Funding the Future

The future of pensions

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Most people worry about their pensions. But the issues that worry them are usually whether they have paid in enough, or whether they have chosen the best provider. It rarely occurs to them to wonder whether they will ever see the pension that they have paid for. And nor do most people ask whether the tax relief for pensions is appropriate, but it costs the nation at least £13.7 billion a year according to HM Revenue & Customs.

Pensions are just a way of saving. Like any tax driven savings system they are heavily regulated. As such they are somewhat inflexible. even given recent reforms. They are cumbersome to set up, require rigid contributions, pay out inflexibly and are virtually impossible to redeem early. But for the tax relief on paying into them it is hard to imagine anyone wanting to buy one.

Added to this, everyone knows there are problems with pensions. We have had the scandal of their mis-selling. But no one seems to doubt that pensions are either a good thing, or that they will pay out. Yet I see every reason to think they will not.

The amount of money paid into pension schemes is vast. About 85% of UKstock exchange investment is owned by life and pension institutions.

Month in, month out, money pours out of individuals pockets into the hands of pension managers. There are only four things they really can do with it. The first is to keep cash, which is reasonably safe, but boring. The second is to lend it to the government, which has about the same attraction as cash. After that they can buy property or they can put it in the stock market. In practice most of the cash ends up in the stock market.

The trouble is, the stock market hasn’t got a clue what to do with it. The stock market appears to behave rather like a pure market. What is on offer is available to everyone, at a price that is known to all. So in theory supply and demand can work, but it doesn’t.

By its very nature a share is intangible. So the perfect knowledge that actually makes markets work in theory is entirely absent from the stock market because no one knows the future, and yet a part of the future is what a share represents. As a result the stock market is the most perfect setting known for the peddling of illusions, because that is what shares are.

The second reason why supply and demand does not work is that despite increasing prices for shares their supply does not increase to match the demand. This, of course, is what we would expect in a proper market. People buy a share because they believe in the company that issued it (or so we would hope). Presumably therefore they would like that company to use their money to better their future.

But that isn’t what happens. Even with more floated companies than ever, the stock market simply hasn’t got enough shares to sell to meet the demand for them. Existing companies have no inclination to meet demand either because of the enormous cost of share issues or the pressure to have continuously rising share prices and earnings per share.

As a result of all the shares sold every day throughout the world well over 99% are second hand. This means that they are not sold by the company who issued them but are instead sold by someone who bought them from that company, or more probably did so via a thousand or more similar sales.

Money invested in real businesses to let them do real things making real jobs for a real future might be of worth to a pensioner. But why a money go round has the same value to them is hard to determine. This is because they are not actually invested in anything real, and they have no real relationship with the company whose share they might own, any more than it has with them.

I fear this illusion will continue to work for some time, maybe even twenty years. Then one day it will fail, and probably badly. That will be the day when people realise that they have invested in second hand bits of paper bearing a promise to pay of considerably less worth than that written on their bank notes.

Serious commentators knows the stock market is over valued at the moment. What no one can work out is why it won’t crash. The answer is it can’t for long, because the investment money will keep coming even if it does. The structure of pensions guarantees it, for now.

But what will happen when the demand for pension payments begins to approach the inflow of cash? Suddenly there will be something like as many sellers as buyers. And on that day investment managers won’t have a clue what to do. Price is simple to determine when there is always a ready market for whatever is on offer. It just keeps on going up. But when supply approaches demand the market will not know what to do. Suddenly it will have to appraise the true value of what it is holding. Fundamentals will come into play. And fundamentally companies just aren’t worth the earnings multipliers we are giving to them now, let alone what they might be after years of further growth, so the illusion will shatter.

Has it before? Of course it has. It did in 1929, but that was a very different stock market. So it’s better to look elsewhere for examples closer to our time. Like the housing market in 1988. Supposedly you just couldn’t go wrong investing in housing at that time. Until a structural change in the market stopped the inflow of money, fundamentals came into play, and everyone realised they had been trading on a myth.

Is this simplistic? Yes, of course it is. But the analysis that would have allowed the collapse in the housing market or the inability of third world countries to repay debt to be predicted was simple too, and yet those markets failed.

Old age matters, a lot. It is a time when we seek security. And we are gambling it, quite literally. The shock of poverty in old age when comfortable security had been anticipated would be enormous. Government would have to step in, and has already acknowledged that it cannot afford decent pensions for all. The risk we are taking by pretending to finance pensions through pouring piles of cash into the purchase of second hand paper is quite mind staggering. Increasingly I have problems persuading young people of the merits of pensions. They simply don’t trust them, although they don’t know why.

This is a problem we need to solve. Cash has to be put to better use than now. Pensions have to be secured.Tax releif has to be given for appropriate reasons. In the long run the pension market we have will not do that. So we need an alternative.

The second part of this article will consider what the options are.