

BRUNEL UNIVERSITY
Economics and Finance

EC1004 LECTURE 8

Institutional Investors

Reading: Madura Chapters 27, 24, 26

Institutional investors – pension funds, mutual funds and life insurance companies - are the main players in securities investment in most countries. In this lecture we will introduce institutional investors as financial institutions and the reasons for their growth and development.

A definition of institutional investors is: “specialised financial intermediaries managing saving collectively on behalf of small investors towards specific objectives in terms of risk, return and maturity of claims”

1 Why are institutional investors important?

- institutions’ growing dominance of the financial system and markets
- main players in securities investment
- illustrate all principles necessary for understanding securities investment
- careers in financial services are either in or dealing with institutional investors

2 Features of institutional investors

Risk pooling/diversification – institutions get a better trade off of risk and return than is possible by direct holdings

Long term liabilities such as pensions and scope for matching – so they can hold high risk and high return instruments such as shares. They are not subject to “runs” unlike banks (due to asset/liability mismatch)

Size – economies of scale lower average costs of investment, for the following reasons:

- Sharing skills of expert managers
- Larger volume of transactions giving lower commission charges.
- Ability to invest in large indivisible assets such as office blocks.
- Countervailing power – ability to take action/retaliate after bad treatment means they can ensure fair treatment by capital market intermediaries and better control over the companies they invest in.
- Ability to offer insurance by pooling individual risks.

Liquidity preference – they prefer large and liquid capital markets so they can readily adjust their positions. This is a contrast to banks who are content to hold illiquid loans.

Information – they have access to better information than individual investors, and more resources to process publicly available information.

3 The nature of institutional asset management

We must distinguish between **asset management** (service involving management of an investment portfolio on behalf of others) versus **institutional investment** (asset holder which may be distinct from the asset manager). So for example the Universities pension fund (institutional investor) may either manage its own funds (internal asset manager), or employ Merrill Lynch (external asset manager) to manage part or all of its portfolio

Fiduciary role – institutions are acting on behalf of others and not themselves, e.g. pension fund member

“Principal-agent” problems – if the asset manager is not monitored properly, they may act in their own interests and contrary to those of investors

Herding? – contracts for asset management involve regular performance checks, which may lead all asset managers to invest in the same way, destabilizing the capital market.

4 The size of institutional sectors

Their size and growing importance justifies a focus on institutional investors. We shall see that institutions become more important as countries’ financial systems become more sophisticated.

There are also key cross-country contrasts in financial structure – overall trends are common across countries but stylised differences remain. Notably, we see that financial sectors are larger and also institutional investors in the UK, US and Canada (Anglo Saxon countries) rather than in France, Germany, Italy and Japan (Europe and Japan).

SIZE INDICATOR OF FINANCIAL STRUCTURE (TOTAL FINANCIAL CLAIMS AS A PROPORTION OF GDP)

	1970	1980	1990	2000	Change 1970–2000
UK	4.7	4.9	8.9	11.0	6.2
UK excluding Euromarkets	4.7	4.2	7.9	9.7	5.0
US	4.1	4.1	5.9	8.4	4.4
Germany	2.9	3.6	4.7	7.9	5.0
Japan	3.8	5.1	8.5	11.9	8.1
Canada	4.7	5.1	5.8	6.6	2.0
France	4.4	4.8	6.9	11.4	7.0
Italy	3.4	3.9	4.3	7.1	3.7
G7	4.0	4.4	6.3	9.0	5.0

We see growth in the financial superstructure (financial deepening) with economic development and growth of income and wealth.

FINANCIAL INTERMEDIATION RATIOS (INTERMEDIATED CLAIMS AS A PROPORTION OF THE TOTAL)

	1970	1980	1990	2000	Change 1970–2000
UK	0.32	0.42	0.47	0.58	0.26
UK excluding Euromarkets	0.32	0.34	0.40	0.52	0.20
US	0.33	0.37	0.34	0.44	0.11
Germany	0.44	0.45	0.43	0.45	0.01
Japan	0.39	0.42	0.42	0.52	0.14
Canada	0.29	0.34	0.37	0.47	0.18
France	0.34	0.62	0.41	0.39	0.05
Italy	0.36	0.32	0.31	0.35	-0.01
G-7	0.35	0.41	0.38	0.45	0.10

