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Actuaries should reconsider how they value pension funds

From Prof Dennis Leech.

Sir, It is increasingly evident that the volatility observed in the funding levels of many private pension schemes is much too large to be a fair reflection of the underlying health of the pension schemes. An example is the universities scheme, USS, the second largest private scheme in the UK, whose triennial valuation shows it 91 per cent funded compared with 103 per cent in 2008. In between it was estimated to have fallen to 75 per cent in 2009.

This volatility mostly reflects short-term stock market fluctuations and does not give a true sense of how well the scheme is doing. The problem arises because pension schemes now have to use different methods to value the assets and liabilities. The liabilities – the needs of future pensioners – are carefully estimated using the best information available. But the future stream of income from investments (mainly dividends from the ownership of company shares) is largely ignored.

Instead, the actuaries rely on a fundamentalist theory, that markets are efficient, and only current market values of assets are needed because they convey all the information needed about future earnings. But these market prices fluctuate wildly for all sorts of reasons unconnected with future earnings – notably short-term speculation, fluctuations in general market sentiment, and so on.

The actuaries should reconsider how they value pension schemes in light of the failure of the efficient markets hypothesis that we have seen during the current financial crisis. It would surely be much more sensible to base pension scheme valuations on a comparison of future streams of income and liabilities on a consistent basis.

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