International Diversification by United States Pension Funds

The investment portfolios of United States pension funds, which have been the largest single source of funds for this country's capital markets, are currently undergoing profound changes. One of these is the diversification into foreign securities in order to reduce the risk of variability of return as well as to raise the level of return. While the absolute amount going abroad is still rather small, the percentage is gradually increasing. Considering the extremely rapid rate at which the pension funds are growing, this diversification could be regarded as capable of having important domestic and international implications.

Many tens of billions of dollars are being invested by the pension funds each year. The greater part is from private pension plans, primarily those sponsored by corporations. Private pension fund assets totaled $450 billion at the end of 1980, having grown by more than 100 percent in just five years (table). A sharp improvement in the market value of equities contributed to an unusually large rise last year. But even in the absence of this development there would have been a very substantial increase. An explosion of investable resources will most probably continue throughout the decade. This will happen even after allowing for inflation. A study prepared for the Department of Labor two years ago estimated that, measured in constant (1975) dollars, the assets of private pension funds will have more than doubled between 1975 and 1985 and will have increased by another 90 percent by 1995.[1]

Close to 40 percent of the private pension fund assets at the end of 1980 was managed by the insurance companies. The remainder, over 60 percent, was handled by banks and adviser/managers. It is estimated that, of the total $450 billion, roughly $9-10 billion was invested in foreign assets. More than half of these foreign assets represented pension fund monies invested by the insurance companies, mainly in debt instruments and largely in Canadian assets, although the holdings included fixed-income securities, mostly dollar denominated, of a number of non-Canadian governments. The foreign investments by the other managers were much more diversified. Geographically, they encompassed assets in about twenty countries, predominantly in Europe and Japan, and smaller amounts in countries elsewhere. Less than one third comprised fixed-income securities (including international agency and other securities denominated in United States dollars, as well as foreign currency securities); more than two thirds consisted of equities.

In preparing this study the author had the benefit of many interviews with pension plan executives and officials of various types of intermediating financial institutions They generally requested anonymity with regard to information provided concerning amounts, approaches, techniques, and views, but the author wishes to express her appreciation to all of them She is also grateful for assistance received from staff members of the Department of Labor and the Securities and Exchange Commission

[1] ICF Incorporated, *A Private Pension Forecasting Model* (October 1979) The forecast for 1985, in constant 1975 dollars, is approximately $475 billion and for 1995, almost $900 billion The forecasts are based on a number of assumptions, including labor force demographics, economic growth rates, and price developments As is always the possibility with long-range forecasts, some of the assumptions might turn out to be quite a bit off the mark, as the authors themselves caution

While state and local government retirement funds total less than half as much as private pension funds, they also constitute a huge pool of investment monies. At the end of 1980 they totaled slightly over $200 billion, having not quite doubled since 1975 (table). These funds operate for the most part under rather rigid investment constraints, but modifications are being slowly introduced. Two states already have started diversifying into foreign assets, and others may eventually follow. Still, it will be many years before state and local funds could conceivably account for a significant volume of foreign investments.

Although there can be little question that, short of some cataclysmic event, private pension funds will be increasing their foreign investments during the rest of the eighties, one can only hypothesize about the pace of the outflows. A good ball-park guess might be that the share of foreign assets in total private pension fund portfolios will rise during the decade at an annual average of about ½ percentage point from the approximately 2 percent they were at the end of 1980. The dollar outflows implied by this assumption would be substantial, but they would not be so large as to have harmful effects on either domestic financial markets or the value of the dollar in foreign exchange markets.

This article examines in further detail (1) the motivations of pension plan sponsors for diversifying into foreign assets, (2) the considerations that in past years restrained the outflow, (3) the activities of financial intermediaries that have sought a role in carrying out the pension funds' international transactions, (4) the manner and quantity in which funds are being placed abroad, and (5) the possible implications for the United States balance of payments and financial markets.

Motivations for international diversification

Two goals are sought by pension plan officials who decide to broaden their portfolios to include foreign assets. The first is a reduction of the risk associated with variability of investment return. The second is an improvement in the level of return. In the private sector, failure to improve return necessitates larger corporate contributions to meet actuarial funding requirements; in the public sector, failure to improve return implies that, as pension commitments rise, larger tax appropriations are required.

