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Pension Fund Investments

A. In May, 1962, there was a drastic fall in stock prices. What effect, if any, has this had upon (*a*) objectives as to the proportion of pension funds invested in equities and (*b*) methods of valuing equity pension assets for pension-fund valuation purposes?

B. Where pension funds are invested in a pooled or commingled account what special problems are encountered in asset valuation for pension-fund valuation purposes as distinguished from investments held in an individual separate account or trust?

MR. ROBERT C. TOOKEY: The Securities and Exchange Commission recently released figures showing that equity investments of corporate retirement fund assets had risen steadily from 18 per cent of book value in 1952 to 38 per cent of book value December 31, 1961. On a market-value basis the 38 per cent figure was actually 51 per cent. Today the market value is considerably lower.

After chatting with several trust officers, I have surmised that the recent market decline has had very little effect on their investment objectives. They try to select stocks on a long-range basis considering intrinsic worth and attractive price. A pension-fund trustee may set a flexible limit for equities, but one trustee reduced his percentage in equities and took profits on some stocks last year simply because he felt they were overpriced. Now pension committees of many smaller funds are asking bank trust officers to pick the stocks for their funds.

The consensus of these trust officers anticipates an economic upturn about the end of 1963 and increased stock prices by the middle of 1963 if the market follows its usual pattern of anticipating the business cycle. This assumes no major international crises, and no further losses of confidence in the administration's attitude toward business, which is not really so much "anti-business" as it is "pro-voter."

The recent market decline may induce an attitude of conservatism in the valuation of pension-fund equities, but the aggregate market value of such equities still exceeds book value or purchase price by a substantial margin. Stocks purchased after 1958 have been the principal sufferers. Alternative methods considered for valuation of pension equities include (1) a multiple of earnings not to exceed market value and (2) increase book value each year by the excess of earnings over dividends. The Treasury Department has been concerned with pension plans that appear to be heavily overfunded because of market appreciation. The recent market drop will not likely temper this concern.

A drastic fall in stock prices just as severe as in 1929 is definitely within the realm of possibility because the sensitive market is too large to be supported by the frail capital of the specialists who match buy orders with sell orders. Should everyone else decide to sell at one time, the market level may decline to less than half its original high because the so-called smart money may wait for lower levels. In December, 1961, the Dow-Jones stocks were valued at twenty-three times earnings. Should a price decrease bring this figure down to eight times earnings, producing a Dow-Jones index of less than 300, I suspect there will be a change in investment objectives.

MR. ANTHONY SHARP: Many asset valuation problems peculiar to multiemployer retirement systems are encountered. All employers may not agree on the asset valuation method. One system successful with its equity investments holds investment fluctuation reserves equal to its realized capital gains; consequently, problems arise with those employers who wish to have immediate recognition of such gains in computing contributions.

When a plan does not call for 100 per cent pooling of experience, problems arise from the need to determine asset shares for individual employers. Some systems began by offering career average benefits and fixed-rate scale contributions from employers using assumptions for salary increases and withdrawals which involved 100 per cent pooling of experience. Periodic experience adjustments were made either by revising the rate scale or by means of crude over-all adjustments, for example, in proportion to employer contributions. When final average benefits were offered, it was no longer feasible to pool salary-increase experience so that a portion of the active life fund had to be allocated to each employer at the time he changed to a final average benefit plan. The problems created include those of making suitable allocation of expenses and capital gains.

A system that maintains separate asset shares for given individual employers can more easily solve the problems encountered when determining the equity of an employer in the system in the event that he decides to withdraw. The problems in this case include that of deciding the adjustment to be made for unrealized capital gains or losses including the recognition, if any, to be given to market values in the years in which the withdrawing employer made his contributions to the retirement system. Plans that provide for the payment of the "reserve" when an employer withdraws ignore the surplus or deficit created by the withdrawing organization. Such a settlement basis is not generally satisfactory and may result in long settlement negotiation (approximately two years in one case).

Individual accounts provide a sound basis for variation (according to number of employees or other classification) in the degree to which experience is to be pooled. While such accounts are maintained primarily for the determination of contributions, they provide more consistent treatment for participating employers and minimize the judgment and negotiations required when an employer terminates.

MR. ROBERT M. DUNCAN: CREF now has about 80,000 participants, nearly all of whom have adhered to the 50-50 split in premiums between fixed dollar and variable annuities. From the end of March to the end of June the fall in asset values of CREF's portfolio was about 25 per cent, which is about the same as the market average. So far there appears to be practically no effect on participation or objectives of participants. We will get a more conclusive test after the end of the year when accumulation value statements are sent to each participant.

CREF's results from June, 1952, to the middle of 1962 are as follows: (1) the effective annual rate of capital appreciation for a person retired in June, 1952, has been about 8 per cent per year, and (2) the annual rate of combined capital appreciations and dividends, derived from the application of equal monthly premiums over the ten years, would also be about 8 per cent.

The United States Bureau of Labor Statistics cost-of-living index has shown 1.3 per cent as the rate of annual increase for the same period. The 50-50 combination has obviously more than kept pace with cost of living changes.

These results might be interpreted as a basis for allowing more liberal funding in equities for pension purposes. But considering the recent market drop, the relatively short period of time involved, and the possibility of fundamental and unforeseen changes in the relative desirability of equity investments, it still appears prudent to adhere to a balanced investment philosophy. Therefore, we have no plans to allow more than 50 per cent of any pension premium to be invested in equities.

MR. DOUGLAS C. BORTON: The larger New York banks have not revised their long-range investment objectives because of the May stock-market drop. Where equity holdings were below desired objectives, many trustees have been buying stocks to take advantage of lower prices. Generally, the desired objective for equity holdings continues to be in the neighborhood of 50 per cent of book value of the trust portfolio. When an insurer holds a substantial part of the fund, the percentage may be higher; when large benefit payments are anticipated in the next few years, the percentage may be lower.

A few of our clients had begun writing up their book values by formula, but even after the market drop substantial margins remained.

We have encountered problems valuing the assets of commingled funds only when the book value is not shown on the trustee's annual accounting. In this event transaction records must be kept so that each employer's share of the total assets may be determined. When a separate account is transferred to a pooled fund, the unrealized capital appreciation is usually realized immediately. These gains may be used as a direct offset against current year's contributions to reduce past-service cost or to decrease future normal contributions.

MR. WILLIAM M. ANDERSON: According to the studies of sources and uses of capital funds for the last three years, acquisitions of stocks by corporate pension funds in the United States exceeded the net issues of stocks by the corporations themselves. Also, net acquisitions of all long-term corporate securities by life companies, corporate pension funds, and state and local funds have for several years equaled or exceeded the net issues by the corporations themselves.

Since direct placements are so prevalent in the long-term corporate debt field, it seems obvious that corporate pension funds may soon have the inside track in the net acquisition of corporate debt. Currently, life companies acquire about 50 per cent, and state and local funds share the remainder about equally with corporate pension funds.

Corporate pension funds invest almost exclusively in corporate securities. So, if you take a composite of all corporate balance sheets, the corporate pension-fund assets appear as long-term corporate debt and stock. Corporate self-administered pension funds, therefore, are merely book liabilities and are unfunded at the level of the composite. As these funds increase their holdings, what is to prevent the equity position of nonfinancial corporation being largely held by their own corporate pension funds? Then who controls the corporations, and what will be the emerging political overtones?

In the next five to ten years the corporate pension funds likely will be net buyers of stocks from the public and quite naturally will be interested in keeping stock prices low. It has already been mentioned that since last spring they have accelerated their buying.