nation, the United Kingdom capital market is linked to the capital market of the whole world.
Capital markets are continually changing---some by slow evolution such as the Euro-currency market, a market in international funds which grew out of controls and tax policies of the governments of some major financial centres. Some changes are sudden such as the increase in the price of oil at the end of 1973 which, in a major way, changed overnight the flow of international funds. Changes internally in the U.K. are less dramatic but take place continually nevertheless. New lending instruments to meet particular needs appear from time to time, for example, for the financing of North Sea Oil exploration, development and production. There are changes in the pattern of bank lending, in public authority borrowing and so on.

The capital market is a fruitful source of learned disputation of the chicken-and-egg type revolving round such quantities as the exchange rate, money supply, public-sector borrowing requirement, inflation rates and interest rates. Which of these is cause and which is effect? I suspect they change roles from time to time depending on the fashion of the day and that it may be impossible to discover any dependable pattern of relationships. Any model which works at a moment of time sets off new reactions which tend to falsify its original equations. We can now make quite a good shot at forecasting some of the main economic aggregates for short periods ahead but we have not reached the stage where all the effects, or even the most important effects, of changes or intervention in the capital market can be assessed in advance.

The market works well in continually matching the supply of funds with the demand but any market where prices adjust freely will do this. Our interest-rate structure, as a price mechanism, is free to move apart from some grooming efforts by the authorities. Freedom of the interest-rate structure to adjust has an important aspect. The major part of demand for capital in the U.K. derives from two base sources. The demand which is generated by the decisions of individuals as to how they will spend or save their disposable income and the demands of the public sector which for non-commercial services spring from decisions in parliament and for commercial services such as fuel and transport again trace back largely to preferences of individuals. To the extent that these demands generate a need for new capital they are satisfied at whatever is the ‘going rate’ for the day and this discipline seems to me to have the important benefit of providing an objective yardstick against which the demands of the public and private sectors of our mixed economy can be judged and balanced. There are other political systems for achieving this balance but they are not consistent with the degree of personal freedom of choice inherent in our own system.

I now propose to develop a few themes in greater detail.

Since supply and demand for all types of finance are equated through the operation of the interest-rate structure, one cannot, for example, have a money mountain in the same way as there is a beef mountain or a butter mountain unless attempts are made to interfere with the price structure, as in the case of the latter two. Changes in the rate of interest will always equate supply and demand. Similarly it is wrong to assume that there will at some times be a shortage of
equity-type investments owing to the pressure of funds seeking investment through the large cash flow of the pension funds and life offices. Changes in differential returns between ordinary share yields and fixed-interest yields or property yields and fixed-interest yields will ensure that supply and demand are met. This will be partly by altering investor preference for the various categories of investment, partly by creating greater demand for equity-type funds by companies, partly by some private companies coming to the market who would not otherwise have done so and partly, a very desirable out-turn, an increase in the number of new ventures that are able to attract equity finance.

There is a fear of a money mountain arising from the cash flow of funded pension schemes and the estimates of what they will be over the next decade or so. The actual numbers appear very large taken on their own but are considerably less daunting when related to projections of Gross Domestic Product calculated on the same basic assumptions. In relation to G.D.P. the figures are not so out of the way as to falsify my view that the capital market will be fully able to accommodate and adapt to the position. The net new amounts available for investment by U.K. long-term insurance funds and funded non-insured pension schemes expressed as a percentage of G.D.P. rose from 3½% in 1966 to 5% in 1972 and remained at that figure up to 1976,* the latest figure available. Some projections see this figure rising to 6% by 1985, which is hardly an alarming rate of change.

This leads on to my next theme.

As I understand it there seems to be an emerging consensus that private-sector pension schemes ought to have fully funded schemes with external assets and that public-service pensions (civil service, armed forces, police, etc.) should continue on a pay-as-you-go basis. The controversial area is that of certain public-sector schemes such as the Post Office, British Rail, etc.

