PENSION FUNDS AND THE SECURITIES MARKETS

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Professors Vickers and Brown have given us an excellent and very useful summary of the findings of the Study of Mutual Funds 1/ as regards the relations of investment companies to the securities markets. In their paper they indicate briefly that privately administered pension funds are almost as important as mutual funds in considering stock market activity -- from some viewpoints more important. I feel that this warrants a little more investigation in a session such as this on new developments in the securities markets. I would like to take this limited opportunity to point up a little more some of the developments in the pension fund field and also to touch lightly on the corporate bond market.

Portfolio investments

In the early years of pension funds both U. S. Government and corporate bonds constituted the most important investment outlet. During the post-war period of rapid growth, however, more and more emphasis was placed on yield and on appreciation. This led to the growing investment of new funds in common stock, and in recent years, a start toward mortgages and real estate. Corporate bonds managed to maintain an important place in the investment portfolio in order to achieve balance but U. S. Government bonds lost position as regards new investment.

1/ Report of the Committee on Interstate and Foreign Commerce, prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce.

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In contrast to Government bonds, corporate bond holdings kept pace with the general rise in pension fund assets. Pension fund investment in this form rose from about $3 billion at the end of 1951, 45 percent of total assets, to $15 billion ten years later, 47 percent of total assets. During the period as a whole corporate bonds represented the most important outlet for new pension fund investment, $12 billion out of a total of almost $26 billion. As opposed to Government bonds, investment in corporate bonds was relatively more important for the larger funds.

The long bull market of the fifties brought into sharp focus the possibilities of greater stock investment by pension funds. Partly this reflected consideration for long term inflationary trends and partly as a consequence of the large increase in collectively bargained plans. Under the latter plans benefits were usually the basis for bargaining. As a result increased yields and capital gains would tend to reduce the cost of pensions. The attractiveness of common stock led to increased investment in this form. New funds went directly into stocks, the older funds changed their investment policies to allow a greater proportion of assets to be put into stocks.

At the end of 1951 common and preferred stock held in private pension funds had a book value of a little over $1 billion and accounted for about 16 percent of the assets. At the end of last year investments in stock amounted to almost $12½ billion and represented over 38 percent of the assets. On a market value basis stocks were about half the total although this ratio has receded somewhat, as a result of the market drop since the end of last year.

The attempt to raise the proportion of assets invested in common stock has necessitated that larger and larger proportions of the net cash inflow be put into the stock market. Last year over 55 percent of the net receipts of pension funds was used for net purchases of common stock. In 1951 not quite 22 percent of net receipts was used in this way. There was considerable variation among industries reflecting various amounts of catching up considered necessary. Funds in the transportation industry last year invested over 80 percent of their net receipts in common stock compared with less than 15 percent in 1951. Reflecting the change in policy, the communications industry put 31 percent of their receipts in common stock, up sharply from less than 3 percent as recently as 1957.

Net inflow

As in the case of mutual funds the impact of pension funds on the securities markets depends first on the net inflow and second on investment policy as regards that net inflow. As has been pointed out before, pension funds have been growing at a spectacular rate, particularly since 1950. Last year the net cash inflow amounted to a record $4 billion and we appear to be heading higher this year. In the first half of 1962 it is estimated that the net cash inflow was $2.3 billion.

Last year this cash inflow constituted almost one-fourth of net financial saving of individuals. In the first five years after World War II, saving channeled through pension funds averaged 10 percent and even less earlier.

The question arises as to the effects on saving patterns of the development of this new form of such substantial magnitude. It is considered more likely that saving in mutual funds has a large substitution effect on other

forms. Funds that have been or would have been placed in other savings media, such as savings banks, government bonds, or savings and loan associations, are placed in mutual funds and indirectly in the stock market. It is also likely that there is a small stimulant effect causing some additional saving.

The situation is different as regards pension fund saving. Here there does not appear to be much of a substitution effect. There is little evidence to indicate that individuals cut down on other saving because of pension funds, although the stability of the saving rate has sometimes been used to claim this. In view of the many possible changes that can affect the saving rate it is rather hard to accept this. In other words pension fund saving is almost entirely additional saving which would not have taken place otherwise. However, there could be differing effects depending on the alternative distribution of the employer contributions -- whether to higher wages, lower prices, retained earnings or dividends -- and the relative propensities to save. It is also possible that pension fund saving acted as a stimulus on other forms as the result of greater recognition of retirement needs by individuals such as developed after the introduction of Social Security. Broadly speaking, pension fund inflow appears to be a net addition to saving and this addition has largely been channeled into corporate securities. On the other hand, although saving in mutual funds is also channeled into corporate securities, it is more likely to represent a substitution for other forms of saving rather than a net addition.

