North American Actuarial Journal ›
Volume 9, 2005 - Issue 3

Original Articles

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

Jeremy Gold FSA, PhD

Pages 1-21 | Published online: 03 Jan 2013

Cite this article https://doi.org/10.1080/10920277.2005.10596209

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 and value it based on reported earnings.

Defined benefit pension plans- earnings (expenses) are computed using actuarial methods and economic assumptions that anticipate expected equity returns and strongly dampen the volatility of actual equity returns. Thus, corporations whose plans

invest in equities overstate the financial value of their earnings and understate the volatility of such earnings.

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.