It is not within the scope of this address to enter into the argument about the funding of these schemes ranging widely as it does over economic, political and commercial questions, but I would myself like to pose a question. It arises from a train of thought (i) that these industries ought to make full provision for pension liabilities which accrue during any trading period in order to have sound pricing policies (ii) that a pay-as-you-go scheme would require a government guarantee and hence government involvement in the details of all forms of remuneration which is undesirable (iii) that nevertheless the government has a moral obligation to ensure that the pension expectations of its public-sector employees are fulfilled and in practice there is an implicit guarantee, (iv) that the pursuit of equity-type investments by these funds whose employers do not generate an open-market demand for equity is unbalancing the supply/demand position in the capital market which is undesirable even if the market is able to adapt (v) that moving to pay-as-you-go would have many uncertain consequences and might not suit the preferences of the employees and (vi) that investment of cash flow back into the

* Source: NIE 1966/76 Tables 1.1 and 4.6.
employing corporation—so-called balance sheet funding—risked the misalloca-
tion of capital resources.

My question is this. "If these are the relevant considerations, does the logic not lead to the conclusion that the majority of the cash flow should be invested in government stocks?" Given the nature of the employer, this would be a sound investment policy for the trustees of the schemes to follow and appears to me to make a useful contribution to the solution of the problems under discussion. These schemes are so much part of the public sector that I don't think this suggestion has implications for the private-sector scheme nor does it imply the need for general direction of pension fund investment policies.

I turn now to discuss some current criticisms of capital markets but it is worth reminding ourselves of the truth that no system devised and administered by human beings can achieve perfection. A truth that is forgotten by those who argue that the presence of imperfections is sufficient reason for advocating change.

I would like to comment on what I call a 'valuable early warning system' and others call a 'gilt-edged strike' or, in other words, a temporary interruption in the government's funding programme such as occurred for a few weeks during 1976 and for a few weeks during the early part of 1978.

Much of the comment is superficial and proposes remedies for symptoms rather than for the underlying disorder. It involves the kind of approach which finding a man ill with a high temperature would recommend that he be put in a refrigerator.

To begin with, the use of the word 'strike' is graphic but wrong. A strike is a group of people banding together and acting in concert to achieve some objective. For all straight commercial decisions such as the timing of gilt-edged purchases, institutional investors do not work in concert and therefore if, as a group, they suspend their buying of government stocks, this is a well-informed body of people who have come independently to a common view that the current level of interest rates will have to be changed.

One can say that this is the herd instinct of institutional investors or blame it on stockbrokers' circulars, but since institutional investors bring a sophisticated approach to their problems, it must be fair to enquire whether a common view exists because developments in the economic situation cause them to arrive at the one interpretation. I don't find this difficult to demonstrate. In 1976, even while the value of the £ was depreciating, the Government's funding programme continued and it was only in late September when the position got markedly worse that the problem appeared—a problem that was finally solved with the conclusion of an agreement with the International Monetary Fund.

In 1978 the gilt market first started to show signs of nervousness when the Chancellor, in his Budget speech announced an expected borrowing requirement of £8.5bn and a growth target for the money supply of 8–12%. Rightly or wrongly there was a general view that the forecast borrowing requirement and the monetary target were incompatible without a rise in interest rates. The sums were
too tight, or to put it another way, too many things would have to go right. It was not long before things appeared to be going badly wrong. The March trade figures were very poor, raising doubts about the trend in the balance of payments and sterling came under pressure with reserves being used to support it. There was a large over-shoot in the 1977/8 money supply which was not expected by the institutional investors and neither, one suspects, by the Government. Given the additional pressure on the exchange rate by the tendency for U.S. interest rates to rise, the picture began to look once more very like that of Autumn 1976 although the severity of the crisis was not so pronounced.

Even if the institutions had gone on buying in a blinkered fashion, the economic chickens would have come home to roost and changes in government policy would have been forced in some other way, most probably through a rapid worsening in the exchange rate. Measures thus forced could well be far more severe. In my view the action of the stock market in providing an early warning system is a source of strength and not a weakness. It should not be forgotten that the course of events in 1976 and 1978 that I have described were highly unwelcome to the institutions who found themselves facing substantial losses in the market value of the stock that they had bought only recently.

Another area where the system suffers from lack of understanding and a certain amount of criticism is that of secondary markets, by which I mean here the buying and selling of ordinary shares as opposed to primary markets which supply new capital to companies. To those of us who operate in the field the benefits of active secondary markets are plain and obvious but for those who are not so involved and may only notice the secondary markets at the time when there is a froth on the top from an unusually active volume of trading, it may be difficult to appreciate the solid benefits of the normal trading in secondary markets.