Not surprisingly, the pioneers in foreign asset diversification were primarily pension funds sponsored by large corporations whose officials were already familiar to some degree with foreign economies. However, many sponsors of smaller private funds are now also involved in such diversification. Most recently, some officials responsible for public employee pension funds have begun to shed their diffidence concerning foreign asset diversification. The states of Alaska and Vermont have been leaders in passing the required laws and purchasing foreign assets, and there may be other states considering enabling legislation. However, the great majority of states still have laws that prohibit public pension funds from making foreign investments other than in Canada. Public pension funds governed by New York State law are prohibited from investing even in Canadian corporate equities, although they

Assets of Private and Public Pension Funds

In billions of dollars, year-end values*

Year	Private noninsured pension funds	Private insured pension funds†	Total private‡	State and local government retirement funds
1974	115 5	60 8	176 3	88 0
1975	146 8	72 2	219 0	104 8
1976	171 9	89 0	260 9	120.6
1977	178 5	101.5	280 0	132.6
1978	198 6	119 1	317 7	153.0
1979	222 4	139 2	361 6	170 1
1980	286 1	164 6	450 7	202.7

* Figures reflect equities at market value and other assets at book value.

† Includes noninsured "separate account" pension funds at the life insurance companies

‡ Includes pension funds and deferred profit-sharing funds of corporations, unions, multiemployer groups, and nonprofit organizations

Source: United States Securities and Exchange Commission may invest in foreign debt that is denominated in United States dollars—*i.e.,* in Eurodollar debt rated A or better or in what are called Yankee bonds (bonds issued in the United States by foreign entities). Nonetheless, there is a growing tendency to loosen the very rigid restraints that still limit most public pension fund investment activities.

A number of institutional changes in pension fund practices over the past decade that have dramatically increased pension costs have added to the incentives to seek new avenues for improving investment returns. These changes include (1) heavier weighting of later, higher earning years in calculating pension benefits, and (2) steps to adjust both workers' and retirees' incomes to compensate for increases in the cost of living Pension fund officers have consequently come to regard pension plan liabilities increasingly as a purchasing power liability rather than as a fixed-dollar liability and thereby have been additionally stimulated to look for higher returns than those from the more traditional investments.

Enactment in September 1974 of national legislation popularly referred to as ERISA (Employee Retirement Income Security Act), which governs virtually all privately sponsored employee benefit plans, added to the interest in diversification. Previously, pension fund and other fiduciaries had been required by individual state laws to handle funds as "a prudent man" would In addition, a number of states provided detailed guidelines regarding permissible and prohibited investments, although these were not applicable when a trust agreement governing the creation and administration of an employee benefit trust gave the trustee full investment discretion. ERISA replaced the states' comparatively simple and sometimes restrictive rules with a directive that added considerable complexity to the prudent man rule. Pension fund fiduciaries must now make investment decisions "with the care, skill, prudence and diligence . . . that a prudent man . . . familiar with such matters would use". Moreover, their prescribed duties include "diversifying the investments within portfolios so as to minimize the risk of large losses". Consequently, the national rule is not only more demanding than most of the earlier state laws but in effect insists on diversification. It has thus opened the door to investments in certain types of assets that pension fund officers had previously regarded as impermissible.

Already in the sixties, the spreading knowledge of modern portfolio theory principles had led to wide diversification of portfolios among domestic firms and industries to reduce the risk of variability of return. Increasing numbers of fiduciaries are now becoming convinced that diversification beyond United States markets would further reduce this risk. United States securities markets no longer dominate the world scene to the extent that they did: capitalization in equities markets outside the United States comprise approximately one half of the world total, and foreign bonds more than one half the outstanding total. Moreover, many foreign industrial firms have a very respectable capitalization. In addition, foreign business and interest rate cycles have generally not coincided with those in the United States. Although the world has grown more interdependent over time, this has been an erratic development and the correlations between the United States equities markets on the one side, and foreign markets on the other, remain considerably lower than the correlations of most United States industry groups with the total United States market. For this reason, sufficiently broad diversification across national boundaries is likely, over a period of time, to dampen the variability of total return. Many pension fund officials have therefore concluded that there are numerous prudent investment possibilities abroad and that these permit investments to be made that can be expected to help achieve the ERISA-mandated goal of minimization of risk.

