Institutional asset allocation trends and drivers

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The UK's institutional investors dominate our financial markets. Their investment decisions can therefore sometimes have huge implications for asset prices. In this article Professor Andrew Clare, Legal & General Investment Management's consultant Financial Economist and Professor at CASS Business School, takes a look at the trends in institutional asset allocation over the last ten years and tries to assess likely future trends and consequences.

Institutional investors dominate the UK's financial markets, and more importantly they tend to have the same goals and objectives. This in turn means that they therefore want to buy and hold the same sorts of securities. At times when these investors are broadly satisfied with their mix of assets the impact of their investment decisions tends to be of less importance. However, when a number of them decide to change the composition of their portfolios in broadly the same direction, then unlike the buying and selling decisions of a small private investor, their actions can have a significant influence upon asset prices.

Over the past few years a variety of factors have come together to bring about just this sort of investment environment, where a large number of institutional investors have felt compelled for a variety of reasons to reduce their holdings of UK equities in favour of a larger allocation to fixed income asset classes. As a result, UK equity prices have probably been weaker than they otherwise might have been, while bond prices have probably been stronger.

In this article we take a closer look at the longer term trends in the investment decisions of two of the largest types of institutional investor: life companies and pension funds. We also highlight some of the factors behind this asset allocation move, factors which remain to this day, and which therefore suggest that recent trends will continue into the foreseeable future.

Current holdings

In Figure 1 we present the portfolio holdings by broad asset class of UK life company and pension funds as a proportion of their total long-term asset holdings as they stood at the end of 1994 and at the end of June of this year. Over this ten-year period there have been some important changes to the composition of the portfolios of these investors. The first and most obvious difference is the reduction in the proportion of UK equities for both types of institution. UK life assurance company holdings of UK equities are now around 10% lower than they were at the end of 1994. But the change for the UK's pension funds has been far greater. In 1994 the pension scheme holdings of UK equities represented 51% of total long-term assets; today that figure is almost 20% lower at just under 32% of total holdings.

Another big change in the make-up of pension fund and life assurance company portfolios can be seen in their holdings of UK corporate bonds. In 1994 UK pension fund holdings of sterling corporate bonds amounted to only 0.7% of total holdings, but today they make up 6% of the total, representing an almost ten-fold increase over this period. Meanwhile the UK's life assurers held just under 7% of their assets in the form of sterling corporate bonds in 1994; they now hold nearly 17% of total assets in the form of sterling corporate debt. Moreover, both types of institution now hold a higher proportion of their assets in overseas government and non-sterling corporate bonds too, denoted as 'Other bonds' in Figure 1.

Other notable changes for both types of investor include the higher weightings in overseas equities and in index-linked securities.

Overall then, despite the higher weighting in overseas equities, there has been a broad change over the last ten years with UK equities falling as a proportion of total asset holdings and with the holdings of fixed income assets rising.

INSTITUTIONAL ASSET HOLDINGS

	PENSION FUNDS		LIFE ASSURERS	
	1994	2004 Q2	1990	2004 Q2
Gilts	5.1%	6.1%	15.0%	15.3%
Index-Linked	4.8%	8.5%	1.8%	3.3%
UK Corp Bonds	0.7%	5.9%	6.8%	17.7%
Other Bonds	3.3%	4.4%	2.6%	5.9%
Total Fixed Income	**13.8%**	**24.9%**	**26.2%**	**42.2%**
UK Equities	51.1%	31.9%	41.1%	31.7%
O/S Equities	17.6%	24.1%	11.7%	12.6%
Total Equity	**68.7%**	**56.0%**	**52.8%**	**44.3%**
Property	5.4%	5.6%	9.3%	7.4%
Other	12.1%	13.5%	11.6%	6.1%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Figure 1 Source: ONS

Price changes or asset allocation?

The changes over the last ten years in the composition of life assurance and pension scheme portfolios shown in Figure 1 appear relatively large. However, we cannot tell from these figures how much of the change in the portfolio composition was due to active asset allocation decisions and how much was due to changes in the market values of assets. Changes brought about by outright sales and purchases of assets, over a short period and in large quantity, will clearly have a greater market impact.

To investigate this issue, we looked at the annual changes in the holdings of pension fund and life assurance companies over the last ten years and then stripped out the changes that occurred to the holdings due to underlying changes in market values. The percentage change in the holding after this adjustment can then be interpreted as a crude measure of the conscious asset allocation adjustments to the portfolios each year.