Within the total, there is a rise in intermediation, i.e. in claims that are not direct claims of the non-financial sector on itself (e.g. household holding company shares or government bonds)

**BANK AND INSTITUTIONAL INTERMEDIATION RATIOS (PROPORTION OF
INTERMEDIATED CLAIMS HELD BY BANKS AND INSTITUTIONAL INVESTORS)**

		1970	1980	1990	2000	Change 1970–2000
UK	Bank	0.58	0.64	0.55	0.44	-0.13
	Institutional	0.28	0.26	0.32	0.38	0.10
United States	Bank	0.58	0.58	0.42	0.21	-0.37
	Institutional	0.31	0.31	0.40	0.44	0.13
Germany	Bank	0.84	0.86	0.83	0.73	-0.12
	Institutional	0.10	0.12	0.17	0.23	0.14
Japan	Bank	0.45	0.36	0.38	0.24	-0.21
	Institutional	0.10	0.10	0.16	0.17	0.06
Canada	Bank	0.45	0.55	0.44	0.38	-0.07
	Institutional	0.23	0.19	0.25	0.35	0.12
France	Bank	0.94	0.68	0.82	0.65	-0.29
	Institutional	0.05	0.04	0.19	0.46	0.41
Italy	Bank	0.98	0.98	0.95	0.64	-0.34
	Institutional	0.06	0.05	0.11	0.31	0.25
G7	Bank	0.69	0.66	0.63	0.47	-0.22
	Institutional	0.16	0.15	0.23	0.33	0.17
Anglo-Saxon	Bank	0.53	0.59	0.47	0.34	-0.19
	Institutional	0.28	0.25	0.32	0.39	0.12
Europe and Japan	Bank	0.80	0.72	0.74	0.56	-0.24
	Institutional	0.08	0.08	0.16	0.29	0.21

There is a reduction in the scope of bank intermediation as institutional investors have grown. Banks are still very important.

INSTITUTIONAL INVESTOR CLAIMS AS A PROPORTION OF GDP

	1970	1980	1990	2000	Change 1970–2000
United Kingdom	0.42	0.37	1.02	1.93	1.51
United States	0.41	0.47	0.79	1.62	1.21
Germany	0.12	0.20	0.33	0.84	0.71
Japan	0.15	0.21	0.58	1.03	0.88
Canada	0.32	0.32	0.52	1.10	0.79
France	0.07	0.12	0.52	1.20	1.13
Italy	0.07	0.06	0.15	0.76	0.69
G7	0.23	0.25	0.56	1.33	1.11
Anglo-Saxon	0.39	0.39	0.78	1.55	1.17
Europe and Japan	0.11	0.15	0.40	0.96	0.85

Institutional claims are growing much faster than GDP. The US and UK sectors are much larger than the others, may show future pattern for them.

5 The main types of institutional investor

Institutions are not homogeneous – differ in terms of the contractual relations of investors to managers in terms of distribution of return and risk, and definition of liabilities

- **Pension funds** – involved in pooling and investment of funds contributed by sponsors and members for future pensions. 2 types (1) defined benefit, pension based on final salary (2) defined contribution, pension based on accumulated investments
- **Insurance companies** – life insurance (insurance against risk of death, and also form of saving) and non-life (insurance against accidents etc.)
- **Mutual funds (unit trusts)** – form of saving which are vehicles for pooling of assets to get a better risk/return trade-off. Individual investor chooses the type of asset they invest in and is free to buy or sell at current market prices.

INSTITUTIONAL INVESTMENT, 1998

	Life Insurance		Pension Funds		Mutual Funds		Total	
	(\$bn)	% of GDP	(\$bn)	% of GDP	(\$bn)	% of GDP	(\$bn)	% of GDP
UK	1294	93	1163	83	284	20	2742	197
US	2770	33	7110	84	5087	60	14,967	176
Ger-many	531	24	72	3	195	9	798	35
Japan	1666	39	688	16	372	9	2727	63
Canada	141	24	277	47	197	34	615	105
France	658	43	91	6	624	41	1373	90
Italy	151	12	77	6	436	35	664	54
G-7	7212		9479		7195		23,886	

The UK institutional sector features very large life insurers and pension funds, while that in the US is dominated by pension funds and mutual funds. Elsewhere, pension funds are small. Note that the total size of institutions (\$24 trillion) is comparable with world equities (\$30 trillion) and world bonds (\$25 trillion)

The locus of risk bearing and nature of regulation

In defined benefit pensions and life insurance, there are guarantees by the institution for a fixed return (e.g. a pension equal to a given proportion of final salary). These mean the institution itself bears some risk of bankruptcy, and they are regulated quite strictly. The “deficits” in UK pension funds are a current example of difficulties that can arise.

