Pension funds

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Impact of Pension Funds on National Economy

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The postwar years have seen the progressively deeper involvement of pension funds in one of the most sensitively critical aspects of the American economy--the role of saving and investment. With their tap on the salary and wage income of over 20 million Americans, the pension funds have become big in capital and money markets. They are formidable competitors with banks, insurance companies, saving and loan associations and other financial intermediaries. From small accumulations and little, if any, investment discretion under the law or by contract their managers have been moving into the status of making major investment decisions for the entire U. S. economy. Moreover, there is no discernible evidence that their role in this respect will not continue to grow for some time to come.

In speaking to you today, I want to discuss briefly (1) the magnitude and growth of these funds, commenting on some of the factors which explain their popularity; (2) how the funds affect labor mobility and retirement income by virtue of present vesting provisions; and (3) the effect of their present and prospective investment policies on capital markets.

I. Magnitude and Growth of Pension Funds

Since World War II, the use of pensions to provide retirement income has been pushed ahead on two fronts. One has been the continuing extension of social security coverage to groups formerly excluded. Coverage has risen from less than 60 per cent of all paid employment in 1940 to more than 90 per cent at the present time. The other--and in many ways the more dramatic--development has been the extremely rapid growth in extent and coverage of pension plans for employees of particular corporations, governmental units, and non-profit institutions.

In 1940, such plans covered 1.4 million State and local jobs and 4.1 million jobs with private employers--about one-eighth of all paid workers. By 1960, coverage had spread to about two-fifths of the work force with 4.5 million jobs under State and local plans and nearly 22 million covered by private pension plans. And this trend toward more inclusive coverage is continuing.

A pension plan need not involve saving, i.e., the accumulation of assets at the time credits are earned to actuarily meet future requirements; but in practice almost all of them do, even the most broadly based public plans. If a plan is not thus funded it runs the risk of encountering, at some time in the future, the incapacity of public revenues or corporate earnings to meet contractual claims against it. The employer in a private plan is potentially more vulnerable than a government in a public plan to adverse future experience and--as an additional reason to funding--the employer enjoys compelling tax advantages. In consequence of these and related considerations, the growth of pension plans is likely to continue to progressively add to the total annual savings flows of our economy. In 1964, the combined growth in private and State and local pension fund reserves exceeded $10 billion.

What explains the great and growing popularity of pension plans as a technique for meeting retirement needs? Partly, it is the simple actuarial fact that the cost of providing a given level of life benefits is more predictable for a large group than for an individual and hence it is cheaper and more efficient to accumulate adequate reserves for a group than to attempt to meet individual needs separately.

But there are other powerful reasons. As I have already mentioned, private plans--if they can qualify with the Internal Revenue Service--receive tax benefits which are exceptionally attractive to both workers and management. These benefits are of two sorts. First, employer contributions (including a reasonable provision for funding past service obligations) are current expenses immediately tax deductible to the employer. But they are not taxable to employees until actually received as benefits--and then at rates applicable to reduced retirement income. Second, investment income received by the fund itself is tax free and fully available for compounding during its period of accumulation.

In effect, this form of saving enjoys an advantageous tax treatment analogous to that accorded the home owner--a "subsidy" which has given great impetus to its spread. The fact that such plans are limited in coverage has meant that this tax treatment is available to only part of the public. Recent legislation has attempted to widen eligibility by permitting self-employed individuals to build similar tax-free accumulations of assets if they will set up qualified retirement plans covering themselves and any employees they may have.

The other major factor leading to more widespread establishment and growth of private pension plans has been their emergence as a major objective of collective bargaining. War-time wage stabilization programs diverted the thrust of bargaining from wages toward fringe benefits. Among these, pension funds represented--perhaps more directly than any others--a measurable economic value to covered employees. Furthermore, a Supreme Court decision in 1949 held that pension plans are subject to collective bargaining, and in many industries the extension and improvement of such plans has become an integral part of the over-all wage package.

The accumulation of pension fund reserves is now an important part of total household saving. Like direct financial saving by individuals and families, these funds become available to long-term borrowers in our capital markets. They also represent a buildup of future claims accruing to the consumer sector of the economy. Last year's net inflow to pension reserves was considerably greater than net acquisitions of marketable securities by the household sector; it exceeded the total growth in their time and savings accounts at commercial banks ($8.1 billion) and about matched the increase in share capital at savings and loan associations ($10.5 billion).

