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Do equities provide a sterling return?

Notwithstanding significant moves into bonds and all the talk of liability-driven investment over the past few years, equities still represent more than half of a typical pension fund portfolio, and for a quarter of funds, over 70%.

For many pension portfolios, domestic stocks are at least as important as overseas equities, and equity discussions frequently dominate investment presentations at trustee meetings.

Trustees clearly love equities, particularly UK ones.

Two traditional views are that, as the liability to pay pensions is in sterling, UK equities provide the natural bedrock for portfolios, and that equities provide a superior long-term investment. Both views are open to question.

Does the UK market provide a sterling-based return? And what do we mean by long-term?

In reality, the UK equity market is a blend of large multinationals; smaller, mainly domestic companies; and overseas companies listed in London. The market is also highly concentrated (and always has been). The 10 largest companies now comprise around a third of the total market index. Those companies are essentially multinationals, whose earnings are predominantly overseas rather than sterling, and they are barely dependent on the domestic economy. Whether it is BP, Royal Dutch Shell, Glaxo, or Vodafone, they are global companies whose significant worldwide operations dwarf their UK presence.

These names are familiar in the UK indices, though many other listed companies are not; some are overseas companies that just choose to be quoted on the London Stock Exchange - which has been very successful in promoting itself internationally. We have mining companies from Australia and even Kazakhstan, South African breweries, and so on; perfectly reasonable investments, no doubt, but not obviously UK equities. Do such investments provide a currency match for pensions payable in sterling? Again, not obviously. That is why, increasingly, trustees are investing globally, rather than being over-reliant on the UK equity market.

So UK equities frequently have little to do with the UK. What about equities providing a good long-term investment? A superior return - the 'equity risk premium' - is what investors expect for accepting the volatility of equities. It may come as a surprise to many that, even before the latest rollercoaster, the UK equity market index was below the level of a decade ago. Over that 10-year period we have suffered the risk of extreme volatility, yet received no capital gain in return, merely a dividend yield amounting to considerably less than we could have earned by leaving cash in the bank (though maybe that's risky these days as well).

When it comes to equity investment, trustees should realise that long-term means just that. In any specific period, even one spanning a decade or more, superior equity performance cannot be guaranteed. And 'UK equities' means equities quoted on the London market, nothing more.