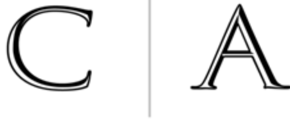

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EUROPEAN MARKET COMMENT: U.K. PENSION FUND ASSET ALLOCATION

March 2003

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U.K. Pension Fund Asset Allocation

Recent commentary in the United Kingdom has focused on the convergence of gilt yields with the equity market dividend yield, and the implications this has for pension funds seeking to match assets and liabilities. A growing number of pension schemes are considering a shift from equities in favor of bonds, following the well-publicized move made by the Boots pension fund two years ago. However, we suggest that despite asset-liability matching pressures, such a shift is short-sighted, as the following simple exercise indicates.

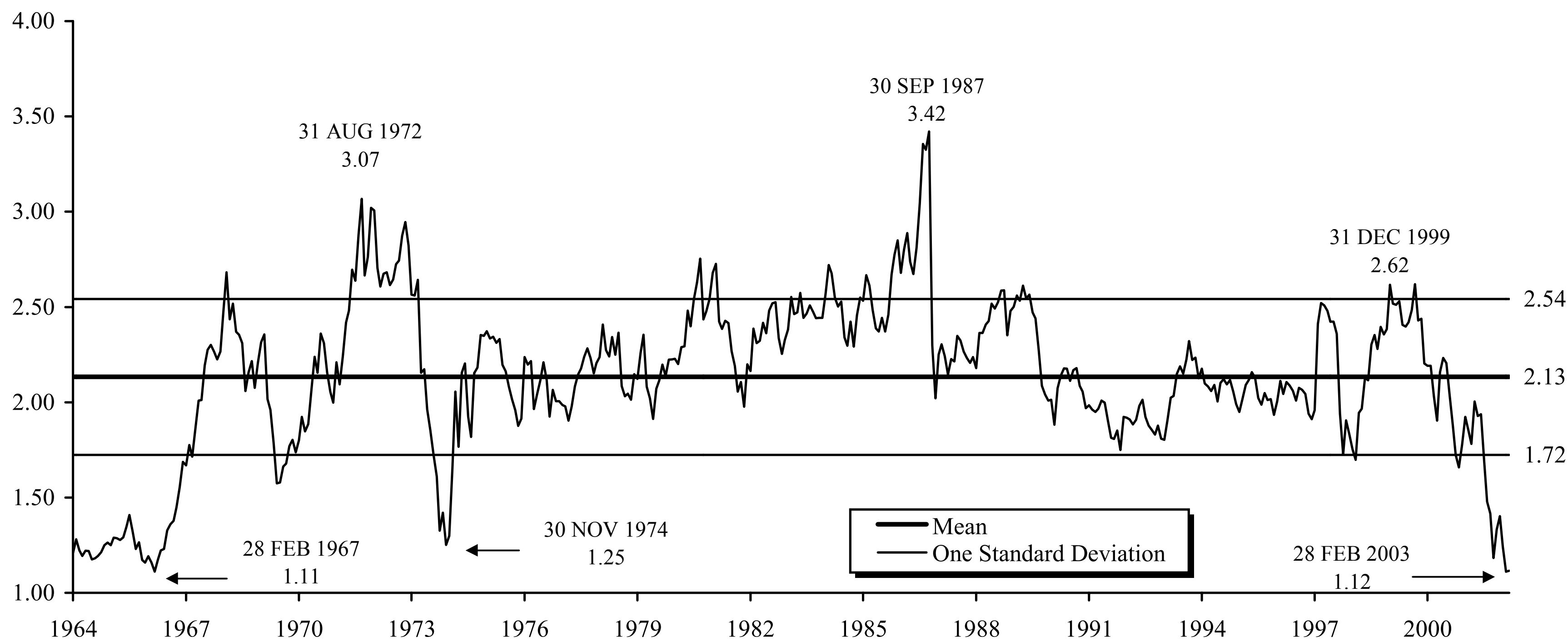
Since 1964, ten-year gilts have yielded twice as much as equity market dividends, on average, but with the FTSE All-Share Index currently yielding 3.8% and ten-year gilts, 4.2%, this ratio has now dropped to 1.1 (see Tables A and B). Over this same period, equity market dividends have grown at an average annual rate of 7.3%, although growth in the past 12 months has been -1.7% (see Table C) and could slide further if recent dividend cuts by Abbey National, Aviva, Prudential, and Swiss Re prove contagious. Over time, however, one should expect dividends to grow, reflecting growth in aggregate corporate earnings. How quickly the cash flow from dividends will exceed that from gilts depends, of course, precisely on this issue of the health of the corporate sector, but if dividend growth were to revert to its long-term rate of 7.3% (coming off a depressed base), it would take only 18 months for dividend cash flow to exceed that of ten-year gilts. In addition, gilts are far more exposed to any rise in the rate of inflation, since corporations generally pass on inflation to their customers, preserving the real value of their earnings and therefore of their dividends.