We have performed this exercise for all of the asset classes, but owing to a lack of space here we concentrate upon UK equities and UK corporate bonds – respectively the biggest asset class loser and biggest asset class winner over the last ten years.

UK equities

In Figure 2 we have plotted the annual percentage changes in the holdings of UK pension funds in UK equities. The dark blue bars represent the total annual percentage change, while the light blue bars represent the annual change net of market movements. The Figure shows clearly that the UK's pension funds have been actively selling UK equities for the last ten years, both through the bull market of the mid to late 1990s, but also through the recent bear market too. For example, for the most recent full year of our sample, 2003, pension fund holdings of UK equities increased by 12%. But once the surge in equity prices in 2003 is stripped out we can see that UK pension funds actively reduced their holdings of UK equities by around 9%, equivalent to just over £16bn worth of equities (depending upon when they were sold). However, in the first quarter of this year the further, small fall in total UK equity holdings is due almost entirely to the change in the value of UK equities over this period.

In Figure 3 we present the UK life assurance equivalent of Figure 2. Figure 3 shows that as a group, the UK's life assurers have been net sellers of equities over the last two years. Over 2003, they sold approximately 5.0% of their combined UK equity portfolio into the equity market strength of that year, equivalent to around £16bn worth of UK equities. A significant proportion of this figure would have been due to the well publicised sale of UK equities by Standard Life over the early part of 2003.

Taken together our calculations suggest that pension fund and life assurers sold approximately £32bn of UK equities over 2003.

UK corporate bonds

Figures 4 and 5 show both the total annual change in UK corporate bond holdings and the net asset allocation changes for pension funds and insurance companies respectively.

Figure 4 shows that the vast majority of the move into corporate bonds by the UK's pension funds over the last ten years was the result of a conscious decision to buy these bonds. For example, back in 1995 when sterling corporate bond holdings represented a very small proportion of total holdings, of the increase in holdings of nearly 80% on the previous year around 60% was a conscious asset allocation decision.

Similarly, for the life assurers, active asset allocation played the dominant role in the increase in corporate bond holdings over the last ten years as can be seen in Figure 5. The figure shows that unlike the UK's pension funds, the UK's life assurers were net sellers of corporate bonds over 2003, but that they have returned to the market with renewed enthusiasm this year. During the first half of 2004 they increased their holdings of UK corporate bonds by nearly 9%, approximately equivalent to a net investment of £12bn.

What have been the drivers?

Figures 2 and 3 show clearly that the "cult of the equity" has been in decline since the early 1990s – at least in the minds of the UK's most important institutional investors. And, although we do not report the details here, the fixed income data show this too. Higher allocations to conventional gilts began in the early 1990s and ended in 1999 for the pension funds and in 1998 for the life assurers. Similarly the data show that a move into index-linked gilts began in the early 1990s and furthermore that this move is continuing; the life assurers in particular still appear to have a strong desire to buy index-linked gilts.

The move from equities into fixed income asset classes began before the equity bear market. What then were the initial drivers of this move?

First, for both types of institution the strong equity markets of the 1990s undoubtedly encouraged some to lock in some of these gains by selling equities and buying bonds. The clearest example of this was the move by the Boots pension scheme which made a wholesale switch from equities into bonds. But there were more institution-specific reasons too.

Pension Funds

For the pension funds the initial spur was probably the gradual maturation of UK defined benefit pension schemes, a natural consequence of the UK's ageing population. As schemes become more mature – with an increasing number of members drawing their pension or coming close to retirement – fixed income securities become an increasingly natural asset class to back such liabilities.

This 'natural' inclination to hold more bonds as pension schemes gradually matured was exacerbated by the introduction of MFR in 1997, which effectively compelled pension schemes to hold higher proportions of gilts in their portfolios. MFR regulations have now been superseded by FRS17, known to some as "son of MFR". FRS17 requires companies to place their pension fund deficit/surplus on their balance sheet, and also requires them to discount (value) their liabilities using AA-rated corporate bond yields.