Activity in secondary markets is important in fixing a company’s price relative to others and thus determining the terms on which it can raise new money. Analysis of balance sheets and profit-and-loss accounts can never take account of all the factors that affect a company so that different investors will reach different conclusions about its value. Their dealings in secondary markets produce a price which represents the collective judgment of them all.

The existence of a secondary market is attractive to investors for various reasons. Private investors and some institutions need the liquidity which it provides. When a company makes a rights issue to shareholders it enables those who don’t wish to take up their rights to dispose of them. When the structure of a portfolio needs to be changed, the mechanism is there to do it, and so on.

The verdict of the market place also provides a powerful test of the quality of management visible to all. A company’s rating relative to that of its competitors carries a strong message to management, particularly if the rating is a low one and points to under-utilization of assets which some other company may decide would be worth acquiring and operating more effectively.

There is inevitably in a market like this a certain amount of speculation.
Depending on the circumstances, it can increase volatility when the speculation is in the same direction of the trend or damp it down where there is speculation on a change in trend. It is doubtful whether the actual volume of speculative activity is today of a significant size in view of the increasing proportion of the total share market held by long-term-minded institutions but to the extent that it takes place it increases the volume of transactions and hence the income of those who make the market, thus making it remunerative to employ more capital in the jobbing system than there would otherwise be.

Improvements in secondary markets continue. Greater disclosure requirements, additions to the Stock Exchange listing agreement and the activities of the Takeover Panel are all directed to avoiding false markets and providing honest and fair markets for those who deal in them. Among other things the attitude to insider trading has changed greatly. Twenty years ago it would probably have been the objective of any investor to obtain some inside knowledge from which to profit whereas nowadays all the responsible institutions take particular care to ensure that if they do get into the position of having price-sensitive information they do not deal on the basis of it. There are those who argue, in my view wrongly, that one of the imperfections in the market is that institutional investors are short-term minded and that there must therefore be a number of worthwhile long-term industrial projects going begging. They therefore propose that a proportion of institutional cash flow be put into a special fund devoted to developing these projects. This proposal is still being advocated in spite of the heavy weight of evidence that institutional investors are long-term minded and more evidence that commercially viable projects do not go begging, even if they are very long term and slow to mature such as, for example, the off-shore oil industry where substantial institutional funds were devoted first to wild-cat exploration and then to the development of discoveries.

The long-term/short-term position is really the other way round. The insurance companies and pension funds have no option but to take the long-term view. The administrators of this proposed special fund would not be subject to the same constraints and discipline and would be liable to undertake propositions which met some short-term political need.

I don't think there is any strong body of opinion which argues that the people who invest via the institutions should receive less than the going rate on such a fund and this could only be ensured by the issue of securities which had government backing which would mean that the fund would be regarded as part of the public-sector borrowing. From this it seems clear that the institutions would class such a fund as part of their portfolio of government stocks and the fund would pre-empt part of the total borrowing of the public sector. Any special projects would thus form one element in government expenditure and would be in competition with the many other demands which are made on the public purse. There are already many forms of government aid for special projects together with various tax advantages and it seems better to use these existing mechanisms rather than introduce new machinery for a purpose that can be attained without it.
And so to my final comment on the capital market. It copes well with its own complexities and need for continual adaptation but problems for the authorities must arise from time to time. Currently when this happens there is no established mechanism for consultation between them and long-term investors about the nature of the particular problem and the options for action. This mechanism surely ought to exist. My earlier comments on the Government's funding problems in 1976 and 1978 are a case in point. When an economic problem looms, investors can react quickly in adopting a wait-and-see attitude. The government who will have to develop new initiatives must take its time. Hence the interruption in the Government's funding programme.

Here is a problem about which some informal soundings are taken but these could have no impact on the vast majority of institutional investors who are not consulted. We need more formal consultation between long-term investors and government to add to what already exists with the banks, building societies and others. In the discussion of future policy there is the traditional tripartite discussion between government, Confederation of British Industries and Trades Union Council. Finance is obviously regarded as having a relatively passive role to play and I am inclined to believe that this is correct. But some aspects of policy, acting on the financial system, do produce far-reaching effects and the lack of adequate consultation with long-term investors is an obvious gap.