Many pension fund executives also think international portfolio diversification provides opportunities for increasing the absolute rate of return for any given degree of risk A large number of the most rapidly growing firms are situated outside the United States, reflecting fast expanding overseas markets and abundant overseas supplies of industrial raw materials and of labor at various skill levels. Moreover, while opinions differ, some managers believe many foreign securities markets are less "efficient" than United States markets, resulting in more opportunities for finding undervalued securities. There is, in addition, the possibility of boosting returns by moving funds around to take advantage of the different cyclical stages characterizing business conditions, equities markets, fixed-income markets, and exchange rates in the various countries. Interest was also spurred by negative attitudes toward domestic investment. The lag in United States government and industry policies in adjusting to the steep rise in energy prices, and the delay of certain United States industries in responding to foreign innovations, enabled numerous enterprises abroad to become very competitive and profitable while United States firms lost markets and ran into financial difficulties. Many pension fund executives have also been displeased with the performance of managers of domestic portfolio investments. Given such considerations, a growing number of pension fund officials have come to feel they might gain a higher return by investing part of their funds abroad.

These views have been bolstered by the favorable conclusions of a number of statistical studies, based on various hypothetical portfolios over different time periods. These studies have shown there would have been definite benefits from foreign investment, both in the level of return and the reduction of variability. The degree of benefit demonstrated varies from one study to another, depending upon the particular time span used by the author, the countries covered, and the types of investments, but the positive conclusions persist through all of them. Moreover, the development of sizable dollar exchange rate fluctuations after the end of the Bretton Woods par value system had little effect on the results. Whether measured in local currency terms or converted into dollar terms, over any substantial time interval the advantages of higher levels of overseas returns and of generally low correlations between economic fluctuations in the various foreign countries outweighed any risk from currency fluctuations.[2]

Deterrents to international diversification

Despite the many lures of international portfolio diversification, the majority of pension plan sponsors, particularly those responsible for plans of moderate and lesser size, had remained leery of foreign investments for general as well as concrete reasons until recently.

The general deterrents

Primary among the deterring general factors had been most sponsors' unfamiliarity with foreign markets. This implied complete dependence on outside advisers and managers. Such a situation could intensify sponsors' feelings of insecurity regarding the appropriateness of foreign investment and could even prompt a concern that they might be failing to meet ERISA prudential requirements. A second impediment had been the fear that foreign investments might be regarded by important sectors of the community, whether workers in the firms or others, as "un-American". Investment in a country that had been a wartime enemy can occasionally bring forth particularly strong complaints, as can investments in countries where the governments in power are considered antagonistic to, for example, racial equality or civil rights Thirdly, there are relatively few persons in positions of responsibility who want to be first in a new area. If someone makes an unusual investment decision, and this turns out poorly or even is simply somewhat less remunerative than other investments that fall within a well-trodden path, the person responsible cannot take refuge in having done "the same as the others".

These considerations have lost force during the past half decade as international trade has increased, corporations have gone transnational, and publicity has developed regarding the growing number of pension plan sponsors and other institutional investors that are undertaking international diversification. Undoubtedly, there is also the consideration that foreign diversification has by and large proved attractive. Moreover, an increasing number of pension fund advisers and managers have been developing services and expertise to help investors choose and manage foreign financial assets and have engaged in intensive advertising of these services.

The informational problems

There are other, concrete deterrents to international investment, but in recent years these have also diminished in importance. One of the principal complaints had been that there was insufficient information about the condition of individual foreign firms. There is no equivalent on the European continent or in other foreign countries of the United States Securities and Exchange Commission (SEC), with its requirements for full and adequate disclosure of a firm's business particulars, except for British Company Law, which has similar disclosure rules. However, the swelling activity during recent years in international bank credits and bond issues, in international mergers and acquisitions, and in foreign portfolio investments has led to a gradual increase in the amount of business information available. Companies in Germany and Japan have been among the leaders, with growing numbers seeking to promote foreign interest in their securities by offering detailed briefings to securities analysts and others, even to the extent of holding meetings in this country.

