



WHAT ROLE NOW FOR IRISH EQUITIES IN PENSION FUNDS?

By Frank O'Brien

Irish equities have been the cornerstone of Irish Pension Fund Investment Strategy for many years. Before the introduction of the euro, the Irish equity market was the only equity market which pension funds could access on a currency-risk free basis. Not surprisingly, Irish equities were an enormously important asset category at that time.

As the table shows (page 13.), Irish equities accounted for 26% of total pension fund assets at end 1998.

In a number of respects this level of exposure to a relatively small, highly concentrated market was uncomfortable. For example, the weightings of the five largest companies in the Irish Index (Iseq) implied average pension fund exposure (table 2, page 13.)

The advent of the Euro saw Irish person funds prudently avail of the opportunity to geographically diversify their equity portfolios as they could now access Eurozone equities on a currency-risk free basis. Exposure to Irish equities by end December 2006 had been reduced to 11% whilst exposure to Eurozone equities increased significantly from 7.9% at end 1998 to 17.5% at the end of last year.

EQUITY MARKET RETURNS

This strategy of diversification operated against an environment of dramatic upheaval in equity markets generally and continuing strong growth in the Irish economy. The technology bubble peaked in Market 2000

and instigated a dramatic bear market in equities. From 31st December 1999 to 31st December 2002 the Irish equity market fell by just under 20% in capital terms. However international equity markets suffered far more. The MSCI World Index fell by 44% (in dollars capital only) whilst the MSCI Europe ex UK fell by 48%, (in euros, capital only). The outperformance of the Irish market during this period was largely attributable to the "old economy" nature of the domestic market and to its relatively modest exposure to the overheated "Technology, Media, Telecoms" sectors.

The period end December 2002 to end December 2006 captures most of the upleg of the recent bull market. Over this period, the Irish market again performed exceptionally well with a gain of 136% in capital terms. This compares with a capital gain in the MSI World (Dollars) of 87% and the MSCI Europe ex UK of 93% (Euros). This outperformance is testimony to the benefit enjoyed by Irish companies from the strong Irish economy.

The sustained outperformance of the Irish market over this prolonged period indicates that Irish pension funds paid a high price for the broader diversification put in place post euro.

The significant role allocated to Irish equities in Irish pension fund strategy rested largely on the view;

- That there is a linkage between, on the one hand, growth in the Irish economy, growth in profits and earnings and growth

in share prices and, on the other, growth in the economy, growth in wages and growth in pensions;

- That Irish share prices, albeit reliant to a significant degree on overseas profits, were nevertheless heavily influenced by Irish inflation and by Irish interest rates and;
- That the superior growth rate of the Irish economy vis-a-vis its European counterparts made Irish equities in exceptionally fertile environment for profits growth.

There is little doubt that these justifications for Irish equity exposure have been diluted in recent years. The "classical linkage" has been undermined by the rising share of international profits in the overall profit mix as Irish companies continue with the overseas expansion that first got seriously underway in the 1980's. Equally corrosive of the classical linkage has been the reduction in emphasis on the long term dimension of pension funds and the increasing focus placed by trustees on short-term factors such as IAS 19 and the Funding Standard.

The rationale that Irish interest rates help to determine Irish share prices has been weakened, but not removed by the introduction of the euro. Irish interest rates are now centrally determined by the ECB which is far more concerned with economic developments in Germany and France than with Ireland.

Finally, the super-growth phase of the Celtic Tiger is now behind us. Indeed Irish economic growth rates have been flattered in recent years by the boom in residential house building. This traditionally volatile and cyclical sector is now poised to sharply reverse its contribution to domestic economic growth.

Nevertheless, while the case for a continuing role for Irish equities within pension fund asset mixes has weakened, it still retains a certain validity. Irish equities, because of their domestic profits content, are a better match for long term pension fund liabilities than any similarly international equity market. Similarly Irish companies are more sensitive to Irish inflation than their international peers. Thirdly, the long term prognosis for superior Irish economic

and profits growth is good given our more favourable demographic profile.