There are certain differences in the determinants of the inflow of pension funds and mutual funds, which have significant implications for the

securities market. Vickers and Brown pointed out the reduction in cash inflow to mutual funds following a decline in stock prices reflecting discretionary action on the part of individual savers. The inflow of pension funds is much more regular since it does not depend on the discretion of the individual but is rather a matter of contract. As mentioned before there is some discretion allowed to employers so that contributions could be cut if the fund has a substantial capital gain on its portfolio and the company runs into a less profitable period. The reduction in inflow, however, is more likely to be spread over some time and not tied to stock price declines.

Impact on securities market

Looking at market impact from the point of view of net purchases compared with net new issues we see that private noninsured pension funds have been the most important institutional group in the stock market since the early fifties. Over the eleven year span, 1951-1961 they purchased on balance $11.4 billion of common and preferred stock compared with $7.7 billion by the next most important institutional group, open and closed-end investment companies. During this period all institutional groups combined, made net purchases of $26.1 billion about the same as the amount of net new issues of stock of corporations other than investment companies.

Pension fund and institutional impact have become more significant in the last few years. Last year, pension funds purchased stock equal to two-thirds of the net new stock issues other than investment company shares, while in 1960 net purchases exceeded net new stock issues.

In the first half of this year pension funds raised their rate of stock buying slightly over last year. Net purchases of common and preferred stock amounted to about $1.1 billion in the first half of this year, compared with $2.0 billion in the full year 1961. Investment companies increased their rate of purchase significantly during the market decline. In the first six months of 1962 investment companies purchased on balance $1.1 billion of corporate stock. In the full year 1961 they made net purchases of $1.3 billion. It should be noted that in 1961 investment companies had an excess of cash inflow over net corporate security purchases. In the first half of 1962 inflow equalled corporate security purchases. Generally it appears that institutions did not stop buying stock after the market reached its peak last December, but to some extent, increased the rate of purchases.

The impact of steadily maintained institutional buying of stocks takes on greater significance in the light of the supply of new issues being floated. The market decline this year saw a reduced volume of flotations with less than one-half billion dollars of stock other than investment company shares, in the first half. Pension fund net purchases alone would thus amount to almost three times the net new supply of stock issues.

Generally the investment policy of pension funds has been to concentrate on higher grade stock, the so-called blue chips. The study by the Banking Department of the State of New York 2/ revealed that in 1953 practically all the common stock held by the New York banks were of investment grade (98%). The staff report to the Committee on Banking and Currency, Institutional Investors and the Stock Market, 1953-55, indicated that

2/ Pension and Other Employee Welfare Plans, George A. Mooney, Supt of Banks.

purchases of 25 high grade stocks during the period accounted for one-fourth the total common stock purchases for the funds sampled. Monthly data on transactions for the 34 month period related transactions in the individual stocks to total transactions. While this will overstate the case due to off-board transactions, there were many instances of months when pension fund purchases accounted for more than 10 percent of all transactions in a particular stock.

The above studies tend to show that pension fund impact can be a lot more significant than the overall figures indicate, due to the investment policies followed. The gradual institutionalization of higher grade stock, even in large corporations with many shares outstanding, can result in reduction of the floating supply of popular issues. It appears that, while steady purchases of stock dependent on regular contributions of employers can have a stabilizing effect, in individual stocks large transactions can be destabilizing as the result of the effective retirement of shares into investment portfolios.

Another approach to measuring the market impact of pension fund purchases and sales is an analysis of transactions at the time they occur. The New York Stock Exchange has surveyed the transactions taking place on particular days in each year beginning with 1952.

There are some problems in using these surveys due to the difference in presentation and variation in depth. In only one year, 1955, did the New York Stock Exchange go behind bank transactions to determine the beneficial owner. In that year approximately 16 percent of stock transactions of commercial banks were pension funds. Three-fourths of the stock transactions of pension funds on the exchange are handled through banks.

Within the limitations of the data and making certain assumptions it is

possible to arrive at some conclusion as to the importance and trend in stock transactions of pension funds. While detailed data are not available in the 1961 survey, institutions and intermediaries on an overall basis accounted for more than one-third of all stock transactions other than those of member firms. In 1953 this ratio is somewhat less than one-fourth. More information is available for 1960 so that by estimating the transactions going through banks it appears that around 5 percent of all transactions other than by member firms was accounted for by pension funds. In 1953 the survey showed about 1 percent. The further increase in 1961 in the institutional share would imply a further increase for pension funds. The increase was faster than that of mutual funds which went from about 3 percent in 1953 to 6 percent in 1960.