I now turn to investment matters. I am not going to talk about the basic principles of investment since I have little new to say about them and they are well set out in the Institute's textbooks and A.T.S. courses. The first theme I have chosen to develop concerns the relative importance of the income from a fund as against capital gains and losses and how that relationship varies.

Consider first the return from any single investment after it has been sold. This can be calculated from the income that was received from time to time and the difference between the acquisition cost and realization proceeds. Here the contributions of income and capital can be identified. Consider now the private individual: capital gain on an investment may well increase his spendable income but in any case is desirable in increasing his total personal resources. He is likely to regard capital gains as having a higher priority than income which is subject to high rates of tax. Turn now to the attitude of those running large expanding funds of traditional life assurance or pensions type and the priorities become different. Where the fund is well established, there will be large amounts of unrealized capital gains, which if realized would add to the cash flow and fall to be reinvested. To the extent that capital gains are realized and reinvested what is happening is that one stream of income is being swapped for a different stream of income. The investment problem of long-term expanding life or pension funds is therefore one of maximizing income. I do not think we emphasize this enough. As an example, take the experience of the last few years. The capital values of an ordinary share portfolio fluctuated wildly. As measured by the F.T.-Actuaries All Share Index between the end of 1972 and the end of 1974, there was a fall from an index number of 215 down to 67; by the end of 1977 it was back to 215 again.
Over the whole of that period dividend income increased year by year and the overall gain for that five-year period was an increase of 65%. Although the capital values were heavily down and sharply up over that period, our life and pension funds strengthened continually as the higher level of dividend income materialized.

Values in the property portfolio showed the same pattern of a fall followed by a rise but the extent of the fluctuation was only about half that of the ordinary share portfolio. Current rental values in some areas such as the City of London did fall quite sharply over the period but this would not affect a typical property portfolio where even these reduced rents would be higher than the historical rents at the time when rent reviews fell in. As in the ordinary share portfolio, income in the property portfolio was rising and the funds were thereby being continually strengthened.

Much material in the financial journals is concerned with the affairs of private individuals and with the search for capital profit and the same approach tends to be applied uncritically to large investment funds. We must beware of letting this emphasis lead us to overlook the importance of income to our funds.

If we now move on from purely investment considerations to look at the whole situation of a life fund a new dimension appears.

Our field of choice is between a high fixed income or a low income with growth prospects. To justify the acceptance of a low income now in the hope of greater benefits in the future, it is important to be confident that those benefits will be realized within the period during which an individual is a member of a life fund. Investment managers who take on equity-type investments with a lower yield than gilt-edged do so in the belief that over a period the former will show higher total returns than the latter, but from the fund actuary’s point of view this has two effects. The first is that the lower initial return depresses the yield on the fund below what it would otherwise have been and hence constrains the choice of the valuation rate of interest. Secondly, equity-type investments which tend to have bigger fluctuations than fixed interest will lead him to consider that a larger estate is necessary.

The responsibility therefore comes back on the investment manager to make sure that the investment performance of equity-type holdings will not only give a better overall return than gilt-edged securities but do so by a sufficient margin to provide whatever addition to the estate was deemed to be necessary. The object clearly being to ensure that as one generation of policyholders passes on the assets to another that the bigger estate required will have been provided out of investment performance and not in a reduction of the benefits below what they would have been if fixed-interest securities had been chosen instead.

I realize that I am recommending a forward look years ahead where the potential variations are great but it is possible by making different assumptions to gain a grasp of the position.