Meanwhile, a number of the long term attractions of the Irish equity market remain intact:

- The highly diversified profits base of the quoted corporate sector, whilst it has eroded the “classical linkage”, is a real strength.
- Ireland’s low corporation tax rate continues to represent a significant competitive advantage.
- Irish management is strong, experienced, outward looking and, importantly, much more focused on shareholder value than many of their European counterparts.
- The Irish workforce is young, educated and substantially more flexible than those of our larger European competitors.

On the other hand, those long established characteristics which argue for a low exposure to Irish equities are still in place. The Irish equity market, like its host domestic economy is small by international standards. Market capitalisation is currently some €96 billion. The market thus constitutes a relatively small proportion of the international equity indices. For example Ireland accounts for just 0.3% and 1.4% of the MSCI World and the MSCI Europe indices respectively. Nevertheless, liquidity in the domestic market has improved in recent years. Annualised turnover of the top ten stocks is about 200%.

CONCENTRATED

The market is highly concentrated. The top five stocks account for some 60% of total capitalisation, the top ten for some 80%. Stock specific risk, therefore, for the typical Irish pension fund is still reasonably high. Exposure to Irish equities of 11% implies holdings as a percentage of total fund in the leading stocks (see table 3.)

Sectoral distribution across the market is also quite concentrated. The financials sector accounts for some 42% of the total Irish market, compared for example with 26% in the FTSE, the UK index which is often regarded as highly exposed to financials. Building and Construction companies account for just under 20% of the total capitalisation of the Irish equity market.

Improved diversification finally paid off for pension funds this year as the Irish equity market suffered a dramatic decline, falling

Table 1. Irish Pension Fund Equity Exposures

	1991	1998	1999	2005	2006
Ireland	24.2	25.9	18.8	11.4	11.0
Eurozone Ex Ireland	5.4	7.9	14.6	17.4	17.5
International	22.6	24.6	30.9	36.2	34.9
Total Equities	52.2	58.4	64.3	65.0	63.4

Source: I.A.P.F. Asset Allocation Survey

Table 2. Stock Exposures at 31st December 1998

	Market Weight	Fund Exposure
AIB	20.5%	5.31%
Bank of Ireland	16.6%	4.30%
Elan	14.1%	3.65%
CRH	9.1%	2.36%
Irish Life	4.2%	1.09%

Table 3: Stock Exposures Now

	Market Weight	Fund Exposure
AIB	15.4%	1.69%
CRH	16.6%	1.83%
Bank of Ireland	12.5%	1.38%
Ryanair	8.0%	0.88%
Anglo Irish Bank	10.2%	1.12%

far more than its international counterparts, as concerns mounted over the near-term outlook for building and construction and its knock-on impacted on bank profitability.

Markets everywhere have been inspected by the turmoil in credit markets but the concerns specific to Ireland have seriously undermined investors sentiment in Irish equities. Year to date, to end November 2007, the Irish equity market has fallen by 26%. This compares to gains (in local currency) of 3% in the US 17% in Germany and 1% in France. The FTSE Euro first 100 Index is up 1.4% capital terms. Even though average pension fund exposure to Ireland had fallen to 11% at the beginning of this year, the sharp shake-out in the domestic market will make a serious dent in 2007 returns.

IRISH EXPOSURE NOW?

The poor 2007 out-turn is likely to spark much heart searching by trustees on the appropriate role of Irish equities in the future. Already there are calls for a reduction of Irish equity exposure to its weight in the Europe ex UK index.

I would caution against precipitative action. The 1999-2006 outcome surely argues

that trustees adopt a comprehensive and pragmatic approach.

As discussed, there are still solid theoretical and fundamental grounds for maintaining Irish equity exposure at well above the levels implied by mechanical benchmark levels. Secondly, trustees should heed the advice of Warren Buffett, “invest in companies you know”. Thirdly, and this is where pragmatism may be timely, it makes little sense to sell quality Irish companies at depressed levels. We should bear in mind also that leading edge thinking in pension funds argues that active investment management should be benchmark unconstrained and measured over longer time periods.

The debate between the “benchmark-driven” and the “Irish market loyalists” will be interesting and quite intense over the next few months. I look forward to it but, at the end of the day, I expect Irish exposure to settle not far below current levels.

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