

The new reality for pension funds

In the past year or so, pension funds worldwide have found themselves operating against a very different backdrop from the one they had previously been used to.

This story is not the all too familiar one of falling equity markets and changing asset allocations, though lower returns clearly play their part. Rather, it has its roots in the changed relationship between the pension fund and its sponsoring employer, and in the global move to shine a light on the true value of pension assets and liabilities.

This new perspective forms the foundation for what is loosely termed 'pension economics'.

Of course, pension funds are still based on the fundamental equation that contributions plus investment returns equals benefits. However, the context of that equation has changed as financial markets and corporate managers focus their attention on pension economics. Fiduciaries should evaluate how this renewed attention affects plan beneficiaries.

- The pension fund and the sponsoring company are increasingly being thought of as one linked entity.

- There is a shift towards using the market value of the assets (and liabilities) as a more objective basis for taking decisions.

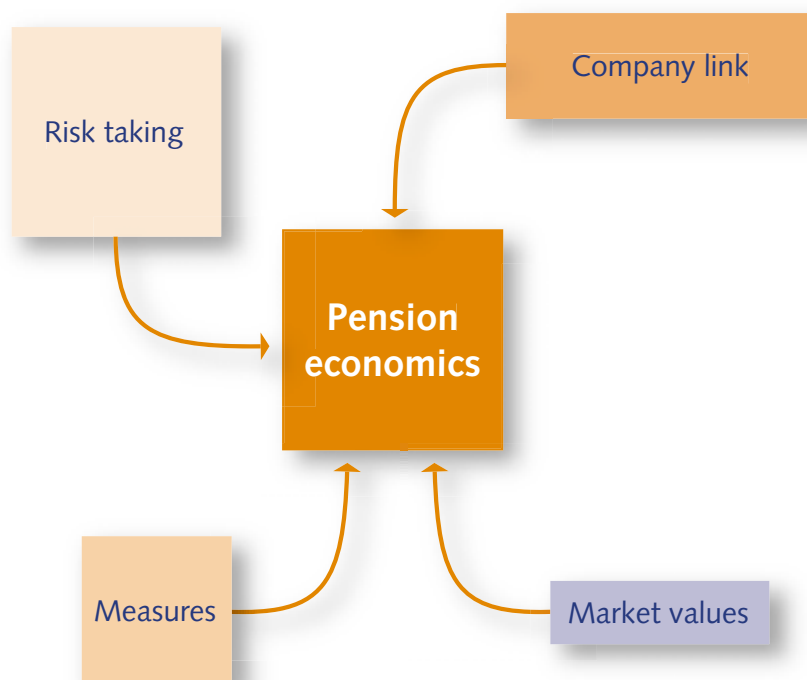
- All decisions are being (or should be) measured on the value that they add, taking account of risk.

- Finally, it is starting to be recognised that all risk taking should be based on some form of sustainable competitive advantage, such as better investment managers or better governance.

These four principles strengthen the underpinning for pension fund

their members and of their sponsoring company. This means considering the pension fund and the company as linked rather than viewing the fund as a stand-alone entity.

This is not the way pension funds are perceived or accounted for in many countries. However, the new view is necessary because the sponsoring company is essentially the key stakeholder in the normal (defined benefit) pension fund 'deal',



investment decisions, particularly in today's volatile and hostile market conditions.

A common goal

For pension funds to be successful, they must fulfil the goals both of

in which the company pays for any shortfall in the cost of the benefits. This way of thinking is behind the current argument that says the pension fund should be valued as an asset and liability of the company's shareholders.

Accounting practices around the world are currently changing to reflect this view, with plan sponsors being required to adopt a more market-based approach to valuing their pension assets and liabilities. The much debated, and often reviled, UK accounting standard FRS17 comes closest to reflecting a pension fund's true (market-based) value.

In contrast, pension accounting has traditionally treated the assets and liabilities of a company's pension fund as basically off-balance sheet items. Even where accounting standards require pension assets and liabilities to be recognised on the balance sheet, the true value is not usually shown. Any surpluses and deficits (under the US's FAS87 and international standard IAS19) are released onto the balance sheet only if they are large, and even then are spread over several years. This 'smoothing', coupled with high return assumptions, has led to a huge gap in the US between actual and reported pension income (see page 24).

The issue of true value has become more urgent as pension funds have in many cases grown to enormous size compared with their sponsoring companies. This means that the fund's impact on the corporate balance sheet and earnings is of vital interest to the company and its shareholders. From this viewpoint, the fund's fiduciaries, when making investment decisions, should consider the potential future effects of the company's position on the plan's beneficiaries.

Firmer foundations

Why do we believe that using market values leads to clearer

thinking and better decisions? The key benefit of market values is that they form an objective basis for measuring a fund's success in terms of both risk and return. For instance, we can predict the real effect a change in asset allocation will have on a company's shareholder value. In contrast, other values, particularly actuarial values, suffer from subjectivity and so make a poor platform for investment decisions.

This market-value approach has led some pension funds in the UK to

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invest their pension fund assets in bond portfolios that 'match' their liabilities. The highest profile move of this kind was by the Boots pension fund in 2001.

But while market values help pension funds to measure and identify risk, they are of less use in deciding how much risk to take and where to take it. Here, it might help to think in terms of competitive advantage. Does the fund have a competitive advantage in its quality of governance and decision making that will turn the risks it takes into good performance?

This advantage might lie in the expertise of the board and the skill of its investment managers and advisers. It might also lie in the wider range of opportunities afforded by a sound funding position, or a strong corporate covenant (that is, the company's

promise to support the fund) that would allow the fund to lengthen its investment time horizon.

One caveat here - markets are generally quite efficient, which limits the potential for profitable risk taking. Bearing this in mind, pension funds need to be highly selective about the types of risk they take on.

These same principles are general enough to apply to DC funds too. They can help DC boards assess which risks to take and what

strategies to follow. Compared with DB funds, DC funds have a simpler ownership structure, with the interest clearly in the members' hands. This simpler picture with easier accounting is one of DC's great attractions for companies.

To sum up, pension funds around the world have had differing degrees of exposure to the four principles outlined above. However, the greater use of international accounting standards, coupled with the underfunding problems many funds now face, means that pension fund decisions must take into account how the sponsoring company's financial position affects beneficiaries.

In the end, this will lead to a firmer foundation for pension fund decision making, and will arm funds with better tools to meet the many challenges confronting them.