Differences in accounting methods gave rise to an allied problem. For example, unlike United States accounting procedures, financial statements in most European countries traditionally conceal the full value of a firm's reserves, thus making it impossible to develop a complete picture of a firm's profit or loss situation. Another accounting problem has been the scarcity of consolidated accounts, which include a firm's subsidiaries and other affiliates. An increasing number of foreign companies, however, are now reporting on a consolidated basis. Moreover, some American analysts, rather than attempting to compare foreign balance sheets or profit and loss statements with those of American firms, now try instead to discover the factors on which major foreign market participants focus. They believe that emulation will enable them to make more successful investment recommen-

[2] A bibliography of some of the more recent studies is available upon request

dations. At the same time, steps have been taken by groups abroad to produce information that would be more comparable and comprehensive. Federations of financial analysts have been set up within the past two or three years in France, Germany, and the United Kingdom with the explicit intention of trying to develop reporting standards that would be similar for all European business firms. How quickly this goal will be achieved remains to be seen.

The liquidity issue

Many pension fund sponsors have been concerned that foreign securities markets were not sufficiently liquid. Compared with the United States market, some markets do indeed have only a few stocks that are very actively traded. In Europe and Japan together, there may be only about one hundred issues that are extremely liquid. However, there are many stocks in which the trading is about on a par with trading in the United States in "special situation" stocks. On an overall basis, a number of markets are at least as liquid as the United States market, and in some countries, including markets as different in size as Japan and Hong Kong, the annual turnover rates, measured as a percentage of capitalization, are even higher.

Intermediaries who take a positive view toward the liquidity of foreign markets sometimes stress that, in the absence of broad and deep markets, it is intimate knowledge of the participants in the markets that is most important. Transactions can be successful if one knows who the stockholders are and works through appropriate channels.

The question of costs

Higher transaction costs have disturbed some sponsors. It has been estimated that turnover costs for a "round trip" in the market—*i.e.,* a purchase and a sale —would generally amount to about 8 percent in Europe and 6 percent in Japan, including the brokerage fees or commissions, the spreads quoted by market makers, and the government "stamp taxes" or "transaction fees". These figures contrast sharply with the 1 or 2 percent prevalent in the United States. Management fees and custodial fees are also higher abroad. Some United States managers comment that, because of the various higher costs, they have to be particularly careful in revamping a foreign portfolio. Others observe, however, that on a net return basis the higher foreign costs are not very significant, inasmuch as the yields from foreign market investments may be many percentage points greater than those from comparable-risk United States investments.

Some of the larger intermediaries deny that transaction costs are necessarily higher overseas. Unlike the current situation in the United States, most foreign markets are still on fixed-rate schedules and one cannot negotiate commissions on a trade-by-trade basis, but discounts can be obtained in certain countries. In Japan, for instance, where rates are fixed by the Ministry of Finance, a bank or other financial institution can receive up to a 20 percent discount from the fee normally charged by a securities broker Similarly in Germany—where, as in other countries on the Continent, the brokers are usually banks—discounts of up to 25 percent can be obtained by banks, insurance companies, or other large institutions. In Australia, one can get a discount whenever there are big blocks of shares around.

Foreign withholding taxes on interest and dividend payments are, however, a cost that presents a particularly thorny question to pension fund officers. Since pension fund investments are not subject to income taxes in the United States, pension plan sponsors often do not regard it appropriate to pay withholding taxes abroad. Although not every market that is popular with United States investors imposes withholding taxes—Hong Kong and Singapore are such exceptions—bilateral tax treaties between the United States and many countries in Europe, as well as with Australia, Canada, and Japan, for example, do contain provisions for withholding taxes. The percentages vary from country to country, but are generally less for interest payments than for dividends.[3]

Exchange rate and capital transfer problems

The risk of unfavorable exchange rate developments is another reason some pension plan executives have been wary of international diversification. It would appear, however, that most of those who have overcome their hesitation feel they do not have to worry about short-term currency fluctuations since current liabilities constitute only a minor part of their total pension fund liabilities. Hence, they would never be obliged to liquidate the (relatively small) foreign portion of their

