SUPERANNUATION, LIFE OFFICES AND INFLATION – the failure of the investment system

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INTRODUCTION

Superannuation funds, life offices and other forms of long term saving are facing great difficulties. By 1974 the distress of long term saving and the impact of inflation were manifest. Life insurance policies, affected already by increases in life office taxation, were failing to provide a store of value in the face of rapid inflation. Companies were watching nervously as the value of the assets in their final salary superannuation plans sagged and the liabilities soared.

In 1975 alarums and excursions abound: life offices defend against this threat and that; slightly dazed investment managers look for new strategies; warnings spread about the advance in liabilities of final salary superannuation plans; and calculation rituals, such as investment performance comparisons, gather new adherents.

Of course there are those exceptional investment managers who not only know that the key to good investment results is investment timing, but also seem able to move short or long, or from equity to fixed and vice versa, at the right time. For them, present troubles provide a new range of opportunities to earn good results. For most funds, however, rapid inflation means massive depreciation in asset values (in response to higher interest rates and private sector difficulties) and the prospect of negative real rates of investment return on those depreciated asset values.

The failure of the conventional wisdoms concerning investment is at the heart of the threats facing superannuation and life insurance. Yet the desperately urgent jobs of providing new types of asset for long term saving and reassessing the capabilities of investment seem to receive little constructive public attention.

This article has been written to give the distress of long term saving some attention and to advance the discussion of the possible solutions to the difficulties. Before turning to a discussion of how to repair the investment system it is necessary to consider for a moment the liabilities side of the coin, which has already been given most of the public attention. Concern, understandably, is widespread about final salary superannuation plans.

Some companies are asking their actuaries to ensure that the necessary safeguards are present, to instal new safeguards and even to instal new types of plan. It was this concern which intensified the reaction of the private sector to the much publicised improvements to the superannuation benefits of Australian Government employees.

Concern arises, however, not because the liabilities are inappropriate, but because long term saving cannot at present be protected against inflation and maintained in real terms.

In other words, the level of inflation does not change the need to provide reasonable superannuation relative to a person's standard of living before retirement, but a high level of inflation does render the assets of long term saving incapable of doing the job.

Likewise, inflation does not remove the need for long term saving through life offices, but rather it prevents the assets from generating sufficient savings in real terms. The central problem with life offices and with superannuation is not their objectives, but the assets available to achieve them.

THE EXISTING SYSTEM

When I refer to the problem with the investment system, I am not really referring to the present fall in market values. Rather I am concerned about the permanent effects of a wobble in the system. Suppose we suffer an 8-year bout of 20% inflation, at the end of which the economy returns to normal and market values recover, showing an investment return on a superannuation fund over the period of 10% p.a. If that fund were <u>fully</u> adequate to support benefits at the start of the period without further contributions, then it would be only <u>half</u> adequate at the end of the period. The wobble would have wiped out half the fund in real terms. Actual funds are, of course, somewhere between this position and the position of a fund commencing at the end of the period (which would be unaffected by the wobble) and the extent of the damage depends on how large the fund was relative to the value of benefits. The system cannot stand too many wobbles of this amplitude, or even the prospect of such wobbles.

The conventional wisdom held that real assets, such as ordinary shares and property ownership, would retain their value in real terms. This, by and large, was true in the past and until recently there were no indications to suggest that it would not hold in future, although it was recognised that it might not hold over short periods.

The so-called wisdom thrived on the mood of optimism surrounding corporate prospects which characterised the sixties. By the time the mood changed and a more realistic assessment was made, share prices had been pushed up to unrealistically high levels.

Even when investors were optimistic, companies were far from maintaining their earnings in real terms. Without the recognition of proper inflation accounting techniques, most companies typically overstated real earnings, set prices too low and, to make matters worse, were charged tax on profits which had not really been earned. When the inevitable shake-out arrived, the conventional wisdom was discredited.

With property investment the conventional wisdom lives on to some extent, apparently because values (if not incomes) are so sluggish in response to changes in supply and demand. As with investment in ordinary shares, investment in property depends for its success on a healthy private sector. The experience with shares should serve as a cautionary tale for property investors.