Adding the pension fund position on to the balance sheet has the potential to make the balance sheet much more volatile, especially given the size of some pension funds relative to the size of the company's business. Because under FRS17 rules the liabilities are discounted using the prevailing yield on AA-rated sterling corporate bonds, one way of reducing this volatility is to hold AA-rated assets. With this strategy the assets and liabilities will tend to move in line with one another thus reducing

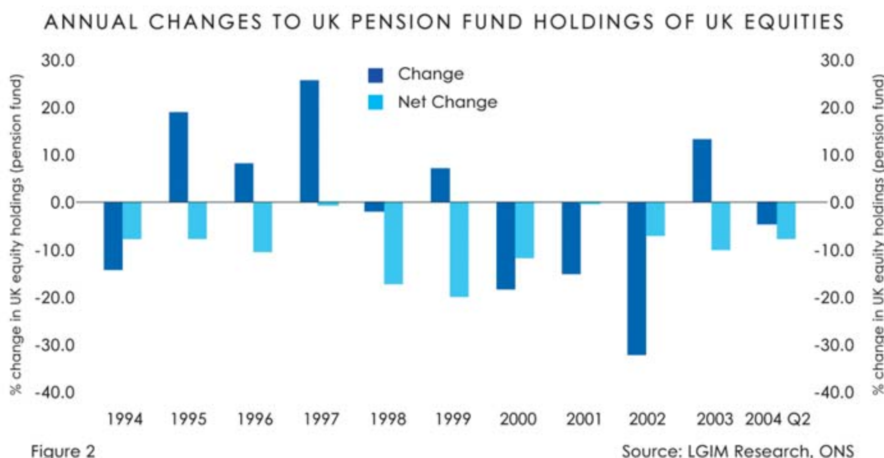

Figure 2 Source: LGIM Research, ONS

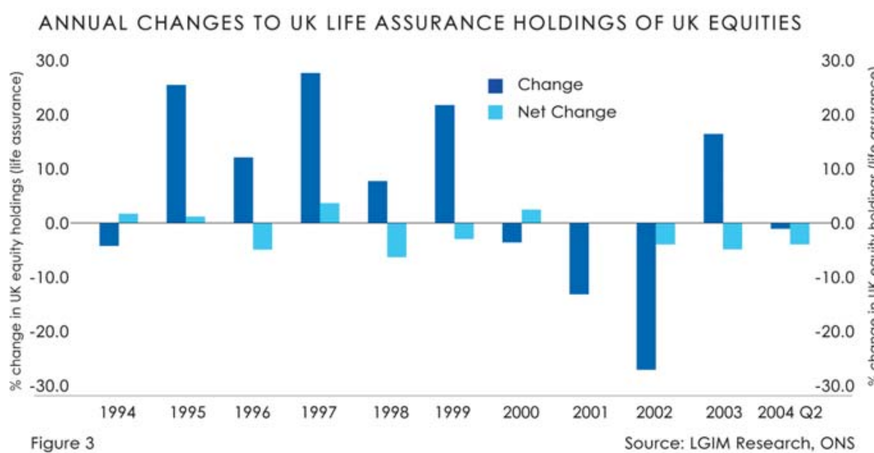

Figure 3 Source: LGIM Research, ONS

both pension fund and balance sheet volatility. FRS17 has therefore been one of the key motivations for an increase in pension fund holdings of corporate bonds.

On top of all this the equity bear market has quite understandably convinced many pension fund trustees that equities may be more trouble than they are worth. The bear market has also convinced many scheme sponsors' to close their DB pension schemes to new entrants, thus accelerating further the process of scheme maturation.

Life Assurers

As Figure 1 shows the UK's life assurers started with a proportionately lower holding in equities than the UK's pension funds. Despite this, Figure 3 shows that they too became net sellers of UK equities as early as 1996 as they also began to lock in the extraordinary gains generated by the equity markets at that time.

However, as the equity markets collapsed, the pressures to reduce equity weightings in an effort to limit losses and maintain solvency ratios grew more and more intense, culminating in some cases with large scale sales of UK equities which exacerbated the equity market gloom.

Both types of investing institution then had good reason to reduce equity weightings, but their combined size meant that this decision has had wider financial market consequences.

Summary

There is no doubt that over the last couple of years UK equities have suffered as institutional investors have sold large quantities of UK equities at approximately the same time. The main beneficiary of this move has been sterling corporate bonds. In our view, in the absence of this asset allocation move, UK equity prices would have been higher, and corporate bond prices lower over this period.

But what does the future hold for UK equities and fixed income asset classes?

We should perhaps begin by answering this question by reminding ourselves that for every seller there is a buyer. Evidence from the UK's balance of payments data suggest that overseas investors have been taking advantage of the desire of UK institutions to sell UK equities, or conversely that UK institutions have been willing to oblige overseas investors who want to increase their holdings of UK equities. Viewed from this perspective one could see this move as part of a global desire on the part of investors everywhere to hold a higher proportion of their equity portfolio in the form of overseas equities.