When translated into terms of growth rates, private pension funds have been the most rapidly growing form of saving during the postwar period. Throughout the decade of the 50's, their total assets expanded more than fourfold. Since then, expansion has been a little less explosive, but the book value of holdings last December was half again as much as it was at the end of 1960. Assets held by private pension funds now amount to $77 billion while State and local funds hold assets worth another $30 billion.

Growth rates for the future could slow. Funds established in the 40's and 50's will approach maturity. Funding of past service obligations will be completed, and benefit payments to a growing population of retirees will absorb more of investment income and current contributions. On the other hand, as living standards rise so will benefits and a younger work force means a longer period of accumulation. The net of it seems to be that we will have large annual accumulations for many years to come. A recent study estimates private fund assets at $225 billion by 1980 and State and local accumulations of $85 billion by that time.

In assessing the impact of pension funds on the economy we need to look at their role in two areas. First, I will mention briefly some aspects of their impact on those for whom these savings are being accumulated. Then I want to turn to the impact of pension funds as investors on the volume and form in which credit is made available to long-term users.

II. Pension Funds and Retirement Income

When the household sector of the economy is considered as a whole, the accumulation of pension fund reserves is an act of current saving just as is an increase in savings accounts or securities holdings. But from the standpoint of the individual saver, this form of savings differs very significantly from deposits in savings accounts or acquisitions of securities. The differences may be summed up by saying that his claim against these pension accumulations is both contractual and contingent.

Contributions to pension funds are made on behalf of an individual employee as one of the terms of his employment. Whether shown as a direct deduction from gross wages or indirectly as the employer's contribution, they are part of his wage package. As such they are subject to modification, through collective bargaining or otherwise, but the job holder himself has no day-to-day options over spending or saving this part of his compensation. Indeed, he ordinarily has no individual option beyond taking or leaving the job. And, of course, once reserves have been accumulated, the benefits also are contractual and become available only in accordance with the provisions of the plan.

This eventual receipt of benefits is also contingent, for each individual, on an eligibility test. For more than a third of all workers covered by private pension plans, this test is simple and restrictive. They must actually be working in a job covered by the plan at the time of retirement. If a worker leaves prior to that time, he obtains no benefits from the employer's contributions on his behalf although these were--as a matter of fact if not of semantics--part of his total compensation.

Under more liberal plans, workers above a certain age (most commonly 40) who leave a covered job after a specified period of service (usually 10 years or more) take with them a vested right to a deferred pension at retirement age based on their period of coverage. A recent study of private pension plan provisions indicates that a worker taking a job in covered employment at age 25 has only a 50-50 chance of obtaining vested status after 20 years of continuous employment by age 45. Even among those with vested rights, about 15 per cent would be protected only in event of layoffs or plant closings--not if they changed jobs voluntarily.

In the light of these provisions, it is hardly surprising that growth in the number of pension beneficiaries is not expected to fully match expansions in coverage. In 1960, pension plans covered about 40 per cent of the work force--a share which is expected to increase steadily. Also in 1960, about 12 per cent of all retired workers above age 65 were receiving pension benefits outside the social security system. Some of this disparity was to be expected, since so many retirees had left the work force before the jobs they had held were covered by pension plans. But by 1970, the proportion is still expected to be only 20 per cent, and even by 1980, 33 per cent. This implies a continuing high withdrawal rate, and cost estimates for pension funds do, in fact, take into account past and expected labor turnover experience.

This gap between what an employee is led to expect and performance in providing pension benefits to those for whom funds are accumulated raises serious questions about the conditions for payment of benefits. Quite aside from questions of equity, the predominance of extended vesting provisions has an adverse effect on labor mobility. And the inability of workers to transfer benefits from one employer to another increases the difficulty faced by older workers in finding jobs.