[3] Under the tax treaties, withholding taxes on dividends are usually 15 percent In some countries, the *gross* tax initially withheld is higher than 15 percent, and the United States investor has to reclaim the excess In a few countries (including Austria and Canada), the *net* tax is less than 15 percent As for interest income, the United States model tax treaty calls for no withholding tax, but some countries are unwilling to go along with this Germany, the United Kingdom, and the Netherlands do, but Belgium and Canada, for example, have a withholding tax of 15 percent, France and Japan 10 percent, and Switzerland 5 percent There is usually no withholding tax on capital gains A new model tax treaty has been drafted by the United States Treasury Department, but it will probably not affect tax rates for institutional investors Some countries, it should be noted, provide the possibility of exemption from withholding taxes for certain categories of investors

pension fund assets on short notice, when currency movements might make such a step undesirable. Regarding the medium and long term, some pension fund managers believe it is possible to forecast the direction in which a currency will move largely on the basis of fundamental economic considerations such as likely inflationary developments, the probable rate of real growth, and expectations regarding the foreign trade or current account balance. Others take the "neutral" position of making no currency assumptions since they believe (1) it is impossible to predict what the currency developments are likely to be, and (2) other factors are more important in the choice of foreign investments. In some cases, foreign currency-denominated investments are being hedged.

Another type of conversion risk is the erection of government barriers to the withdrawal at will by foreign investors of earnings or liquidation proceeds. Many of the nonindustrial countries already have regulations that impose certain explicit limits on withdrawal Others provide for *ad hoc* administrative decisions by some government agency. Of 140 member countries of the International Monetary Fund (IMF) covered in a 1980 Fund report, only thirty-three had no restrictions of any kind on capital payments.[4] Of these, sixteen were either industrial or oil-exporting countries.

Although a country might not have restrictions on capital payments, it might have, or choose to impose, restraints on foreign capital inflows. A number of countries that hold strong attractions for foreign investors limit such investments through either legal or regulatory barriers. During the past year, however, there has been some small evidence, with actions by Mexico as one example, of a possible tendency to ease these restraints, partly in the belief that economic progress could be furthered more rapidly if foreign private capital were allowed to make more of a contribution.

The intermediaries for pension fund diversification

As pension plan sponsors began to display a growing interest in foreign portfolio investments, partly in response to suggestions by a few outside advisers, financial intermediaries of various kinds strove to position themselves to compete in this new field. These included the traditional managers of pension funds, namely, commercial banks and insurance companies, as well as the other types of investment managers that had acquired a significant share of the pension fund business beginning in the 1960s. Others sought to gain entry by showing that, unlike most United States pension fund advisers and managers who had had little experience with foreign markets and therefore were unable to produce relevant track records, they, on the contrary, had the requisite knowledge and experience. Still others found a niche for themselves by establishing services that were ancillary to the international investment management function itself.

The banks

Bank trust departments are still the principal managers of pension plan funds—and now also of a large portion of the internationally invested assets. Even the larger banks that have become active in foreign asset management had initially to intensify their knowledge in certain relevant areas, while others had to work from a much lower base to acquire expertise on foreign economies and companies, foreign securities markets and currency markets, and the relevant networks of foreign intermediaries. A few put securities analysts and investment managers on the scene in existing foreign branches. Others have gathered information on foreign firms and monitored economic developments in part through extensive visits abroad. Over time, some of the banks have established new foreign affiliates of various kinds, with one purpose being to handle the foreign investing or, as a minimum, the associated foreign research activity for the banks' United States clients. Where these foreign offices are managing the investments, they deal with foreign brokers. These are usually London or other European brokers if the manager is operating out of London or some other European city, and Japanese brokers if the manager is operating out of Tokyo or Hong Kong in connection with Asian and Australian investments. A number of banks are also providing global master custodianship services (box).