Also, though defined benefit pension schemes may wish to hold less UK equities in the future, this will be compensated going forward to some degree by the growth in defined contribution pension schemes, which will have an ongoing need to purchase equities. And, perhaps of more significance, the better tone to the UK equity market recently and the generally low level of corporate bond yields, may convince some that equities may not be all bad after all.

There are then forces that will act to offset the institutional desire to continue with this asset allocation move. However, having said this, most of the original drivers of this move which we outlined above, are still with us today. We therefore believe that outright sales by UK institutional investors of UK equities and outright purchases of fixed income securities – most likely sterling corporate bonds – will continue for the foreseeable future, even though the majority of this switch may be behind us now.

The longer term consequences of this move may be far reaching. For example, suppose that overseas investors do take up the ongoing slack in demand for UK equities. If they do, and early evidence suggests that this may be the case, their demand is more likely to be for highly liquid, blue chip stocks, rather than for smaller UK corporations. This could make equity finance more expensive for the UK's smaller companies than might otherwise have been the case. In turn this might force some smaller companies to seek alternative sources of finance, perhaps via the corporate bond market (thus helping to satisfy the ongoing demand of the UK's pension funds for sterling corporate bonds), or perhaps by delisting and taking their companies private. It is not inconceivable then that this asset allocation move could have an impact on the balance sheet structure of UK plc.

It is too early to tell how the change in the demands of these investment institutions, which we have seen over the last few years, will impact upon the wider world, but it seems likely to us that ultimately the move will be felt beyond the confines of the financial markets.

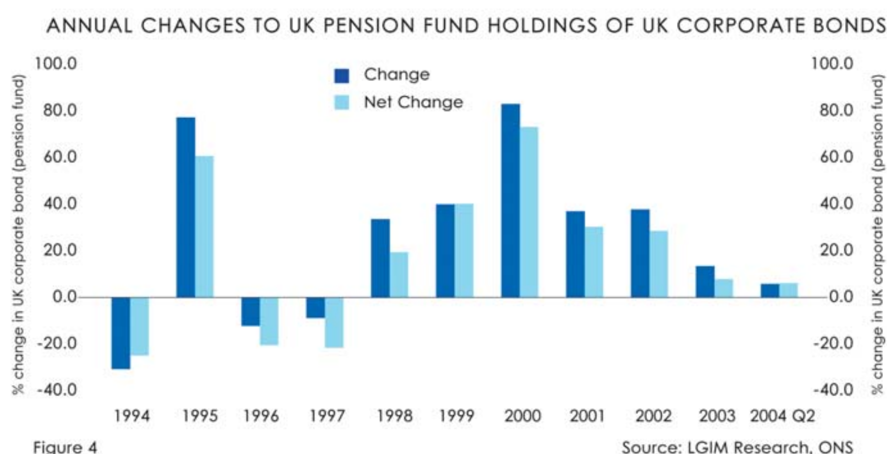

Figure 4 Source: LGIM Research, ONS

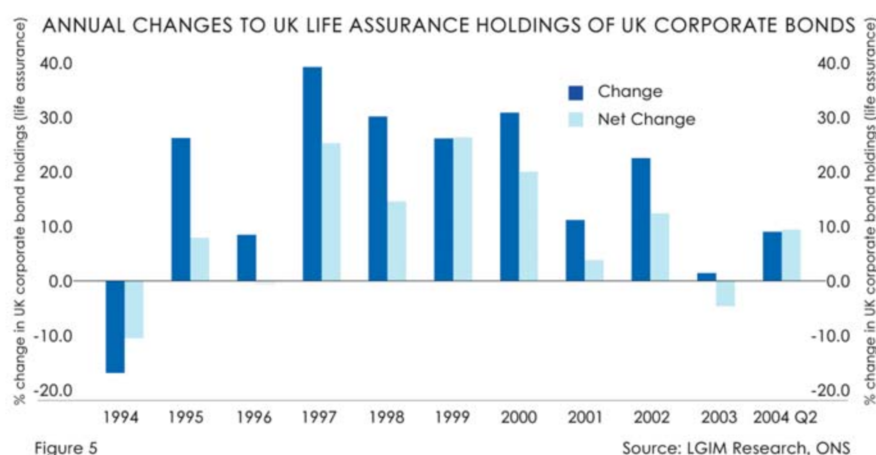

Figure 5 Source: LGIM Research, ONS

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