Of course present events may be little more than a wobble in the system, as far as real assets are concerned, with a shake-out for over-enthusiastic investors being a necessary part of the recovery. With intelligent investment timing, owning real assets (purchased at the right price) may once again maintain the real value of savings, provided there is an early return to adequate real, after-tax profitability of the private sector.

Even if this is the case, however, saving is more than owning real assets – it is also investing in government securities, company debentures, mortgages on real estate and other forms of loan capital. These assets were not designed to cope with inflation as a widely fluctuating variable in the economic system. It is here that we face fundamental problems crucial to the survival of long term saving.

Inflation plays havoc with fixed interest assets. When inflation was modest and seemingly predictable, allowance for inflation could be built into interest rates. When inflation is variable and uncertain it cannot be built into long term interest rates.

The main components of an interest rate are:–

(a) an underlying real interest rate;
(b) a premium for investment risk; and
(c) a component equal to the expected rate of inflation over the term of the loan.

If there is no reasonable confidence in any estimate of the inflation component, only short term fixed interest transactions are acceptable and longer term transactions are subject to floating interest rates.

MODIFYING THE EXISTING SYSTEM

The more direct solution to coping with a variable inflation component is to omit it from the interest rate and instead to adjust regularly the investor's capital in line with an appropriate indicator, such as the consumer price index.

Thus if inflation were 10% p.a., the real rate of return 2½% and the premium for investment risk nil, the conventional approach is to lend $100, charge $12.50 interest at the end of a year and have $100 outstanding at that time; whereas the indexed approach would involve charging $2.50 interest at the end of a year and then have $110 outstanding. At the end of the second year, the interest and the new loan outstanding are based on the loan outstanding at the end of the previous year, and so on.

Such an indexed investment is similar to a floating interest rate investment and would hold its value in real terms in spite of changes in inflation, whereas a fixed interest investment changes in value as interest levels move in response to inflation.

Furthermore the shift of the inflation component out of interest rates overcomes some serious difficulties which are inherent in the conventional approach, particularly in the politically sensitive area of housing finance.

To illustrate this latter point consider a borrower who earns $7,000 per annum before tax and who borrows $20,000, repayable over 30 years by level instalments of principal and interest. If the interest rate is 1% p.a. the repayment in the first year is 11% of the borrower's gross income, whereas at rates of interest of 6%, 11% and 16% respectively the repayment absorbs 21%, 33% and 46% respectively of gross income in the first year! In subsequent years a lower proportion is absorbed as the borrower's income rises.

If, however, the borrower were given an indexed loan at a rate of interest of 1% (with capital outstanding and hence repayments being index-linked), the repayments would absorb a constant 11% of his gross income (assuming it also increased in step with the index), regardless of the rate of inflation!

It is clear that the incorporation of an inflationary element in interest rates combined with the system of level repayments can, in inflationary conditions, place enormous strain on a borrower's resources.

Quite apart from disrupting the housing industry, the existence of this politically sensitive effect acts to prevent all interest rates finding their natural level and helps produce present negative real rates of interest. The indexed approach overcomes this difficulty. It is however essential that borrowers clearly understand that repayments and principal outstanding are indexed.

Indexed mortgages are simply one possible form of indexed investments, along with indexed government securities and indexed company debentures. It is time to explore thoroughly the implications of introducing indexed securities. The alternative to indexation of capital is a degeneration of loan markets into totally short term finance. It will be a long time before investors trust arrangements which assume that the rate of inflation will be predictable in other than the short run.

Except in the case of superannuation funds (which are tax exempt), the taxation of conventional fixed interest investments is a further powerful reason not to save. The effect of incorporating an inflationary element in interest rates is that an item of capital is being taxed as income. It is clearer under an indexed investment that the regular accretions of capital should not be taxed, because they are merely maintaining the value of the capital in real terms. Only the interest under such an arrangement represents a real return on capital and it alone should be taxed.

