Ewart S Williams: Investment strategies in an uncertain world

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Business Insight Caribbean Investor Conference, Port-of-Spain, 1 December 2006.

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Good afternoon, ladies and gentlemen. Let me first thank the organizers, Business Insight Limited, for inviting me to this very interesting conference which focuses on "Investment Strategies in an Uncertain World". The media release couple days ago observed that the Conference was prompted by the significant declines experienced in the stock markets of Trinidad and Tobago, Jamaica and Barbados over the last two years and noted that investors and market practitioners were looking for answers.

I saw from the programme that there was a discussion this morning on the evolution of the market in Trinidad and Tobago and it may well be that you have already solved the problem. I hope it is not too late to give my take on the matter and discuss some options, which in my view, could ease some of the current pension funds restrictions while maintaining prudential standards to protect the workers' savings.

Let me first give the background to the current issue.

Since its inception in 1981 there has been little growth in the number of companies listed on the Trinidad and Tobago Stock Exchange. In 1981 there were thirty-five listed companies with a total market capitalization of $2.3 billion. Twenty-five years later, there are thirty-two listed companies with a market capitalization of approximately $110 million.

It is estimated that institutional investors (largely pension funds) account for about ninety percent of total demand in a market in which only about twenty-two percent of shares are actively traded – the remainder having been bought to hold.

Since it was established in 1981, the value of stock market capitalization in Trinidad and Tobago has grown by over 50 times and much of the increase has taken place since 2002. In that year market capitalization was $48 billion and this grew to a peak $120 billion in mid 2005 before falling to $107 billion at end of 2005. Since then market capitalization has declined by a further 18 percent.

When the IMF conducted its financial sector review in mid-2005, prior to the slide in the market, it observed that, "the sharp increase in stock market capitalization was not reflected in earnings". From a sample of 13 firms, representing some 60 percent of market capitalization, stock prices between 2001 and mid-2005 rose 1.5 times while earnings per share increased 0.5 times. For conglomerates, stock prices increased almost 2.5 times, while earnings per share increased by 0.6 times.

The IMF experts suggested that such large spreads were usually due to the weaknesses in market infrastructure and the fact that share prices have been driven up by speculative demand. In the case of Trinidad and Tobago market, they pointed to the poor supply of stocks, a trading system that allowed significant price increases on unmatched bids, highly illiquid stocks and a tendency for institutional investors to buy and hold stocks rather than trade.

The Central Bank assumed regulatory control of the insurance industry and private pension funds in June 2004: by end 2004, the Bank wrote to the pension plans reminding them of the fifty percent limit for equity holdings. At that time some 42 out of 204 active pension plans had exceeded the fifty percent limit and their average holdings were fifty-eight percent. It is estimated (on the basis of incomplete information) that by end December 2005, about 11 pension plans still had equity holdings in excess of fifty percent of total assets and that as of September 2006, two plans remain in excess.

There is no doubt that the stocks sell-off by pension funds contributed to the decline in stock prices. From January 2005 to September 2006 net sales by pension funds amounted to about $700 million.

However, some other factors would certainly have contributed to the decline in the market. In the first case the market was due for a correction, following the increases in stock prices which could not be justified by the earnings performance of the various companies.

Second, the introduction of electronic trading in March 2005, by making price movements dependent on actual trades, as opposed to "bids" would have had a dampening effect on stock prices.

Be that as it may, the fact is that the stock market index declined by about thirty percent between its high point in mid-2005 and end-September 2006. This sharp decline in stock prices has caused widespread concern among market participants as well as the public at large and a call for an increase in the limit on investments in equities.

It is useful to understand the history behind the fifty percent limit that now exists for pension funds. In order to mitigate the volatility associated with equity investments, the drafters of the Insurance Act proposed broad investment limits to ensure that the portfolio of a pension plan will follow a certain prescribed **"risk-averse**" structure. Consistent with this philosophy, it was stipulated that no pension plan could invest more than **forty percent** of its assets directly in equities. This limit was increased to **fifty percent** in November 2000 in order to accommodate new public offerings resulting from the Government's divestment programme (NFM and NEL).

Statutory limitations imposed on institutional investors are in no way peculiar to the region. The majority of OECD countries have limits for equity as an asset class in their pension fund regulation. Recently, the EU introduced a prescribed limit of seventy percent of assets for equity investment, in combination with the Prudent Person Approach. Notwithstanding, higher legal limits, actual equity holdings by pension funds in most countries are seldom above 30-40 percent.

In recent times, the trend has been to reduce equity exposure in light of poor stock market performance. It is interesting to note that this is being done even in markets that are more efficient and liquid than ours.

While there are no legally prescribed limits, actual equity holding of pension funds in Jamaica have averaged around twenty-six percent of total pension fund assets; the ratio for a range of Latin America countries is between four and thirty percent. In these countries, the investments of choice for pension funds are **government securities**. The rationale for the investment pattern is that pension liabilities span many years and require reasonably predictable cash flows. This makes them less suited to the risky volatile returns that are typical of equity markets and more suited to the assured cash flows of government securities.

In supporting an increased limit for equities, pension fund managers point to the lack of alternative investments. And that's largely true. With the government budget in chronic surplus, the supply of government debt has been declining (in terms of GDP), and there continues to be a dearth of corporate bonds. Pension funds are allowed to invest up to twenty percent of total assets in real estate but this window has not been utilised (holdings of real estate now average one percent of total pension fund assets). Pension funds are allowed up to twenty percent of total assets in foreign investments but this also has not been fully utilized, with foreign investments averaging only about nine percent of total assets.

