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Accounting/Actuarial Bias Enables Equity Investment By Defined Benefit Pension Plans

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Abstract

Although pension finance theory says most defined benefit pension plans sponsored by publicly traded corporations should invest entirely in fixed income, 60% of assets are invested in equities. The existing theory makes a strong—but often unstated assumption of transparency, implying that investors view the pension plan as a financial subsidiary of the operating parent and value it as a market portfolio. I explain the equity choice made by managers as a reaction to how investors perceive the opaque standard pension accounting model. Investors view the plan in operating terms

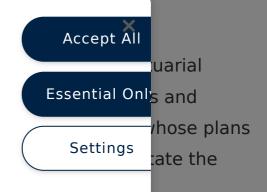
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Under the transparent model, managers who invest in equities may be confronted by arbitrage arguments that show equity investment injures shareholders. Under the opaque model, these arbitrage arguments are not available and managers who invest in equities enjoy premium returns to risk while those who invest in fixed income instruments are punished by higher costs without visible risk reduction.

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