Guarantees are absent in defined contribution pensions and mutual funds. The household investor bears the risk. If the stock market collapses just before you retire, you get a very low pension.

Pension funds hold more equities, insurance companies more bonds, reflecting liabilities. All institutions hold less deposits than households do, as they do not need liquid assets for daily spending. There are large cross-country differences in asset composition.

PENSION FUNDS' PORTFOLIO COMPOSITION, 1998

percent	Liquidity	Loans	Domestic Bonds	Domestic Equities	Property	Foreign Assets
UK	4	0	14	52	3	18
US	4	1	21	53E	0	11E
Germany	0	33	43	10	7	7
Japan	5	14	34	23	0	18
Canada	5	3	38	27	3	15
France	0	18	65	10	2	5
Italy	0	1	35	16	48	0

LIFE INSURERS' PORTFOLIO COMPOSITION, 1998

Percent	Liquidity	Loans	Domestic Bonds	Domestic Equities	Property	Foreign Assets
UK	5	1	25	48	6	13
US	6	8	52	26	0	1
Germany	1	57	14	17	4	0
Japan	5	30	36	10	0	9
Canada	7	28	55	26	7	3
France	1	2	74	15	7	0
Italy	0	1	75	12	1	0

OPEN-END MUTUAL FUNDS' PORTFOLIO COMPOSITION, 1998

Percent	Liquidity	Loans	Domestic Bonds	Domestic Equities	Property	Foreign Assets
UK	4	0	8	56	2	33
US	17	0	30	51	0	N.A.
Germany	10	0	22	18	0	29
Japan	23	18	27	9	0	22
Canada	20	3	18	31	0	23
France	29	0	37	20	0	14
Italy	19	0	54	22	0	0

6 Reasons for growth of institutional investors

6.1 We can understand growth of institutional growth in terms of three stages of financial development

In all phases banks provide liquidity and payments services but locus of savings shifts

- **bank-oriented phase** – no institutional investors, household assets in bank deposits, corporate finance via loans, banks using private information
- **market oriented phase** – institutional investors develop with bond and equity markets. Institutions using public information share monitoring of firms with banks

- **securitised phase** – institutional investors dominant. Market provides bulk of finance to non-financial sectors via bonds and commercial paper, mortgages and consumer credit securitised. Monitoring is by rating agencies, investment banks, analysts. Extensive risk management via derivatives.

Underlying forces are technological developments, deregulation and wealth of individuals.

6.2 Household sector assets and institutional investors

How were assets held before the advent of institutions? – the wealthy held diversified securities portfolio at high cost, uneconomic for those at lower wealth who held deposits

Development of household sector portfolios shows a rise over time in holding of institutional investments and a decline in deposits. Also a decline in direct holdings of securities, as individuals switched their assets to institutional investment.

Note that households still hold much more liquidity/deposits than institutions do.

HOUSEHOLD SECTOR BALANCE SHEETS (% FIN ASSETS)

		1970	1980	1990	2000	1970-2000
UK	Deposits	34	43	31	22	-12
	Bonds	7	7	1	1	-6
	Equities	24	12	12	17	-7
	Institutions	23	30	48	56	33
United States	Deposits	28	33	23	12	-16
	Bonds	13	10	11	07	-6
	Equities	36	21	14	25	-11
	Institutions	22	28	39	49	28
Germany	Deposits	59	59	48	34	-25
	Bonds	08	12	16	10	3
	Equities	10	4	7	16	6
	Institutions	15	17	21	34	19
Japan	Deposits	55	69	60	54	-1
	Bonds	06	9	9	8	2
	Equities	12	7	9	3	-9
	Institutions	14	13	21	31	17
Canada	Deposits	31	38	36	25	-6
	Bonds	14	8	5	5	-9
	Equities	27	24	21	27	0
	Institutions	22	21	28	41	19
France	Deposits	49	59	38	25	-23
	Bonds	6	9	4	2	-4
	Equities	26	12	26	37	12
	Institutions	6	9	26	23	18
Italy	Deposits	45	58	35	25	-21
	Bonds	19	8	19	19	-1
	Equities	11	10	21	26	14
	Institutions	8	6	8	30	22
G7	Deposits	43	52	39	28	-15
	Bonds	10	9	9	7	-3
	Equities	21	13	16	22	1
	Institutions	16	18	27	38	22
Anglo-Saxon	Deposits	31	38	30	20	-11
	Bonds	11	8	6	4	-7
	Equities	29	19	16	23	-6
	Institutions	22	26	38	49	27
Europe and Japan	Deposits	52	62	45	35	-18
	Bonds	09	10	12	10	0
	Equities	15	8	15	20	6
	Institutions	11	11	19	29	19