The Government's plan for the reform of the financial sector includes the preparation of new pension legislation. The Bank has already begun preliminary work on a new Pension Act which is expected to be completed, after consultation with all relevant stakeholders, in the next eighteen months to two years.

In the meanwhile, the Bank has been discussing with stakeholders the challenges now being faced by pension funds and which are contributing to stagnation in the stock market.

The proposals that have emerged from our discussions fit into three categories:

(i) Noting that pension plans have exceeded that fifty percent limit because of the sharp use in equity prices, some stakeholders advocate valuing equities at original cost with a premium adjustment of, say 25 percent.

    This approach has several practical difficulties in that the valuation basis for the same equity will differ according to the time of purchase. There are also practical difficulties involved in retrieving data on historical costs. Perhaps more importantly, however, this proposed valuation procedure goes against the current dominant trend (best practice) of **market valuation**.

(ii) There is also a proposal for increasing the limit from the current 50 percent to 60 percent. While this has the merit of simplicity, it has serious drawbacks in failing to recognize that a fifty percent equity limit is already too high for pension plans that are underfunded and that lack even rudimentary investment policies and guidelines.

(iii) The third option which has much support, uses the principles of the investment regime now applicable to insurance companies.

The main elements of this option are:

(a) Define a **funding threshold** of one hundred and fifty (150) percent of pension liabilities to which the fifty percent equity limit is applicable. Put differently, all plans with a surplus of less than fifty percent of pension liabilities will remain subject to the equity limit of fifty percent.

(b) Plans with a funding ratio in excess of one hundred and fifty percent will be allowed to invest in equities beyond the fifty percent limit. Put another way, trustees will be able to make additional equity investments with any surplus in excess of fifty percent of pension liabilities (up to a maximum level, to be determined).

The merit of this option is that it provides the additional room to wellfunded pension plans. The additional equity is really financed out of pension fund's surplus after providing a buffer, equivalent to fifty percent of pension liabilities.

As you may know, the investment regime for insurance companies allows for fifty percent of the statutory fund to be held in equities. However, the statutory fund must only be sufficient to cover policy holder's liabilities and thus any excess or surplus assets are not subject any limits, but need to be

An examination of thirty-seven pension plans which account for eightyfive percent of total equity investments of pension funds indicate that there are about 10 plans which are way below the 50 percent equity limit, and which could potentially invest about $1.1 billion in equities, if they so chose. They have not done so because of their own investment preferences. This proposed scheme would free up another $1.5 billion for equity investments. This amount compares with $700 million which was taken out of the equity market by pension funds since the end of 2005.

In our discussions with the stakeholders it was felt that pension funds desirous of making use of this option should (i) prepare an investment policy, in accordance with the Central Bank's guidelines on Prudent Person Approach to Investment and Lending which was issued in May 2005; and (ii) submit quarterly reports to the Central Bank.

The proposed approach – which is a liability-based approach – is not without its implementation problems.

A major implementation challenge will be to ensure the accuracy of the liability data and consequently the calculation of the pension fund's surplus, on an ongoing basis. Liability information will always be out of date given that investment management operates on a continuous basis but actuarial valuations are done at fixed dates, typically once every three years.

It will be very costly (and a major challenge) to require annual actuarial valuations. However, a possible fall-back will be to operate on the basis of estimated annual liability figures (following the three-year actuarial exercise), based on the assumptions utilized to produce IAS 19 figures (that's the calculation of the pension surplus that feeds into the sponsoring company's annual balance sheet). One would need to examine the feasibility and implications of using this estimation procedure more carefully.

Another issue is that as of now, there is no standardized actuarial regime in Trinidad and Tobago, for pension funds. Actuarial liabilities depend on the actuarial methods and assumptions used to determine them and as you know, there is a range of acceptable methods and assumptions. This has important consequences if liability values are used as a basis for equity limits.

Let me end with some thoughts on considerations to be taken into account in the preparation of the permanent investment regime for pension funds (the new legislation that we expect to have in place in a period of eighteen months to two years).

The current orthodoxy is that pension plans should be free to invest as much or as little as they want in equities provided that it is done on a "prudent person" basis and is done within the framework of a proper investment policy. This investment policy should take into account the plan's liability profile, funding level and the risk tolerance of the plan's sponsor – in terms of the sponsor's willingness and ability to increase contributions if the investment policy does not deliver. Such a policy would then be based on input from the trustee, sponsor, management committee and actuary.

While this is attractive in principle, there are practical issues. For example, if there are no limits on local equity purchases in a small stock market like Trinidad and Tobago, the imbalance between demand and supply of equities could push prices beyond levels justified by the fundamentals (as has happened hare over the last few years).

A second practical issue is whether there should be limits on foreign investments. The current thinking in industrialized countries is that the absence of limits on international investments allows for superior performance in terms of risk and return. In a small developing country like Trinidad and Tobago, there are practical considerations of the effect that unfettered overseas investment would have on exchange markets and the exchange rates.

Whatever investment regime is finally decided upon for the long term, its efficiency and sustainability will ultimately depend on (i) a significant increase in the range of available domestic investments (including government securities and private bonds); increasing liquidity in the stock market by encouraging more listings providing inducements for trading as opposed to the current system of "buy and hold" and reducing the dependence of the stock market on institutional investors.

These are tough but winnable challenges.

The Bank will continue to discuss these issues with stakeholders with a view to agreeing on a temporary investment regime early in the New Year.