In view of the emphasis on income and before turning to the next theme, I propose to comment on the category of assets that yields no income, mainly
works of art—it is unlikely that investment in commodities would ever be other than a short-term speculative activity for life or pension funds. The argument for purchasing works of art points out that capital values have performed satisfactorily over the past and to the extent that one is buying products of the past one has a continual increase in scarcity value as the number available, for one reason or another declines and finally that one has a very large market and it is possible to obtain a sufficiently good spread to ensure that the vagaries of fashion over, let us say, the works of one individual artist can be compensated. It is not difficult to envisage what would happen to the market in works of art if the habit of institutions to buy them became widespread. We do have some cautionary tales from the past and I would cite first of all the U.S. stock market of the late 1960s and early 1970s where there was a strong move by institutional investors into the so-called growth stocks. The case for these particular stocks was a good one inasmuch as their prospective growth in earnings was high relative to the rest of the market and in fact the expectations were very largely fulfilled. What went wrong was that the institutions were prepared to pay ever-increasing multiples of earnings in buying these stocks. Clearly, if the multiple is constant or rising, whether one pays 20 times, 40 times or 100 times earnings doesn't matter. Earnings growth of, for example, 15% p.a. will give a satisfactory performance. So long as the institutions kept on buying into this sector it was, of course, a self-fulfilling policy, but the moment the buying pressure was withdrawn the fatal flaw was revealed and prices fell back to levels at which they could be justified on intrinsic grounds. A rather similar example could be drawn from that of purchases of fine clarets in the years up to 1972. Again a large volume of speculative buying on the grounds that prices would only go up eventually led to an unstable situation in the market and substantial losses were suffered.

My guess is that a general move by institutions into the art market even with only a small proportion of their funds would inevitably force prices up and thereby justify the policy. The process would continue, probably reinforced by private speculation, until the market became unstable as in the two precedents I quoted and some adverse development caused buying to cease (it would not be necessary for actual selling to take place, even if it were possible, which it probably wouldn't be) when the whole price level would collapse. Prices came back to the level that drinkers could afford to pay.

My next theme takes as its text the Institute's Guide to an Appointed Actuary and the recommendation to "assess the nature of the portfolio and consider the likely rate of return of capital and income". The extent and degree to which the Appointed Actuary needs to pursue this recommendation would vary from one case to another depending on the asset margins and reserves that are present. Actuaries concerned with steering life funds through bonus declarations or assessing funding rates for pension funds should also be interested in these assessments.

In assessing the nature of the portfolio there are two broad aspects—that of the compatibility of the assets and liabilities and that of the quality of the assets. My concept of compatibility includes our theoretical concept of matching or im-
munization against interest-rate changes and also, for example, that equity-type investments are particularly suitable for a final salary-based pension scheme but would be considerably less so for a non-profit life fund or, alternatively where the benefits are linked to some index the assets should be compatible with those comprising the index.

The assessment of the nature of a portfolio can be studied in levels of increasing depth. At ground level so to speak there is the normal analysis of the proportions of the portfolio in cash, fixed-interest securities, ordinary shares and property, calculated at market value, which gives the first assessment of compatibility. Going down to the next level involves the study of the spread of terms of the fixed-interest portfolio. We have our basic theories of the matching of assets and liabilities by term in order to equate movements in the values of each for small changes in the rate of interest. Except in the special case of a declining fund where precise matching for any change in interest rates may be possible, the theory as applied to expanding funds requires continual adjustment of the spread of the assets as interest rates change. This is not possible in practice for large funds nor is it possible for all small funds to do so since they are large in total and it is certainly not possible for the life-assurance sector as a whole to do it. We should all ask the question “If we move to some very different level of interest rates, what would be the effect on the values of the assets and liabilities?” Rises in interest rates can give serious problems where the beneficiary has an option such as a guaranteed surrender value and give technical problems associated with increases in the valuation rate of interest. Falls in interest rates which cannot be ruled out, and must at some future date be expected, eventually have a severe effect on the level of bonuses and greatly reduce the cover for the contractual liabilities. Since, as I have said, portfolios cannot be readily adjusted, it is essential for their composition to be studied in the light of major changes in interest rates. This has to be a subjective matter as far as relative movements in different types of asset go but valuable insights can be gained nevertheless.

Before turning to the question of assessing the quality of the portfolio, I would insert one further test which can be done readily for life funds but less so for pension funds—that of a comparison of the spread of the assets in the fund being studied as compared with those of other funds. I am not advocating a policy of playing safe by trying to be average but I do think that being out on a limb is something which the actuary should know about.

Turning now to the question of quality, there are routine analyses which need to be made, namely the spread by industry of an equity portfolio compared with that of an index such as the F.T.-Actuaries All Share Index and an analysis of the property portfolio geographically, by type of property and by type of tenure. These studies will give warning of imbalance or unusual features in the portfolio for which due allowance ought to be made, but they don’t tell the full story. It is still possible to have portfolios of different quality without it necessarily showing up in the analysis. For a full assessment of quality one must dig deeper. The importance of this can be seen from our experience of the last five years where
even such a mundane item as cash on deposit led to considerable difficulties for some life funds where they had their cash on deposit with fringe banking companies which failed.