The growth of pension plans has proceeded despite these grave disadvantages. It has been based on its economic efficiency as a technique for providing retirement income, and fostered by tax advantages and union promotion. These forces are long-term in nature and portend further growth in the accumulation of pension fund assets--at least for the years immediately ahead. Future trends may be expected to include some broadening of coverage and some reduction in the impediments to mobility. These should include speedier vesting and the negotiation of industry-wide or regional contracts permitting workers moving from job to job in the same industry or geographic area to carry retirement credits with them.

Despite such changes, some elements of a lottery will remain in determining what benefits, if any, an individual is eligible to receive at retirement. For the foreseeable future, it will probably remain accurate to class as a pension "elite" the growing group among the retired who receive pensions as well as social security benefits.

III. Pension Funds and the Capital Markets

If the major impact of pension funds on retirement incomes still lies in the future, their maximum impact on credit markets occurs during the period of establishment and accumulation. Annual growth in reserves, now running at $10 billion, is expected to reach $14 billion by 1970, and although <u>rates</u> of increase will probably slow, the absolute amount of funds available for investment is expected to continue upward for some time thereafter.

One may doubt that this entire sum is a net addition to aggregate financial savings. If the incentive to saving is the provision for old age and that end is achieved through pension plan participation, personal savings in other forms might be expected to be less. Such evidence as we have--and it is not conclusive--suggests this has not been the case. One rather large sample study, stratified by income level, indicated that households which were covered by pension plans saved somewhat more in other forms than those which were not.

Certainly, statistics for other savings in recent years do not suggest a net diversion. Savings in the form of accounts at savings and loan associations, banks and other institutions have been at record levels. Some of the leveling off since 1950 in savings through life insurance reserves may be traceable to the growth of pension funds. This would be the savings form most directly competitive with the accumulation of pension credits. On balance, however, it seems that the accumulation of assets by pension plans has represented a substantial increase in the funds available to money and capital markets.

Broadly speaking, all pension funds share similar investment objectives, and these differ in significant ways from those of most other major capital market participants. Funds in their growth phase enjoy the prospect that current contributions will be subject to a long period of tax-free compounding to meet predictable obligations. They need not provide for prior liquidation or distinguish between principal and income in transactions involving capital values.

Despite their similar objectives, the three major types of pension funds (State and local retirement systems, insured plans and the non-insured plans) have differed sharply in patterns of market behavior. The differences are traceable to the fact that the three types operate within quite different frameworks of statutory and traditional constraint. Their histories, growth rates and portfolio policies, therefore, must be considered separately.

For example, managers of State and local retirement systems--those with which you are most directly concerned--have been, and for the most part still are, the most restricted in their choice of assets. Private pension funds operated by insurance companies--the so-called "insured" plans--have also been subject to limitations the same as insurance companies generally. The non-insured private pension funds, however, have enjoyed much wider latitude in formulating and carrying out flexible investment policies, and it is generally their portfolio policies which are cited when reference is made to the growing capital market role of pension funds.

The non-insured funds' combined assets have increased from \$6.5 billion in 1950 to well over \$50 billion at book values and about \$60 billion at market, reflecting higher prices of common stock holdings. Reserves set aside for insured plans have also increased, but not nearly as spectacularly. Their growth has been from \$5.6 billion to about \$25 billion.

This period of rapid growth has been accompanied by striking portfolio shifts. At the beginning of the 50's, trustees managing non-insured funds had about one-third of their assets in U.S. Government securities, about 45 per cent in corporate bonds and only 12 per cent in common stocks. Cash and bank deposits accounted for another 4 per cent of the total. Now, cash and Government securities together make up considerably less than 10 per cent of all holdings; common stock accounts for 40 per cent of the whole, with mortgages making up an additional 5 per cent, and corporate debt securities accounting for most of the rest.

Such composite portfolio figures, moreover, greatly understate the concentration on such investments as stock and mortgages by the more aggressive funds. A recent tabulation of 1963 holdings for the 25 largest corporate pension funds shows common stock holdings ranging from 10 to 52 per cent of total on a book basis (and much more, of course, in terms of market values). For some funds, mortgage holdings ranged above 10 per cent. On the other hand, many utility funds--and particularly those associated with the Bell System--had very heavy concentrations of corporate bonds, with stock holdings as low as 10 and 12 per cent.