The banks have been using commingled funds especially established for foreign investments as the principal vehicle for investing those portions of clients' pension funds that have been designated for investment abroad, although a few banks also manage foreign assets for pension funds through separate accounts. In addition, some relatively small amounts are invested in foreign securities for pension fund clients who have not explicitly allocated a portion for foreign investment. This occurs when some other type of commingled fund to which some of a client's assets have been allocated (whether it be a diversified common trust fund, for example, or a growth fund or some other specialized fund) includes securities of foreign firms that fit within the framework of that particular

[4] International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Restrictions* (1980) For two additional countries, the IMF was unable to determine the situation

Custodial Services for Pension Funds' Foreign Investments

Under ERISA's rules concerning fiduciary responsibility, the so-called indicia (evidence) of ownership of foreign assets held for employee benefit plans must be maintained in locations subject to the jurisdiction of United States district courts, except as might be otherwise authorized by the Secretary of Labor by regulation. Prior to 1977 there were many questions concerning the effect of this rule on holding indicia abroad. In that year, however, the Department of Labor, which is the agency with primary jurisdiction over employee benefit plan fiduciary responsibility, issued a regulation specifying that indicia could be held abroad if the related assets were under the management and control of a United States bank, insurance company, or investment adviser/manager registered with the Securities and Exchange Commission, providing these met certain given criteria. Otherwise, the indicia could be held abroad only if in the physical possession of a United States bank or an SEC-registered broker or dealer, or if in the custody of an entity designated by the SEC as a "satisfactory control location".

Many United States banks were not happy with the 1977 ruling since only brokers and dealers, but not banks, may appear before the SEC Thus, for foreign locations where a bank did not have a branch that could render custodial services, the bank had to have a broker or dealer intercede with the SEC for approval of a foreign custodial agent, or else had to utilize the services of a branch of a competitor United States bank. In response to appeals from banks and the American Bankers Association, the requirements were eased effective March 30 of this year to permit United States banks to keep the indicia in the custody of a foreign bank or other specified types of foreign entities as long as the custodian is supervised or regulated by a government agency or regulatory authority in the host country.

Several United States banks are now also providing so-called global master custodianship services that further facilitate the handling of foreign investments for any given pension plan sponsor. These services are provided regardless of who the managers are. Chase Manhattan Bank is the major global master custodian for United States-based sponsors, having started this activity in the early seventies before enactment of ERISA. It has relied upon its foreign branches as subcustodians in most of the countries where it has branches and has used foreign banks in the same capacity in other countries. Citibank also has provided such services for a number of years. In the past few years there have been several additional United States entrants into the field. Some of these actually rely heavily upon another large domestic or foreign bank and its network of branches or correspondents for the custodial services required in the many locations where large corporate plan sponsors may have foreign investments A particularly interesting recent entrant is the Mitsubishi Bank of California. Many of the clients for its global master custodianship services are regional banks that are master trustees for pension plans with rather small amounts invested overseas. To provide its global custodianship services, the Mitsubishi Bank makes use of the worldwide facilities of the Mitsubishi Bank of Japan and the latter's various financial affiliates.

The global master custodianship services offered are more comprehensive at some banks than at others, but among those generally available are safekeeping of the indicia, collection of dividends and interest, currency translation, and centralized reporting of all investments and income. Thus, no matter in how many countries the funds of a pension plan are invested, and no matter how many managers are handling portions of that plan's funds, overall responsibility for the custodial, bookkeeping, and accounting operations can be placed in the hands of a single overseer.

fund. At the end of 1980, international commingled funds amounted to 2 percent of all employee benefit commingled funds set up by banks and approximately ½ percent of the aggregate employee benefit funds managed by them as either trustee or investment managing agent.[5]

The Morgan Guaranty Trust Company pioneered in establishing an international commingled fund for ERISA accounts. It informed all ERISA clients in 1974 that, unless the client opted otherwise, a modest proportion of their pension fund reserves would be invested in foreign equities, to be built up at about 1 percent a year to around 5 percent by 1978.[6] Subse-

[5] Federal Financial Institution Examinations Council, *Trust Assets of Banks and Trust Companies—1980* These data are compiled by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency

[6] Only a few clients rejected Morgan's plan, and this "strong" approach is known to have been followed by three more banks Other banks propose foreign commingled fund investing to their clients on an "invitation" basis

quently, the maximum allocation was raised to 10 percent, and Morgan now has one equity fund and two bond funds holding most of the assets purchased with ERISA reserves designated for foreign investments—about 6-7 percent of the total discretionary employee benefit funds under its management. Citibank, which set up its first international fund for ERISA clients in 1978, does all the foreign investing of allocated reserves through commingled funds. Currently, its international equity and bond funds total close to 3 percent of its aggregate discretionary employee benefit funds, and it is recommending to most clients that they increase their international allocation to 10 percent over the next few years

