Equities · Fixed Income · Real Estate · Multi-asset · Private Equity
ROLL OVER TO FIND OUT MORE
Standard Life Investments
RYDER CUP WORLDWIDE PARTNER

FACE TO FACE

November 6, 2011 5:03 am

Boots' bonds architect on the merits of switching

By Pauline Skypala

Ten years ago, the news broke that the £2.3bn ($3.7bn) Boots pension scheme had switched all of its assets into bonds. From a position of 75 per cent equities and 25 per cent short-dated bonds, over 18 months it moved to being 100 per cent in long-dated, high-quality bonds, a quarter of which were index linked. The index-linked proportion was later raised to 50 per cent.

Actually, the news was leaked by John Ralfe, then head of corporate finance at Boots and architect of the revolutionary move, who felt there was no point in having effected the change if no one knew about it. Once it had completed the switch Boots was dithering about making an official announcement, he says, "because it was aware the move to bonds would be dynamite. They were worried the City would say 'those people at Boots are just bonkers'."

That was more or less the reaction, because it was such a challenge to convention. It directly opposed the hallowed assumptions that equities outperform bonds over the longer term and offer a better hedge against inflation; that diversification is the first rule of sensible portfolio allocation; and that active fund management is a skill worth paying for.

But Mr Ralfe, now an independent consultant, was not steeped in these investment beliefs. To the contrary, he had been heavily influenced by a 1997 paper written by Jon Exley, Shyam Mehta and Andrew Smith: The financial theory of defined benefit pension schemes. This argued for applying a financial economics analysis to corporate pension provision, and in particular for using a mark to market valuation approach rather than the traditional actuarial one.

Perhaps more pertinently, it also maintained that, leaving aside tax and other considerations, "there is no specific reason to suppose that one asset class is preferred for the pension fund over any other".

Curriculum Vitae

John Ralfe
Born: 1956

1978 Balliol College, Oxford (philosophy, politics & economics, first class hons)

1980 Kings College, Cambridge (graduate economics)

1980 Credit trainee and marketing banking products, Chase Manhattan Bank

1984 Executive, marketing and syndicated credits, SG Warburg

1986 Manager, marketing syndicated credits, Swiss Bank Corporation

1989 Director, advised companies on treasury management, Ernst & Young

1991 Head of corporate finance, The Boots Company

2003 Adviser to companies & trustees on pensions, John Ralfe Consulting

Around the same time, Mr Ralfe was co-opted onto a pensions working party set up following a tax change to the taxation of dividends in 1997 and began taking an interest in the Boots pension fund.

It became clear, he says, "that nobody was really managing the Boots pension scheme", from the point of view of the risk it represented to the company in terms of its contribution liability.

There was also no consideration of tax efficiency, with a view to maximising shareholder value.

"The crucial part of the whole process, often forgotten, is the idea that if you reduce risk in the pension scheme you can then increase risk on balance sheet through more debt, which is tax efficient. So the Boots £300m share buyback was always in my mind from the very first day." The buy-back was announced in March 2002.

This is different from the liability-driven investment approach advocated by investment consultants, says Mr Ralfe, where the aim is for assets to match or outperform liabilities. There is no consideration of whether that approach is good or bad for shareholders.

Mr Ralfe's logic has not found favour with other pension schemes. The only other pension scheme to have moved entirely to bonds (95 per cent in index-linked gilts) is that of the Bank of England, which does not have shareholders.

But he may have paved the way for the acceptance of buy-outs as a means for companies to remove pension scheme risk from the balance sheet, where an insurer takes on a pension fund's assets and liabilities.

Mr Ralfe, who was sacked by Boots in 2002, says he has been surprised at the way buy-outs have taken off. "I didn't think you would get enough finance directors to say, we're getting the chequebook out, in order to shift this deficit we have to put in £200m or £500m, or whatever. I just thought that would be too difficult a decision to have to take."

This was based on his own experience of persuading decision-makers at Boots to allow the switch to bonds.

"I knew how difficult it was to get the non-executive directors at Boots to say, we are prepared to do something out of line with what everybody else is doing and will see us being heavily criticised."

He got them there in stages. "The first stage was a move to 50 per cent long-dated matching bonds, and that made it more difficult for [those who objected] to say, this is outrageous, moving from 25 per cent to 50 per cent."

Implementation began in April 2000 and was complete by autumn. Phase two, going to 100 per cent bonds, involved more negotiation with the non-executives, but eventually started in early 2001 and was complete by summer.

Mr Ralfe maintains this step-by-step approach remains a sensible approach to the issue of switching out of equities. He has not changed his mind about the efficacy of such a move, although he acknowledges it is easier to convince directors to start down this path if a pension fund is in surplus (as the Boots scheme was at the time of the switch).

"None of the companies I have been working with have been in surplus. It's about saying, do we feel comfortable with the current position of, say, 80 per cent equities – not really, so let's start to move to 50/50. You don't have to agree an endgame."

As for objections to switching to bonds due to the current low yields on index-linked gilts, Mr Ralfe points out people have been saying yields could not go lower for years, but they have. Quantitative easing is a factor, but the more important driver is demographics, as the baby boomers reach retirement age.

"There is going to be major demand for bonds, especially index-linked bonds, for a long time." Once the DB scheme legacy has gone through the system, which will take another 25 years, demand from individuals will take over. "We are still in the middle of a structural change where the world needs more bonds."

He does not see this structural change as a problem for the economy, opining that if DB schemes switch out of equities, scheme members will adjust their overall portfolio to take account of this.

"The individual should therefore reverse the switch, ie sell bonds and buy equities to restore their preferred equity/bond split."

Does he have any regrets about his role in driving and publicising the Boots move, given that it eventually ended in his dismissal? Of course not, he says: "You have to do the right thing."

RELATED TOPICS Mergers & Acquisitions, Private equity, Pensions crisis

You may be interested in

Equities' value is an irrelevance

SEC takes stricter line on derivatives disclosure

ECB to buy ?40bn in eurozone bonds

Printed from: http://www.ft.com/cms/s/0/d7464f76-064c-11e1-a079-00144feabdc0.html

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© THE FINANCIAL TIMES LTD 2013 FT and 'Financial Times' are trademarks of The Financial Times Ltd.