In short, the current enthusiasm for bonds among U.K. pension schemes strikes us as a classic rationalization of bear market sentiment and perhaps a useful contrarian indicator. Whatever their asset-liability models may dictate, we think these investors should resist the temptation to shift wholesale into bonds right now, because they may be doing so at exactly the wrong time—better to implement such a shift at a more opportune point in time, or gradually over a period of years.

Table A

RATIO OF U.K. TEN-YEAR GOVERNMENT BOND YIELDS TO FTSE ALL-SHARE DIVIDEND YIELDS

31 December 1964 - 28 February 2003

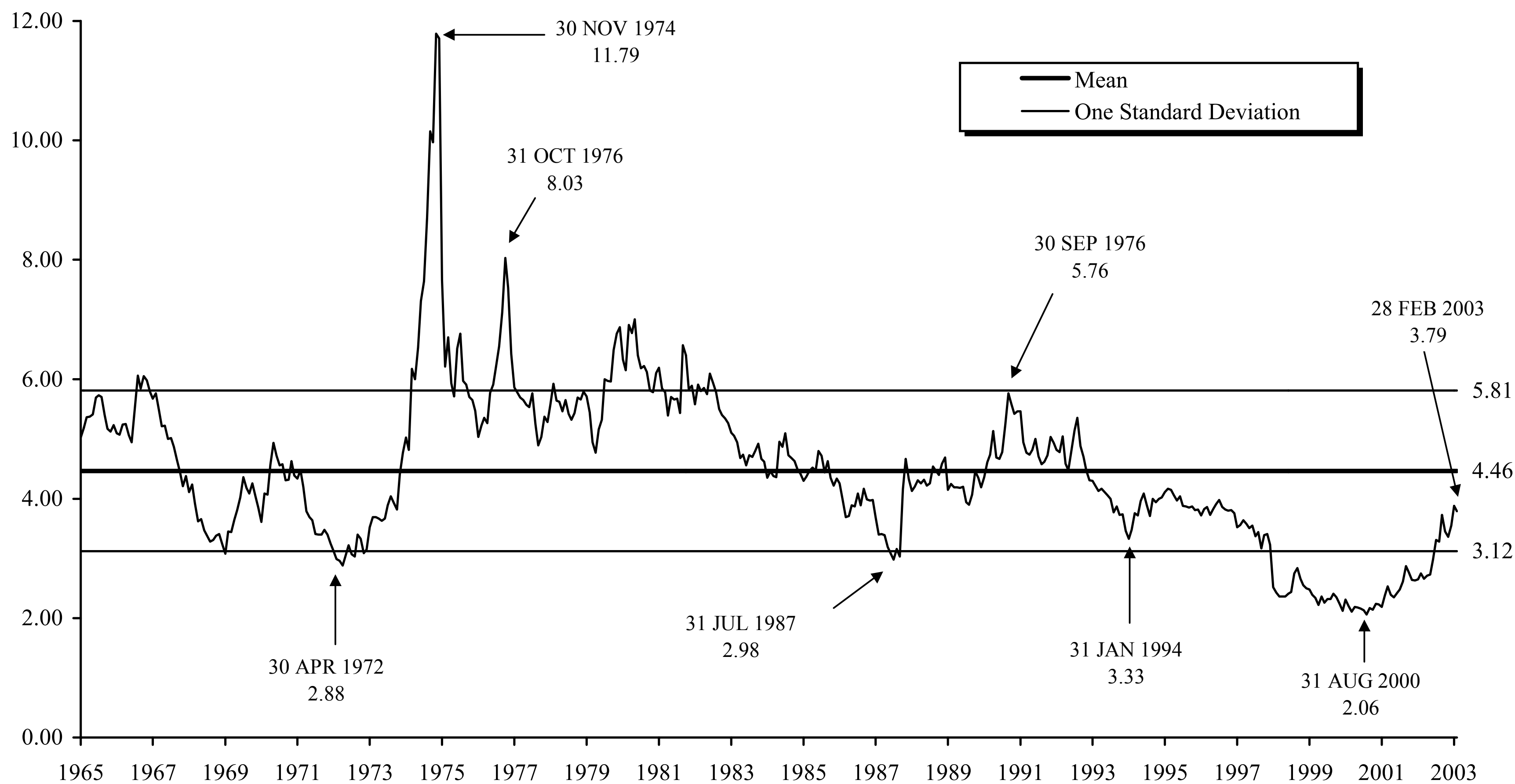


	As of 28 February 2003
U.K. Ten-Year Government Bond Yield	4.23
FTSE All-Share Dividend Yield	3.79

Sources: Global Financial Data and Thomson Datastream.