Since the mid-1970s a number of other banks have also established international commingled funds. The smallest is the Girard Bank, which has only about $800 million of total employee benefit funds under management but nonetheless introduced an international pooled fund this May. In contrast, some banks that are among the largest holders of ERISA funds hesitated for quite some time before deciding to offer international investment services to such clients. Now they are ready to join the competition. Bankers Trust has reorganized a commingled fund that had been relatively dormant for fifteen years and is currently talking to clients about the desirability of foreign diversification. Chase Manhattan Bank has two international commingled funds starting operations, and plans to ask all of its ERISA accounts to put in 2-3 percent of their reserves And the Bank of America has just established a commingled fund with three divisions, for investments in equities, fixed-income securities, and/or international cash. This apparently is the first international fund with a separate cash division; it will enable a pension plan sponsor to make a specific allocation for investment in highy liquid foreign assets.

At all but the very largest banks, the complexities and costs of handling foreign investments generally rule out separate accounts as opposed to commingled funds. At any institution where an account is handled separately, the client is not only charged a higher fee but is generally required to undertake a minimum foreign investment of several million dollars. The main reason for this latter rule is that prudent minimization of risk is regarded as necessitating diversification into securities in at least five different countries.

The life insurance companies

Life insurance companies rank second to banks in the volume of pension funds managed. At the end of 1980, pension fund assets accounted for 35 percent of the companies' total assets. These pension funds are handled either as part of each insurance company's "general account", where the funds are mingled with life insurance and health insurance funds, or individually as "separate accounts". Most states impose severe restrictions on general account investments, including rigorous restraints on foreign investments. New York State, for example, limits portfolio investments outside the United States to stipulated percentages of an insurance company's assets, namely, 10 percent for Canadian securities and 1 percent for all other foreign securities.[7] The rules of New York State are important even for insurance companies based in other states since they must be in "substantial compliance" with New York regulations if they wish to do any insurance business in this state. About half the states are even more restrictive than New York. Neighboring New Jersey, however, is among the less restrictive states That state imposes no limit on investments in Canada, deemed not to be a foreign country for investment purposes, and permits investments in other foreign securities of up to 2 percent of assets, although investments in any one foreign country are not to exceed 1 percent. Ten states have no statutes at all regarding foreign investments.[8]

In many states the life insurance companies have some extra leeway for general account foreign investments by way of a catch-all investment clause, referred to in the industry as the "basket" clause, which permits a small percentage of total assets to be held in almost any way an insurance company sees fit. In New York State this "basket" amounts to 4 percent; in New Jersey it is 5 percent. Most companies prefer to utilize this leeway for domestic investments, but a few may be making use of part of it to add to foreign investments beyond the limits otherwise permitted

"Separate accounts" were introduced in the early 1960s, when strong competition for pension fund business began to emerge from new sources, and sponsors were manifesting discontent with the returns from their traditional investments with the life insurance companies. The separate accounts have no restrictions regarding foreign or any other types of investments, although ERISA "prudent man" responsibilities hold for the management of these accounts as for other accounts.

7 The life insurance company's assets that are used as the base for determining the indicated amounts are actually the company's "admitted assets", a term denoting assets that are in good standing. The above-mentioned permitted foreign investments are in addition to investments in any foreign country where the company is authorized to do business The latter investments are not to exceed one and one-half times the company's reserves and other obligations in that country, or the amount it is required by law to invest in the country, whichever is greater

8 The author is indebted to the American Council of Life Insurance for information on the various state laws

One insurance company—The Prudential Insurance Company of America, the largest United States life insurance company—moved more quickly than others in diversifying into foreign assets. As early as 1976 it established a commingled fund for pension and profit-sharing funds called PRIVEST, whose assets were to consist primarily of private (*i.e.* direct) placements, traditionally an important part of life insurance investments. One of the initial guidelines specified that up to 10 percent of the portfolio could be allocated to Canadian investments and up to 5 percent to other foreign investments. This year, in another move, Prudential embarked on two pilot programs of $50 million in foreign bonds and $25 million in foreign equities to test and develop its acquisition, trading, and other operations in the foreign securities markets. The company expects that by the beginning of 1982 it will be able to offer a pooled fund for foreign bonds and one for foreign equities to any pension plan sponsor wishing to diversify internationally. It also anticipates establishing an internal unit to handle foreign currency-denominated investments for its general account; such investments would, however, be constrained in size by state regulations regarding foreign investments.