Vickers and Brown have presented some information on the ratio of the dollar volume of purchases and sales of common stock by mutual funds to the total dollar volume of transactions on the New York Stock Exchange. This same comparison can be made for pension funds. A certain amount of inaccuracy is introduced due to the fact that some of the pension fund transactions are handled off the New York Stock Exchange. In 1954 this amounted to about 15 percent. Compensating, to some extent, is the inclusion of preferred stock and warrants in the New York Stock Exchange volume.

In 1951 gross purchases of common stock amounted to less than 2 percent of exchange volume, -- 1½ percent for net purchases. These ratios showed a fairly regular rising trend in the years that followed. Gross purchases accounted for almost 6 percent of total transactions in 1961 while net purchases came to almost 4 percent of exchange volume.

Impact on the Bond Market

I would like to make a few comments on the bond market which has been somewhat neglected today. Life insurance companies, of course, rank first in overall net purchases with pension funds and state and local trust funds rather distant second and third. In the eleven year period, 1951-1961, life insurance companies made net purchases of $26 billion compared with $13 billion by pension funds and $8 billion by state and local trust funds. These purchases were equal to 23 percent and 45 percent of net new issues of corporate bonds during the period.

In comparing bond purchases of pension funds with those of life insurance companies, however, it should be kept in mind that about 40 percent of the net new issues of corporate bonds are privately-placed. These issues are arranged directly between the issuer and a limited number of large institutional investors and rarely get into the public bond market. Life insurance companies are by far the most important demand element in the private placement of bonds accounting for almost 85 percent of the total issued. Approximately three-fourths of their new investment in corporate debt securities comes through the private-placement channel.

Eliminating private-placements we find that pension funds become the most important institutional group in the public bond market. Net purchases by pension funds amounted to 35 percent of net new public issues of corporate bonds compared with a little over 20 percent for life insurance companies. Interestingly enough on this basis state and local trust funds turn out to have a greater impact on the public bond market than life insurance companies.

Holding of corporate securities

One other aspect of pension fund impact on the securities markets can be seen in the data on relative holdings. At the end of last year pension funds held common and preferred stock with a market value of $21 billion compared with $29 billion for investment companies and $51 billion for trust funds. Pension fund holdings represented 4 percent of the total outstanding other than investment company shares compared with almost 6 percent by investment companies and 10 percent by trust funds.

Pension fund portfolio holdings of stock have shown the sharpest rise in proportional share of stock outstanding. In 1954 they accounted for only 1½ percent of total market value of stock other than investment company shares while investment company holdings totalled 3½ percent. Personal and common trusts accounted for 10 percent, the same as last year.

The New York Stock Exchange tabulations of institutional holdings of listed stock present a similar picture. Institutional holdings show a rise from 12.7% of total listed in 1949 to 18.0% in 1961. Pension funds accounted for less than ½ of one percent of total in 1949 while investment companies and nonprofit institutions each held 4 percent. In 1961 pension funds held 4 percent, investment companies 6 percent, and nonprofit institutions 4 percent.

As in the case of purchases, life insurance companies were the largest holders of corporate bonds at the end of 1961, almost half the total outstanding, with pension funds a much lower second. However, eliminating privately-placed issues reduced the total outstanding from $107 billion to $71 billion. Of this total of publicly owned bonds, life insurance companies held $20 billion, pension funds $14 billion, and state and local trust funds about $8 billion.

Turnover

Vickers and Brown pointed out that in considering impact on the stock market an important factor is turnover rate. Large holdings, such as for instance those of personal trust funds with low turnover, primarily have their effect through restriction of floating supply. Pension funds have this effect and in addition have made large net acquisitions of common stock. Turnover of common stock portfolio has been quite low, around 6 percent last year and under 4 percent so far this year. Mutual funds have an impact in all three ways with stock turnover rates exceeding the turnover rate of all New York Stock Exchange stocks which last year and so far this year has amounted to 15 percent.

Summary

The above discussion leads us to some conclusions as to the financial impact of pension funds similar to those reached for mutual funds by Vickers and Brown and some which differ.

First, the sharp rise in assets of private pension funds together with impelling reasons to achieve substantial investment in corporate securities has resulted in pension funds gaining considerable importance in the market for both stocks and bonds.

Second, while the cash inflow of mutual funds has some discretionary aspects depending on stock market psychology, this does not appear to be true for pension funds. The flow into the securities market geared to the cash inflow of the pension funds provides a continuing demand. However, the funds tend to concentrate in a relatively few high quality issues so that there exists a sharper impact for these issues.

Third, the investment policies of pension funds have channeled a substantial amount of new saving into common stocks and corporate bonds that would not ordinarily have found its way into these markets. In addition pension funds have added substantially to aggregate saving of individuals.

Fourth, as in the case of mutual funds it can be said that indirectly, this substantial flow of money into the securities markets has facilitated the flotation of securities and the financing of business expansion.