



PUBLIC AND PRIVATE PLANNING

Corporate and public sector funds need different approaches.

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In corporate finance the focus is commonly on the balance sheet, or the relationship between assets, liabilities and equity; a similar approach should be applied to pension fund management. In a pension fund, the assets are the fund's investments, the liabilities are its obligations, and the equity is called the surplus. Since the latter measures the difference between assets and liabilities, we can consider it to be a measure of the fund's tracking error. The management objective is to keep the tracking error as small as possible and not negative. This ensures that there will be enough—but not too many—assets available to cover the pension liabilities.

“SHOULD THE PENSION BE FUNDED NOW OR LATER?”

This leads to two major decisions, the first of which is: should the pension be funded now or later? Arguments for late funding all seem to center on the possibility that the pension may never be funded and the pension obligations will not be met. Since the pension forms part of the employees' compensation, this means that in the end they were paid less than they believed. This is a procedure for increasing the stock price of a corporation at the employees' expense. If we put aside the notion of potential default, and examine it solely from a tax-minimizing perspective, it is probably better to fund earlier rather than later. If you can earn higher investment returns outside the pension than inside the pension, it would be better to invest the money outside the pension and fund the pension later.

The second decision is: what should the nature of the investments be? In other words, should the fund invest in assets that match liabilities or in other non-matching assets? If we invest in matching assets the tracking error is by definition minimized and our objective is achieved. A strategy for non-matching assets might include:

- A pension fund that invests in matching assets (to

minimize tracking error), plus;

- A long-short hedge fund that is long the non-matching assets and short the matching assets.

Proponents of non-matching believe that a hedge fund as outlined above can reduce the cost of the pension plan to the sponsor through its returns. However, the evidence is that it is impossible for such a fund to always be profitable. It may be profitable more often than not but sometimes it will lose money and increase the pension costs.

There is also an important distinction to be made between private (corporate) and public sector plans. Public sector plans have a very long horizon with a low probability of pension fund default and the ultimate funders of the plan are taxpayers. Private sector plans, on the other hand, have limited horizons, a non-zero probability of default and the wealth of shareholders of the underlying firm bearing the consequences of pension fund decisions.

With private sector plans, a broader view of the pension plan and its interaction with corporate risk is crucial: for some funds, immunization is the best strategy; for others, a mismatch is possible. If, ultimately, plan beneficiaries have access to pension fund surplus, corporations are less likely to have positive targeted surplus levels, leaving no cushion for plans to undertake mismatched pension fund risk. The correlation between pension and corporate assets is an important variable in determining the degree of mismatching. If the correlation of assets is positive and large, the logical implication is that the pension fund should immunize.

The obvious question is: where is the gain to shareholders through the pension fund decision apart from the tax benefit from contribution to the pension plan? While movements along the risk-return tradeoff do not create wealth, wealth can be created when beneficiaries do not reflect the risk of pension fund default in direct compensation, the stock market is unable to determine the true risk of the pension fund and the implication for future compensation, or the firm has no intention of meeting the pension promise. ■