BOOTS' PENSIONS: ONE YEAR ON

JOHN RALFE OF BOOTS PROVIDES AN UPDATE TO THEIR PENSION FUNDS' REVOLUTIONARY SWITCH FROM EQUITIES TO BONDS, ANNOUNCED IN NOVEMBER 2001.

It has been a year since Boots shocked the financial world by announcing its £2.3bn pension scheme – one of the UK's 50 largest, with 72,000 members – had quietly sold all its equities and moved all its assets into long-dated AAA/Aaa sterling bonds. (See *The Treasurer,* December 2001). The *Financial Times* described it as the "most significant event of 2001" and *The Wall Street Journal* Europe as "simple, but revolutionary".

Rejecting the holding of any equities challenges the accepted wisdom of the past 30 years that UK and US company pension funds should hold the bulk of their assets in equities.

Boots' rejection of the cult-of-the-equity was based, unashamedly, on financial economics. The conclusion that pension assets and liabilities should be matched, with UK and US pension funds holding bonds not equities, is standard corporate finance textbook stuff, going back to the late Fischer Black in 1980[1].

Boots recognised that a final salary pension fund is, in economic terms, part of the company. This means that pension fund asset allocation should be managed as part of the company's overall capital structure, not in splendid isolation. Changing a company's capital structure by having more or less debt, does not, absent tax, add value for shareholders (ie Miller and Modigliani).

The increase in shareholder return from gearing is just the return for taking higher financial risk. Holding equities in the pension fund is a form of gearing – any extra return, or reduction in pension cost, is just the return for taking higher financial risk.
The move to bonds has:

- reduced risk for Boots' shareholders and bondholders as the value of pension assets and liabilities now move in tandem, reducing the risk of a future pension deficit, requiring higher company contributions;
- reduced risk for the 72,000 Boots pension scheme members as they are no longer reliant on the performance of equities for their pensions. The investment objective of the trustees is to "ensure that the value of scheme assets is always enough to pay all pensions, regardless of movements in financial markets." Against headlines of "pension crisis", the reaction of Boots' members has been very positive;
- locked-in a surplus by selling equities during 2000 and 2001, which has fixed future contributions at their current level in real terms; and
- slashed fees and dealing costs from £10m to only £300,000 a year. The bonds are held with no trading and with automatic re-investment of net income.

SO, WHAT IT WAS NOT ABOUT? People have suggested conventional explanations for the move, none of which apply.

- **The Boots Scheme is neither closed nor very mature.** The Scheme remains open, although new employees join a defined contribution starter scheme for five years. Half of the members are current employees. Company and member contributions of about £75m a year just about match pensions payable.
- **The Boots Scheme in not large in relation to the Company.** The £2.4bn Boots Scheme is now almost a half of Boots market capitalisation. Although this is higher than the FTSE 100 average, many individual companies have schemes which are much larger in relation to the company, with some schemes being larger than the company itself.
- **Boots was not driven by FRS 17.** Although Boots has publicly supported FRS 17 for its consistency and transparency, we were not driven by FRS 17, since any new accounting does not change the underlying economics. FRS 17 allows people to see the reduction in risk by moving to matching bonds.
- **Boots was not taking a view that the equity market would fall.** With hindsight the timing of equity sales in 2000 and 2001 was good, but the move was not about outguessing the market . In May 2000, at the beginning of the transition process, Boots, and many other funds, had a pension surplus - by starting to move to bonds we were happy to lock in this surplus and guarantee the funding position.

WHAT HAS HAPPENED OVER THE LAST YEAR?

- **The value of assets has increased.** From April 2001 to 2002, the value of Boots Scheme assets increased from £2.3bn to £2.4bn, with falling yields on AAA bonds. The April 2001 actuarial valuation showed the Scheme was able to meet all members' accrued pension rights and the fund actuaries have confirmed that this remains the position at April 2002. However, the value of liabilities has also risen, so the surplus remains largely unchanged. John Watson, the

Chairman of Pension Trustees, commented in the 2002 Trustee Review: "If the Boots Scheme had not sold its equities during 2000 and 2001, when the FTSE 100 share index averaged 6,000, there would now be a significant deficit."

- **The inflation-linked position has increased.** The Boots' Pension Scheme guarantees increases in line with the retail price index (RPI), up to 5% a year, so the best asset match is a mixture of fixed rate and RPI bonds. Since the Scheme had only 25% of inflation-linked assets at the end of the transition it remained exposed to significant increases in inflation. Over the past year the Scheme has been able to increase its inflation linked assets to almost 50% through interest rate swaps, with maturities from 2014 to 2030. Under these swaps the Scheme makes fixed payments to the bank from its fixed rate bonds and in return receives amounts indexed in line with inflation. The ISDA agreements have a cash collateral arrangement to minimise credit risk for the Scheme. Some of the swaps are straight RPI, while some have a cap or collar.
- **The company has completed a share buyback.** The Boots Company itself has completed a £300m share buyback, made possible by moving to matching bonds. Reducing risk "off balance sheet" in the pension fund has allowed Boots to increase risk "on balance sheet" Because the credit rating agencies recognised the reduction of risk in the pension fund, this share buyback was possible without weakening the current credit rating.

SO WHAT? The Boots move has reminded people of a self-evident truth which has been forgotten over the last few years – "The pension fund's job is to pay pensions." In conventional terms, asset allocation is driven by the nature and risk of the pension liabilities – the maturity of the fund, the size of the fund versus the size of the sponsoring company, the strength or creditworthiness of the sponsor – and the level of surplus or deficit in the fund.

The world has also been brutally reminded that equities are not a one-way bet. When equity markets were rising inexorably it was easy to ignore those people challenging the cult of the equity. World equity markets at current levels concentrate minds wonderfully – the same value as five years ago, more than 35% off their peak. From today's current absolute levels the equity market could go up or it could go down, just like flipping the coin. Meanwhile, pension liabilities have increased substantially over five years, with falling long-term interest rates.

All UK companies have reported under the first stage of FRS 17 over the last year, with many showing deficits. The aggregate shortfall in UK pension funds, including local authorities, has been estimated at £100bn. Shareholders and the credit rating agencies are starting to ask questions.

The UK pensions world is in a period of major transition. Several funds have made a 10% or 20% shift from equities to bonds and are well below the average of 75% equities. Rumour suggests others are still in the transition process.

Even if UK pension funds seek only to match no more their pensioners and deferred pensioners with long-dated bonds the amounts involved and the implications are profound.

The challenge to the cult of the equity is starting to gain ground in the US – final salary pension schemes are similar to the UK, but where pension funds start from a lower percentage of assets in equities. Underfunding and mismatch by some US companies has been key contributory factor in recent Chapter 11s. Any move by US pension funds from equities to matching bonds would lead to structural change on global scale, dwarfing anything we have seen or are likely to see this side of the pond.*

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*Any views in this article are expressed in a personal capacity.

Note

[1] See Black, F. (1980), The tax consequences of long-run pension policy, Financial Analysts Journal