The effective survival of long term saving probably depends on two innovations:–

(1) the introduction of indexed arrangements; and
(2) the taxation of only the interest under these arrangements.

Inflexible types of asset (such as fixed interest securities) and non-income taxes (such as taxes on capital accretions which merely compensate for inflation) will continue to discourage long term saving to the point of extinction.

Why then does the financial community regard indexed securities with such caution and suspicion? Why is there not a massive groundswell of financial opinion calling for the rescue of long term saving? The answer lies in the arguments against indexation, which show that the process of reform is highly complex.

DIFFICULTIES IN MODIFYING THE EXISTING SYSTEM

There are four main arguments against the introduction of indexed securities, namely:–

(a) the primary task is to control inflation and not to adapt to it;
(b) if indexed government securities were introduced, the share-market would receive much diminished support as an avenue of investment;
(c) if companies were forced to borrow on index-linked terms their ability to earn an adequate return on shareholders funds would be greatly reduced; and
(d) just as tax indexation restricts the scope of fiscal policy, so also investment indexation restricts the scope of monetary policy.

The first objection is strongly held by many people. However it is not possible to systematically subsidise consumption (by not giving inflation proofed returns on saving) without causing a shift from saving and both short run dislocations and long run structural changes in the economy. It is just as important to have the correct relationships between parts of the system as it is to control inflation. If inflation has become variable in the system we need not only to control it, but also to moderate the inequities between different groups in the community caused by variations in the rate of inflation, even if doing this makes inflation harder to control.

The second objection, if it is true, is partly a reflection of the run-down of the private sector, which should be urgently remedied, and perhaps partly an indication that ordinary shares, even now, are overpriced. The sharemarket may indeed find a new lower level with the advent of index-linked government securities, and this may shake confidence and hence diminish its role. It would be important therefore to have well-designed transitional arrangements. Transitional arrangements, however, are very difficult to make work smoothly.

The third objection is an indication that companies desperately need to be allowed to adjust their pricing methods, their methods of measuring earnings and their taxation liabilities to cope with the impact of inflation. Without these reforms they will not have expectations of earning an adequate profit in real terms. In any case lenders will not continue indefinitely to subsidise borrowers and even without indexation companies will eventually be faced with exactly the same problem, by being forced more and more to borrow on a very short term basis at interest rates reflecting actual inflation.

The final objection shows that whereas Government co-operation is essential for indexation of investment to succeed, such co-operation would not be easily forthcoming. Just as fiscal policy would need to work with real rates of taxation, monetary policy would have to work, inter alia, with real rates of interest.

The introduction of indexed securities clearly cannot proceed without the revival of the private sector, the reform of company taxation, the use of inflation accounting, the freedom to adopt proper pricing policies, and the freedom from tax of indexed capital accretions. It is a forbidding total task. Unless it is tackled, however, capital markets will degenerate and long term saving will rapidly go out of style.

It is now time to begin the public debate on the central issue – can the investment system work with inflation as a variable in the system.

Whatever is done two things are certain – the task is urgent and the task is extraordinarily complex.

By a nice piece of irony which helps show how complex the world now is, the task of reform of the investment system has the political advantage of being also a piece of social reform. It would profoundly benefit not the capitalist entrepreneur, but the millions of members of superannuation and life assurance funds.

The Australian Government has an alternative approach to social reform in this area. Rather than necessarily repairing the investment system, it seems likely to provide massive partial substitutes for it, in the form of unfunded, index-linked social programs meeting long term savings needs. But this is another subject, with important implications for the private sector. Rather than explore this subject it is useful to consider the possible future of one form of long-term saving, namely superannuation.

SUPERANNUATION IN THE FUTURE

If the existing investment system is not repaired to cope with inflation as a significant variable in the economic system, it is likely that sooner or later funding will give way to new mechanisms for providing superannuation. The trigger for the change would be a widespread limiting of benefits by employers in response to continuation of the present bout of inflation, or to some future bout or to the gradual failure of the investment system.

