Pensions - Financing
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Should COMMON STOCKS *be used in a* PENSION FUND?

Old Colony Trust Company.

THIS BOOKLET offers a solution to the controversial question so frequently asked today as to the best method of investing funds in a pension trust.

The general policy of Old Colony Trust Company in this regard is stated on Page 9.

If you have any questions, we should be glad to discuss them with you. Write to our Pension Section or, if more convenient, drop in and see us.

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Should COMMON STOCKS *be used in a* PENSION FUND?

THE FUNDAMENTAL REASON for investing part of a pension trust fund in high-grade common stocks is that an investment program which includes common stocks should show, over a period of years, a better combined income and principal performance than can be obtained through an investment program restricted to fixed-income obligations.

Just what is a Pension Trust?

The assets of a pension trust, regardless of the terms of the plan or the method of financing, are essentially a fund established to meet the cost of the liabilities assumed in establishing the pension plan.

General Investment Policy

The principles which govern the investment of a trustee-invested pension fund are generally similar to the principles which govern the investment of any trust.

The trust instrument, of course, controls. It may restrict the investment of the fund, generally or specifically, or it may leave investment policies to be determined by the trustee. From time to time, a pension trust instrument can readily be amended to meet future changing conditions.

Where the trust instrument leaves investment policies to the discretion of the trustee, the latter will naturally act against the background of, and in accordance with, the prevailing law or practice in the State of the trust's jurisdiction.

The "Prudent Man Rule" of Massachusetts

For over a century the investment of trust funds in Massachusetts has been governed by the well-known "Prudent Man Rule," first stated by the Commonwealth's Supreme Judicial Court in 1830 in *Harvard College v. Amory*. More recently Chief Justice Rugg rephrased it as follows:

> "A trustee is required to conduct himself faithfully and to exercise a sound discretion, and to be enlightened by

> observance as to how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital. Good faith and sound discretion, informed by experience and wise observation, constitute the standard. That standard is comprehensive and remains fixed. It is not bound to particular classifications of securities, but continues as a safe guide under changed financial institutions and business customs, usages and investment combinations."*

This sound and flexible investment philosophy continues to guide Massachusetts trustees. In recent years, several States have discarded their statutory restrictions on the investment of trust funds in favor of the "Massachusetts Rule." They have found this "Prudent Man Rule" a more serviceable guide than the narrow confines of a "legal list."

Brought up for six generations under the "Prudent Man Rule," Massachusetts trustees have become accustomed to a freedom of investment and to think in terms of a balanced and diversified portfolio of bonds and stocks. Thus, it is natural to find the Massachusetts fiduciary of today investing a portion of pension trust funds, like other trust funds, in sound common stocks.

*Rugg, C. J., in *Springfield Safe Deposit & Trust Company v. First Unitarian Society*, 293 Mass. 480 (1936).

Estimated Cost versus Actual Cost

It is sometimes said that, because the benefits under a pension plan are payable in fixed dollar amounts, pension funds should be invested in fixed dollar obligations. But this does not tell the whole story.

The cost of a pension plan, whatever method of financing may be used, is the total money actually paid to the beneficiaries of the plan, plus the expenses of administration. At the outset and from time to time thereafter, reasonable estimates can be made of this figure. But a pension plan covers a long period of years during which many changes may occur to cause variations between estimated and actual costs. Thus, there may be changes in tax rates, in Social Security legislation, in wage levels, in rate of mortality, in the amount of income earned on the fund, in the purchasing power of the dollar, in employee turnover, and so forth. Only time can tell what the eventual actual cost to a particular corporation of its pension plan may be.

Diversification of investment, including the sound use of common stocks, should enable a pension trust to show, throughout the changing conditions which will inevitably occur, a better performance than if the fund's portfolio were rigidly restricted.

What Is the Effect of Market Fluctuation?

There is, of course, fluctuation in the market value of high-grade stocks. But this fluctuation presents no difficulty in a well-balanced pension fund, which includes both stocks and also bonds of short and longer terms.

There should never arise a need for forced selling of stocks. In such a pension fund, normal payments under the plan can be met out of the trust's investment income, plus the annual contributions to the fund. Unusual payments can be readily financed through liquidation of short-term bonds, in which the market fluctuation is slight.

Furthermore, the obligation of the employer to contribute is not affected, under existing Internal Revenue Regulations, by "paper" gains and losses on investments in the fund.

The Impact of Investment Return on Cost

The earnings on the investments held in a pension fund are applicable to reduce the cost of the plan to the employer. The larger the earnings, the less the contribution of the employer.

A million dollars invested at 2½%, compounded annually, will amount to two million, ninety-seven thousand, six hundred, at the end of thirty years. A million dollars invested at 3% will amount to two million, four hundred and twenty-seven thousand, three hundred. Thus on each million dollars deposited in the fund, a 3% yield, instead of a 2½% yield, means that the employer will save in thirty years three hundred twenty-nine thousand, seven hundred dollars in the amount which he is liable to contribute to the cost of the plan.

What Happens if Actual Cost is more than Estimated Cost?

If the actual cost of the pension plan proves to be in excess of the estimated cost, or if the benefits themselves are increased, the employer may be faced with the necessity of increasing his contributions to the plan. In the usual type of pension plan, regardless of the method of financing, *the final liability to meet any increased cost is on the employer.*

The trust fund, in a trustee-invested plan, exists to meet the employer's liability. The question of how to invest such a fund turns upon what investments will, in all probability, give the best combined income and principal performance under varying conditions and over an extended period of time.

Superior Investment Results

Experience of Massachusetts trustees throughout the years has demonstrated that a balanced fund, including both bonds and stocks, shows superior investment results.

In recent years—*as at present—the general policy of* Old Colony Trust Company, *as Pension Fund Trustee, has been to invest about 30% of a pension trust fund, where the trust instrument allows full discretion, in common stocks of proved merit and future potentialities.*

This policy is, of course, subject to change from time to time in the future in the light of changing conditions.

Standard Services Rendered by

OLD COLONY
TRUST COMPANY

Trustee under living trusts and wills
Investment Management (with Custodianship)
Investment Consultation
Real Estate and Mortgage Management
Custodianship of property
Executor under wills
Administrator of estates
Agent for executors, administrators, trustees, guardians, conservators
Guardian of the property of others, including minor children
Conservator of the property of incapacitated persons
****Trustee** under pension and profit sharing plans
Trustee under individual and business insurance trusts

Transfer Agent for the stock of corporations
Registrar for the stock of corporations
Trustee for bond issues
Fiscal Agent to pay bonds and coupons of corporations and municipalities
Agent to pay dividends on stock of corporations
Depositary in connection with capital readjustments
Escrow Agent

**This booklet relates to the services rendered by Old Colony Trust Company as Trustee under Pension and Profit Sharing Plans. Information regarding the other services will be furnished upon request.*

THIS BOOKLET is number 7 in a series published by Old Colony Trust Company on various aspects of Pensions and Profit-Sharing Plans. The other titles are:

No. 1—PRIMER ON PENSION AND PROFIT-SHARING PLANS

No. 2—EXECUTIVES NEED PENSIONS TOO

No. 3—WHY A TRUSTEE FOR PENSIONS

No. 4—WHY WORKERS WANT PENSIONS

No. 5—SIMPLICITY IN PENSIONS

No. 6—A PENSION PLAN OR A PROFIT-SHARING PLAN

We will gladly send you copies of any of these publications on request.

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