6.3 Supply-side reasons for growth of institutions as a proportion of household investments

Economies of scale (already discussed)

- indivisibilities
- transactions and management costs
- countervailing power
- insurance

Diversification and risk pooling

Fiscal benefits (e.g. tax relief on pension contributions)

What are the costs of institutional investment? (marketing costs, principal-agent problems)

Recent developments:

Deregulation of markets and portfolios – allowing better diversification and more competition

Technology – institutions are well placed to use IR

New instruments- ability to use derivatives such as futures and options

Alternative products unattractive (bank deposits)

Bull market till 2000 and equity culture (now what?)

6.4 Demand side reasons for growth of institutions

Demographic aspects

- existing fall in birth rates and rise in life expectancy
- effects on the high-saving groups
- prospective population ageing

These imply that a larger proportion of individuals will need to save for their retirement than in the past.

LIFE EXPECTANCY AT BIRTH

Years	1970– 1975	1980– 1985	1990– 1995	2000
United Kingdom	72	74	76	78
United States	73	75	77	77
Germany	71	73	76	77
Japan	74	77	79	81
Canada	73	76	78	79
France	72	75	78	79
Italy	72	75	78	79

FERTILITY RATES

Number of Children per Female	1970–1975	1980–1985	1990–1995	2000
United Kingdom	1.8	1.8	1.8	1.7
United States	1.8	1.8	2.0	2.1
Germany	1.5	1.4	1.2	1.4
Japan	1.9	1.8	1.5	1.4
Canada	1.8	1.7	1.9	1.6
France	1.9	1.8	1.7	1.7
Italy	2.2	1.4	1.3	1.2

PROJECTIONS OF ELDERLY DEPENDENCY RATIO TO 2050 Population 65 and over as a Percentage of Population Aged 15–65

	1960	2000	2035	2050
United Kingdom	17.9	26.6	44.6	45.3
United States	15.4	21.7	38.2	37.9
Germany	16.0	26.6	54.1	53.2
Japan	9.5	27.7	53.9	64.6
Canada	13.0	20.4	42.2	45.9
France	18.8	27.2	47.5	50.8
Italy	13.3	28.8	56.8	66.8

Pressures on public pension systems

Public pensions are usually paid direct to current workers from taxes. Because of ageing and the generosity of such systems, especially in Europe and Japan, we expect rises in public pension expenditures, which cannot be financed without very high taxes.

These mean that there are likely to be reforms, which cut the benefits of public pensions. This in turn leads to increases in demand for private pensions and other forms of institutional investors

PROJECTIONS OF PENSION COSTS (OECD ESTIMATES)

Pension expenditure/ GDP	1995	2000	2010	2020	2030	2040
United Kingdom	4.3	4.3	4.1	3.9	4.3	4.1
United States	4.9	4.4	4.3	5.4	6.2	6.3
Germany	11.7	11.8	11.2	12.6	15.5	16.6
Japan	6.8	7.9	8.6	8.5	7.5	8.2
Canada	5.3	5.1	6.0	7.6	9.6	10.4
France	12.2	12.1	13.1	15.0	16.0	15.8
Italy	13.4	14.2	14.3	14.9	15.9	15.7

Source: Dang et al. (2001).

Non-demographic aspects – wealth accumulation. As people get richer they will invest more in institutions

Exercises

Read my article “Is there a UK pension crisis?” available from www.ephilipdavis.com/ukpencrisis1.pdf

Does the UK have a demographic problem from ageing of the population?

What is the main problem for UK social security pensions – is it “being too generous”?

What is the “deficit” problem of UK defined benefit (final salary) pension funds

Do other types of pension seem more attractive?

Is there a “saving problem” in the UK?

Do you have any ideas how you can ensure you get a decent pension?