For a complete understanding, the deepest level must be reached and the portfolio studied item by item. As far as quoted stocks are concerned, whether fixed interest or equities, it would be possible for an expert in the field with relatively little trouble to give some indication of the quality of the holdings.

It becomes very much more difficult when dealing with a property portfolio. Here an expert would be able to say something of the situation of the individual properties but without having details of the leases would not be able to give a full assessment.

For unquoted fixed interest and ordinary shares the study of recent accounts would be required and these would most probably be available.

The most difficult of all to assess is a mortgage portfolio where full information about the underlying security would probably not be available. The situation and nature of the properties would be known as would the original valuation and some information might be available on the borrower’s covenant but only in those circumstances where it is possible to make full enquiries about the individual properties would it be possible to have a reliable assessment of the quality of the asset backing.

This is a long catalogue but it shows that assessing the nature of the assets is a lengthy business. Fortunately it is only on rare occasions that an assessment from scratch has to be made all at once. In the normal way, various aspects are studied from time to time and a complete picture emerges which can be regularly updated. As I said earlier, the depths to which an actuary needs to carry his assessment on any one occasion must vary with the type of investigation he is undertaking.

I return once more to the subject of income. The Institute’s guidelines also require an assessment of the likely rate of return of both income and capital.

I have just discussed the question of quality in the assessment of a portfolio so do not need to repeat the exercise but the point is most important in studying the income. In particular, any parts of the portfolio which give above average returns need to be examined carefully in case there is also above average risk.

If we consider a portfolio with a full spread of assets—fixed interest, ordinary shares and property, there will be the known current rate of income, there will be inherent increases and expectations of future increases. The increases I have labelled as inherent are in the property portfolio with its custom of having periodic rent reviews. Where the rent review period is long the rent being received may be so far below current rack rental values that some increase at the next review can be relied on. In both the property and ordinary share portfolios there are expectations—the yield differential against fixed-interest securities shows that investors generally are expecting large increases in dividends and rents over the coming years.

In addition to income the guidelines require capital to be brought into account...
in assessing the likely rate of return. What is the quantum of capital to be brought into account? Again one has the inherent and the expectations. Inherent is the appreciation to par of fixed-interest securities standing at a discount or decreases for those standing at a premium. Although the magnitude of the movement is less certain, the value of properties with low current rents appreciates as the rent-review date comes nearer and this is also inherent. The first capital item to be brought in will be these inherent increases or decreases to the extent that they will mature during the life of the contracts being studied.

There is then the problem of assessing the likely contribution to the rate of return from increases in dividend and in rents beyond current rack rental values and the corresponding proportionate appreciation on the capital account which will occur other things being equal. To be realistic, trying to assess future increases in incomes and capital growth over the average life of the liabilities of a life fund or pension fund is pure guesswork. One therefore has to adopt a policy of continual adjustment. To my mind it seems best to accept current income if of good quality, to take account of what I have described as inherent items in both income and capital, and for the rest to calculate what rate of growth in income and capital is required to be consistent with the actuary's recommendations. Bringing this required rate of growth into the open provides a figure to which the test of reasonableness can be applied.

I propose now to turn to a subject which, although not mainly an actuarial matter, is not totally irrelevant. It concerns institutional investors as shareholders and is bound up with current controversy over the control of companies—a matter of great importance to us with such a major part of the funds that we have invested in ordinary shares.

At present we have the position that the risk capital which companies must have is provided by shareholders who appoint a board of directors armed with wide powers to manage the business and with very few restraints. These directors are the agents of the shareholders to whom they have fiduciary responsibility and have to act in good faith in the interests of the company. Acting in the interests of the company clearly involves the maintenance of good relations with customers, creditors, employees, government, etc., but the responsibility for taking decisions rests with the directors.