For non-insured funds as a group, the shift out of cash and Governments into common stocks has been the most notable trend in recent investment patterns. It was undoubtedly accelerated by the desire to hedge against inflationary tendencies in the economy in the 50's. But the preference for stocks has continued into the 60's even though inflationary fears have ebbed. Since 1959, annual acquisitions of stock by the non-insured funds have sharply exceeded their takings of bonds, and for the last three years have, in fact, exceeded the net addition made by equity financing to the total of all corporate stock outstanding. This has been possible because stock purchases by pension funds are made in the secondary market and represent a shift of ownership from individuals (who have recently been net sellers of stocks) to large institutional holders.

Clearly, changes of this sort have longer run implications for the stock market and, potentially, for the structure of corporate ownership and control quite apart from their immediate significance in portfolio management. However, the total value of outstanding stock is so large (somewhere on the order of $675 billion) and the bulk of its ownership has rested so predominantly with individuals that annual reductions of $2 to $4 billion in their holdings would change the balance very slowly.

The growing role of institutional investors--among which private pension funds have been the most dynamic net purchasers--has raised many questions for the future. What is the impact on marketing procedures of the large-block transactions in which institutions typically engage? Institutional demand tends to concentrate on a relatively small range of high quality issues; what is the significance of this for valuation levels and market liquidity? How does the timing of institutional transactions affect the markets in periods of rapid price change?

These are not short-run questions to which dramatic answers are going to be apparent immediately, but they are of broad economic concern. Pension funds now own about 6-1/2 per cent of the shares listed on the New York Stock Exchange, up from 2-1/2 per cent in the mid-50's. This total, incidentally, includes more than $1 billion in State and local pension funds, up from nominal holdings earlier. Several factors point to a continuation of this trend including the continuing rapid inflow of funds for investment and the low stock-to-total-assets ratios which still exist in many older portfolios. The stock accumulations of the past decade have ridden a trend of upward valuations with only temporary set-backs and have provided managers with a gratifying investment experience, and it probably would take something like a really traumatic stock market experience on the part of present-day pension fund managers to change this attitude.

Meanwhile, other significant, though somewhat less dramatic, shifts in portfolio management have been occurring. Holdings of corporate bonds in 1950 were primarily high-grade, publicly offered issues, rated by the professional rating agencies and purchased from underwriters. More recently, pension funds--or at least the larger ones--have joined the life insurance companies and other large scale investors in making funds available to corporate borrowers through private placements. These tend to provide higher yielding assets, but also ones which are less standardized in quality and terms. This trend implies a growing sophistication by fund managers in market participation--and a larger confidence on their part in backing their quality judgments of investment alternatives.

The more venturesome funds have gradually been reaching out into real estate holdings, commercial mortgages, oil production payments and other assets which might have seemed very "far out" indeed to a conservative investment management in 1950. These developments are essentially limited and probing. Some may prove, in the light of changing economic conditions, to have been unwise. But they clearly demonstrate the unique legal and psychological flexibility of non-insured private pension funds in the spectrum of institutional investors.

Under the insured plans, a deferred annuity contract may be purchased for each covered employee or--as is much more frequently done--deposits may be made by the company to build a reserve out of which immediate annuities may be purchased at retirement. But until recently, the sums paid in under these plans have had to be merged into the total pool of assets where they were subject to the investment restrictions applying to insurance companies generally.

This arrangement which is usually regarded as a competitive disadvantage has now been modified. A 1962 change in New York State law (strategic in this case) has made it possible for insurance companies to segregate pension fund assets and enjoy considerably greater freedom in their investment. This change does not apply retroactively to contractual plans already set up, and its impact on the formation and growth of new plans has not been large as yet. Insured pension plans continue to be set up, and existing funds continue to grow. But the tendency is for these to represent smaller groups with smaller accumulations.

How have these developments in the private pension field compared with those taking place in the management of growing State and local retirement assets? The changes there have been at least as striking--but at a somewhat different level of asset composition.

As recently as 1954, almost half of the assets of funds administered by State and local units were invested in U.S. Government securities, and another quarter were in State and local bonds--primarily those issued by the administering unit itself. Nongovernmental securities of all types made up less than a quarter of this composite portfolio.