Table B

FTSE ALL-SHARE DIVIDEND YIELDS SINCE 1965



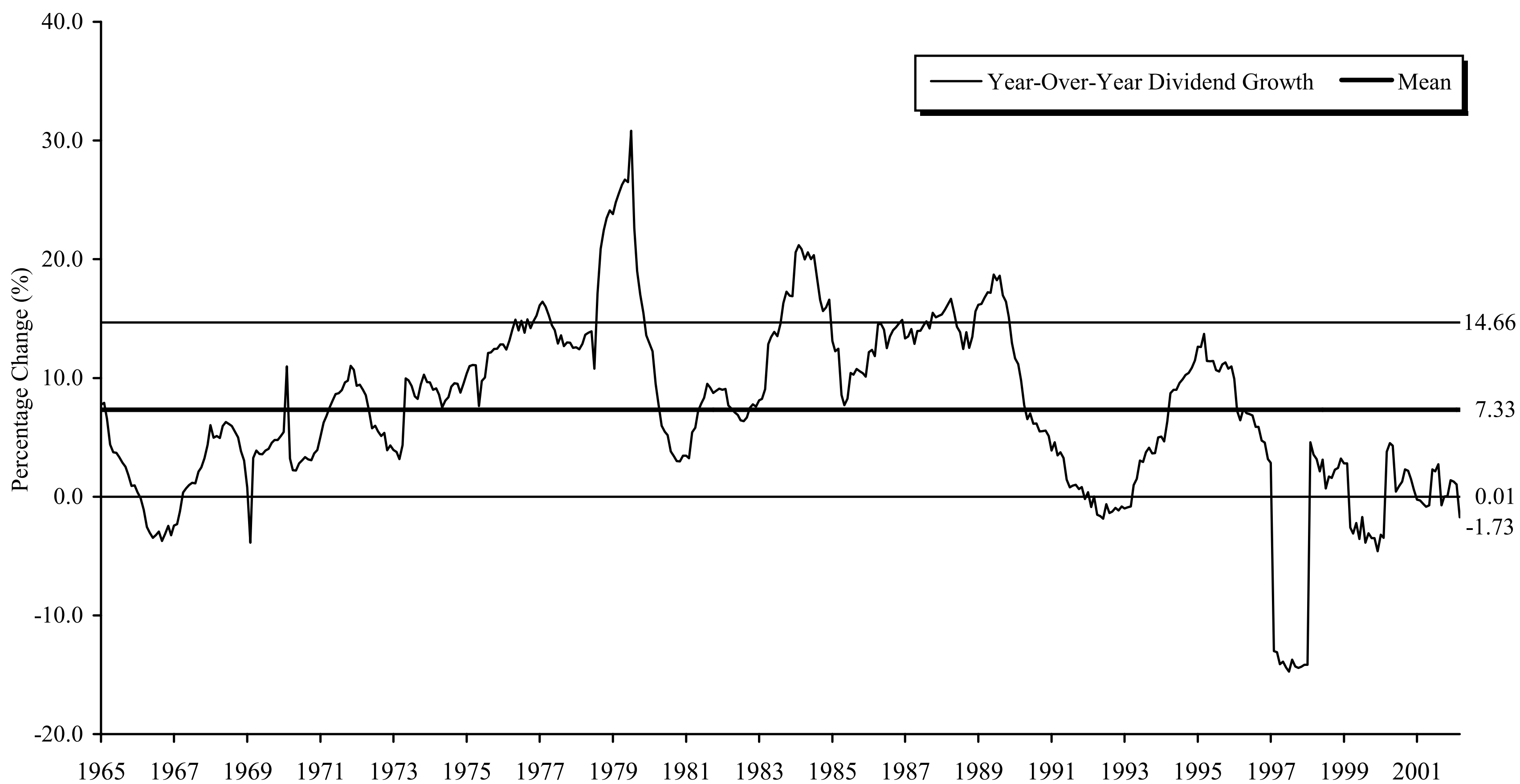
Source: Thomson Datastream.

Note: Data from 31 January 1965 through 28 February 2003.

Table C

FTSE ALL-SHARE YEAR-OVER-YEAR DIVIDEND GROWTH

31 December 1965 - 28 February 2003



Source: Thomson Datastream.