PENSION PLAN TRUSTEES AND INVESTMENT RISK

Jon Spain, BSc, FIA, ASA, Partner in Clay & Partners (Consulting Actuaries)

Pension Plan Trustees (called "Trustees" below) now control a large segment of the UK traded securities market. What is known for certainty about the future is that we cannot be sure what is going to happen. In other words, any investment strategy selected has risks associated with it, which may be unavoidable.

It is, I believe, generally accepted that Trustees must balance the pursuit of any given level of return, fixed or relative, against such risks. Unfortunately, Trustees have been given very little, if any, practical guidance in the past on how to approach this very difficult balancing act. The aim of this article is to indicate how this serious gap may be filled.

As a result of the Financial Services Act 1986, it is unlikely that many UK Trustees will wish to exercise detailed investment control on a day-to-day basis. However, they still remain responsible for any delegation of their investment powers to professional managers. Accordingly, they should put themselves in a position such that they can effectively monitor what is being done on their behalf.

For all investors, there are several types of risk, which can be distinguished as follows, with simplified examples. The first is *default risk*, which would arise where anticipated loan repayments, income or capital, could not be made, following a loss by the borrower. Secondly, we have *dividend risk*, where the possibility is recognised that a dividend may be reduced below expectations or, at the extreme, passed entirely.

Going onto the third, *inflation risk* exists in that the total return may still not match a selected inflation target, particularly serious for Trustees with typical "final pay" liabilities. Fourthly, we have the commonly recognised *market risk*, which is that a sale may be forced when prices have fallen.

Another group of risks comprises *currency risk* and what I call *other markets risk*. The first reflects the fact that losses can be made as a result of exchange rate fluctuations. As for the second, this takes account of factors such as less well regulated markets, or being subject to different legislation (say forced nationalisation, or taxes which cannot be reclaimed).

The final type of risk I wish to consider is what I call *satisfaction risk*, where an investor believes that all is well with the portfolio, when the published return may have been calculated taking no account of the nature (term and type) of the liabilities. This could also be referred to as "over-optimism risk", and is dealt with below in greater detail.

In the US, risk has been defined in terms of price volatility, which is essentially related to market risk. Because Trustees have a longer time frame within which to plan than most other investors, and because they are rarely forced sellers, this particular type of risk is actually irrelevant to Trustees, in normal circumstances.

Having said that, Trustees are, of course, subject to the six other risks mentioned, like any other investors. The traditional approach to coping with risk, in general, is to diversify among markets, sectors and stocks, in the hope that, as a result, the portfolio will not be completely exposed to just one adverse contingency.

In view of the Trustees' long-term fiduciary responsibilities, I think that "satisfaction risk" deserves more attention. For a typical "final pay" plan, an ideal investment instrument would be an earnings-related zero coupon bond, with variable redemption dates. As this is not available yet, other types of asset are used, with inflation hedging being regarded as of particular importance.

This leads to the problem that the investment return cannot be taken for certain when it would be most beneficial. Reported investment returns which depend upon unrealised capital appreciation, which may not be a permanent feature, can lead to over-optimism. However, coming out of the market to realise the capital gain, only to go back into the market, does not offer any protection against future capital losses on the new assets.

Therefore, Trustees need some protection against the insidiously powerful feeling of well-being fuelled by apparently favourable statistics. I take it as a premise that market values are not an efficient measure of "store of value" over a long period. Accordingly, the Trustees would do well to consider the reported investment return as split between that part which might be regarded as inherently sustainable over a long period, the remainder being potentially vanishing "froth". In this context, "froth" represents "satisfaction risk".

In previous articles in this magazine and elsewhere, I have put forward a concept which I called the "Discounted Value Return", or "DVR". This statistic was defined so as to give the inherently sustainable part, the residual from the market-based return being identical with the risk (namely the "froth").

It should not be thought that a "risk-adjusted return", defined in this way (namely the "DVR"), is always lower than the market return. In some cases, the opposite could apply, in which apparently poor market returns might be of rather higher quality than initially thought.

As an example, taking a widely-based sample of discretionary pension plans, over 1979–84, the money-weighted market value return was 20.9% pa. However, using my approach, this would be broken down into a basic sustainable risk-adjusted return of 14.5% pa, plus the "satisfaction risk" of 6.4% pa.

In other words, nearly one-third of the published return might be regarded as "at risk" over a long period. Over 1979–86, the gap may have been of the same order.

To sum up, Trustees need information on risk-adjusted returns, taking account of their liability patterns, in order to be able to take, or approve, decisions on investment strategy. Unless the "satisfaction risk" is assessed, Trustees cannot be sure of the extent to which their asset performance is appropriate, bearing in mind the nature of their liabilities. In my opinion, the "DVR" provides the information which is required by Trustees.

Finally, the views expressed above are my own, and should not be attributed to my partners.

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