Whether the present position needs to be changed and if so in what way is a question to which the answer differs according to individual objectives. These may be the extension of trade union power or the belief that employees not engaged in management can nevertheless make a positive contribution to the running of the business at board level or, as I would hold, that the interests of our whole community are of prime importance and that the promotion of efficient, competitive companies is the best way of achieving that. Suggestions for change in the system centre largely round new methods for appointing directors to boards but a statutory duty for directors to take account of the interests of employees is also proposed. Arguments in favour of change tend to overlook several important basic facts. First it is the business of companies to provide
goods at the right price to satisfy the needs of consumers and that the decision as
to which goods are to be produced and which are not is ultimately determined by
the objective test of comparative profitability. Companies do not exist for the
sole purpose of providing jobs for employees nor of providing goods that some
public body or other thinks that the consumer ought to want.

Secondly, managing a company requires a team, all of whom are pulling in the
same direction—the higher echelons of management are no place for confronta-
tion.

And then again, problems should be seen in dynamic and not in static terms.
This is not a field where the assumption ‘other things being equal’ will prove to be
right. As an example of this point, it is certain that any dilution of the directors’
responsibility to shareholders must lead to risk capital becoming more expensive.
Risk-capital providers would not be prepared to accept low returns in relation to
fixed-interest securities if they lose the confidence that their forbearance will in
due course be rewarded and that more jam tomorrow will make up for less of it
today.

Management today increasingly feels the need to ensure that its employees
have a greater understanding of the factors which govern their company’s and
hence their future and to win co-operation in the continual changes, major and
minor, which are necessary. Much effort is being exerted to this end and there is
no sign that this process of evolution is likely to end. Certainly to the extent that it
brings benefits to both sides of industry it can be relied on to continue.

The proposals for change that I have seen offend in one way or another against
these basic requirements or can be seen to be unnecessary given capable manage-
ments. Responsibility for providing capable managements currently rests on the
shareholders and particularly with their increasing dominance in equity markets
on institutional investors. With legislation adverse to their interests in the
pipeline, shareholders have a strong incentive to discharge their role effectively.
Institutional investors have good qualifications for this role. They have mainly
long-term objectives, they realize the importance of profitability, they do not
interfere in the day-to-day management of companies and since they are often in
competition with one another and only consult on investment matters to a
limited degree, they have the advantage that their decision-making is well
dispersed and the danger of a power bloc forming is remote. At the same time
they have the capacity to keep well informed on a scale impossible to the private
investors who were the dominant factor in former times.

All institutional investors are fulfilling a trustee role or quasi-trustee role on
behalf of the people whose funds are their responsibility. It would be failing in
this role to invest in risk capital and not to undertake the responsibilities that go
with it, particularly in relation to quality of management.

This cannot be done by operating at long range. Regular contacts at senior
level are necessary to enable good judgments to be made and to encourage
managements who need to improve their performance to do so or to make
changes among the board where this is called for.
In order that we do not overburden either side it is necessary for each company to have a few contacts with institutional investors and each of them in turn should have a few contacts with companies.

There is already a substantial measure of this going on but there is something of a problem in making sure that the coverage becomes more complete. It is difficult to organize this on any formal basis without those concerned getting saddled with some undesirable moral responsibility to all other institutions.

So progress in expanding the coverage of investor/management contacts will be slow unless all concerned make positive efforts. I recommend this especially to those institutions who are currently not contributing.

In my experience they will not find that their freedom to deal in the shares of companies that they visit is greatly affected. Directors readily understand that it is normal for institutions to deal in any of the shares in a portfolio provided that price-sensitive information has not passed.

Institutions can no longer ignore the wider responsibilities that come from being a part of the whole sector. They cannot afford to be labelled as 'absentee shareholders' or regarded as being totally passive. With more than 50% of all equity in institutional funds, the sector as a whole cannot dispose of problems by selling its shares. Institutions may swap shares with one another but the problem will remain and the responsibility to seek solutions will remain. With or without the threat of adverse legislation, the willingness of institutional investors to take a more positive role which has been growing over the last two decades must continue to grow.

All the thoughts that I have put forward stem from practical problems which have come my way in recent years. Some of the material may have permanent value, much will prove to be ephemeral. In some places I was trying to inform, in others think aloud. If anything proves to be controversial I will be delighted because controversy in actuarial circles reverses the normal order and tends to generate light rather than heat.

I end with the usual caveat that this has been a purely personal statement by an individual actuary who hopes that some of what he had to say will have interested each one of you.