Since then, holdings of U.S. securities have been gradually but steadily worked down, and since 1960 those of tax-exempt bonds have been slashed. Meanwhile holdings of corporate securities have climbed steeply--both in absolute and percentage terms. Unlike the corporate trend toward common stock and privately placed bonds, however, public funds manifest a strong preference for publicly offered bond issues while stock holdings constitute only about 5 per cent of the total. A handful of public funds now participate in private placements; and for a small but significant minority, mortgage lending and real estate acquisitions have become a significant investment alternative.

Possibly the most important of these composite portfolio changes has been the sharp reduction in holdings of "own-government" securities and their virtual elimination from the pattern of new acquisitions. In economic terms, such holdings are inappropriate for tax-exempt investors since they normally are marketed at yields reflecting their value in tax savings to purchasers. The reduction of such holdings--partly through sales in the favorable markets of 1962 and 1963--has been a clear gain for the funds involved, particularly those of New York City, where assets of this type were concentrated.

Taken as a whole, shifts in the composition of State and local fund assets over the past decade parallel the search for higher earnings carried on by the private funds. But fund managers have operated within a much more constrained framework. State regulations differ widely but generally limit acquisitions to listed categories of assets, and most such lists are very confining. Eligible bonds, for instance, are quite likely to be those on the legal list for savings banks or those meeting severe quality rating or earnings tests. In some instances, an escape clause permits a specified fraction of all assets to take forms not otherwise qualifying for investment.

The reasons for so limiting the investment judgment of fund managers are rooted in the character of State and local funds. In part they are a reflection of the longer history of such funds, expressing a prevalent consensus of what would have been a prudent policy in the past. These standards undoubtedly reflect the more strongly fiduciary character of funds which are partly financed through employee contributions and which were established as a primary source of retirement income rather than as supplements to social security. Investment standards spelled out by law have also represented an attempt to forestall the fact, temptation or suspicion of political malfeasance. Most of all, they probably were introduced to protect relatively inexperienced managers of relatively small asset accumulations from the very real risks of market error.

Time and growth have eroded some of these arguments--not least the presumed lack of size and managerial experience. Despite the multiplicity of pension plans, a very high proportion of their dollar volume is controlled by governmental units administering funds which equal or exceed in size the largest of the corporate pension funds. In 1963, for instance, the largest corporate fund--that for U.S. Steel employees--had assets of $1.6 billion, and only two others topped the billion dollar mark. At the same time, five governmental units were administering funds with assets of $1.5 billion or more. New York City funds totaled $3.5 billion. Along with funds administered by the states of New York, California, Ohio and Pennsylvania, this group represented a combined value of more than $12 billion. Magnitudes of this sort obviously permit broad asset diversification and justify the employment of the highest level professional management.

Although essential differences between State and local retirement systems and the corporate pension funds may warrant somewhat more conservative investment guidelines for the former, it seems inevitable and desirable that recent trends toward wider management options and greater investment flexibility should continue.

I think it appropriate to conclude these remarks by re-emphasizing the importance of savings and capital formation in achieving accepted goals for the U.S. economy. A rising standard of living of necessity requires a rising total of investment, an investment not only in our industrial, commercial and transportations plant but also in community facilities and consumer housing and durables.

In the American financial structure as savings grow debt grows also, because of the predominance of debt instruments in moving savings from savers to users. Without debt the system as we know it simply would not work, and people could save only by accumulating real assets--land, structures, or inventories or equities in them. These are the saving alternatives in underdeveloped countries harassed by inflation and political uncertainties.

If we think we have too much debt we should realize this judgment applies to savings too. In particular, the large and growing volume of contractual savings flows, such as those arising from the growth in pension plans, builds into our system ever expanding needs for profitable investment outlets, which in a free market economy will be sought here or abroad. If we have, in some sense, "too much savings," it is a mark of how much below potential our domestic economy is operating.

The U. S. economy is built on a belief in political stability, monetary stability and a market allocation of savings to uses that will provide the best return. The basic challenge to pension fund managers is to locate and develop within our institutional framework those uses of savings that are most productive and profitable. In doing this, the independent action of each provides a composite of judgment, which gives stability and soundness to our money and capital markets and the quality of credit.