Consider for a moment the shape of the future. Projecting trends in society into the future is a current fad, but if the future comes as much by design as by chance it is also a worthwhile science. Social scientists working in this field have projected three futures for society in or about the year 2000:–

- The politicised society – the state has emerged as the one and only institution with the power to handle problems.
- The post-industrial society – knowledge industries dominated by intellectuals have replaced corporations as the primary institutions of society.
- The corporate society – corporations have come to dominate society within a democratic framework by acquiring a high sense of social responsibility.

Each of these futures is profoundly different from the present and from each other. The politicised society and the post-industrial society are bleak places, symptomatic of a civilisation deep into its decline. Only the corporate society, built on social responsibility, is consistent with a civilisation still in its stage of growth.

What does this have to do with superannuation? Simply this – the way in which we attempt to solve the present difficulties in this significant area tells us something about the direction of our future.

Briefly, there are four paths for superannuation at this crossroads in our civilisation and each helps take us to a different future. Firstly, the existing investment system can be repaired, with indexed investments being introduced once the necessary pre-condition of a healthy private sector has been met. This helps maintain present society and increases the chances of achieving the corporate society. Secondly, there can be greatly increased and even total reliance on National Superannuation. This helps move us towards the politicised society. Thirdly, neither Government nor the private sector need do anything. This helps move us towards the post-industrial society with all kinds of frightening possibilities concerning the problem of the retired, such as the use of cost-benefit indexes to decide whether a life can continue. Finally, the private sector can provide adequate superannuation based on a different form of security to the conventional external fund. This helps move us towards a form of the corporate society in which there are no significant long term financial intermediaries and in which capital formation relies upon the banking system and the internal resources of companies.

Let me make the central message of this discussion of the future perfectly clear, lest it be lost in obscurities about hypothetical societies in the year 2000. What I am really saying is this – if the present investment system fails, then unless the private sector in Australia finds a socially responsible alternative to wholesale limitation of superannuation benefits, the private sector as we know it is greatly increasing the probability that it will have a minor role in Australian society in the 21st century.

As the repair of the investment system has already been discussed and as paths to the politicised society and the post-industrial society hold no attractions for me, let us look along the final path, towards one form of the corporate society.

SUPERANNUATION IN THE CORPORATE SOCIETY

A superannuation model for the corporate society which does not involve an investment system already exists, in France. Following a prolonged bout of inflation from 1938 to 1958 at a similar level to that currently being experienced in Australia, the great mass of workers in France completely lost confidence in the traditional concept of providing for their security in old age through pensions expressed in currency and backed up by investment funds also expressed in currency. Searching for a more realistic and reliable basis of security, with a better chance of survival in the long run, the French worker elected to place his trust in a broad social group, including both active workers and old persons, the solidarity and inner loyalty of which would offer the hope of a more durable assurance of help and protection in old age.

A transfer payment based on a collective guarantee, with each generation within a broad group formally committed to support the former generation, has therefore largely been substituted for prefunding through the accumulation of funds which rely upon the proper functioning of the investment system.

The broad groups are set up by agreement between groups of workers and groups of employers, with contributions by both parties. The system calls for medium to long term balancing of inflows and outflows and actuarially is just as sophisticated as a funding system. In immature groups where there would be a substantial excess of income over pension payments, the solution is to charge the company contributions, but not collect them until they are needed thus leaving them with the company in the meantime. It is a remarkable system, which at first sight one would not expect to work and which one might expect to starve France of funds for capital investment. On this last point, precautionary and other short term savings through the banking system, retained earnings in companies and investment from the United States have kept funds for capital investment flowing.

The importance of the French system lies in the fact that it was sought by the workers and granted by the employers in order to give adequate superannuation in spite of the failure of the investment system. It is indeed the solution of the corporate society. In Australia, however, introduction of such a system would be an achievement attended by horrific structural changes for long term savings institutions.

CONCLUSION

Where do we go from here? What I have discussed is not a matter of day to day detail of the sort with which we all are continually overwhelmed. It is a matter of grand strategy which will affect all our futures.

As I see it, there is only one attractive option – to repair the investment system. If this cannot be done there is again only one attractive option – to replace the investment system with some other means of securing superannuation.