Aetna Life Insurance Company has chosen a different path. In June it combined with Warburg Investment Management International, an SEC-registered British firm that already was managing a sizable volume of ERISA funds, to form a jointly owned United States subsidiary, Aetna Warburg Investment Management International. Aetna is responsible for the marketing operations and Warburg, operating out of London, for the investment and administrative activities. In this undertaking, clients' funds are being handled in separate accounts.

Other life insurance companies are already thinking of following suit via one channel or another that would enable them to provide foreign investment facilities to employee benefit funds. One is actively studying the alternative routes for entering the foreign portfolio investment area, with the expectation that a decision will be made within the coming year. Another is contemplating the introduction of foreign investment services when it considers exchange rate conditions more opportune. In at least one state where the regulations regarding foreign investments are even more restrictive than in New York, steps are being taken to try to get these changed, which would open the way for insurance companies to offer pension funds foreign investment opportunities.

Some insurance companies have been especially interested in foreign investment in Mexico. In 1979 the life insurance industry attempted to gain passage by the New York State Legislature of a bill allowing the companies to invest up to 10 percent of their general account funds in Mexican securities—as can be done with Canadian securities When this effort failed, the approach was shifted to obtaining two statutory changes: (1) an increase in the general ceiling on foreign asset investments from the present 1 percent to 2 percent; and (2) permission for an additional 1 percent of total assets to be placed in Mexican investments. These changes came very close to passage in 1980, and their sponsors are fairly hopeful of actual passage this time around.

Investment advisers and other intermediaries

The third group of portfolio managers, those called investment advisers by the SEC, play a particularly important role in handling pension fund assets for the larger United States corporations. They are also avid contenders for the new foreign investment business. There were only a very few such managers two years ago, but a total of about forty today.[9] Current competitors include foreign as well as United States firms and also United States subsidiaries set up by foreign firms or jointly by United States and foreign firms. The recent development in this country of mergers resulting in large financial conglomerates that encompass a wide range of financial operations may make for an increasingly varied picture.

Those managers of ERISA-subject pension funds that are not United States banks or insurance companies must be registered with the SEC. While a number of foreign-based managers are registered, many do not wish to make known all the information that SEC registration requires. They avoid this by setting up special subsidiaries, usually in the United States, to deal with ERISA clients. Apparently the majority of these subsidiaries are, at most, contact points with United States clients. The actual foreign investment activity and relevant research is generally undertaken from an office located in a foreign market center.

In general, firms of foreign origin are able to display a longtime knowledge of, and experience in, foreign securities markets that puts them, in the opinion of some pension plan executives, a big step ahead of domestic managers, even those that have opened up foreign offices. A number of the foreign firms have been active for many decades rather than for just a few years—although in most cases their foreign investment operations until rather recently did not include Asian and other areas outside Europe that are now attracting considerable attention from international investors. United States managers, on the other hand, are often considered to have an advantage because of their fre-

[9] For a listing, see *Pensions and Investment Age*, "International Profile" (April 27, 1981)

quently greater familiarity with sophisticated investment tools, including modern portfolio theory and advanced statistical techniques. Moreover, for many sponsors, the ability of a management firm to show it has a well-structured decision-making process is of greater importance than the nationality or location of the firm.

Some domestic firms seek to acquire the familiarity with foreign markets and foreign securities necessary for managing foreign investments by placing staff abroad. Others rely upon the availability of increasing amounts of published information from around the world and facilities for instant global communication. Neither tactic, however, provides the track record sponsors often want to see. Hence, another approach has been to team up with an experienced foreign money manager to form a United States subsidiary. There are now a number of such joint ventures. Whatever the setup, where there are both foreign and domestic offices, the United States-based representatives generally act primarily as contact persons while the overseas personnel are the ones most directly involved in the substantive issues of portfolio diversification. As is the case with the foreign firms, overseas offices deal with foreign brokers. Although a few United States brokerage firms have established new offices abroad during the past two years, the business of these branches is more in the retail end and with foreign institutions that wish to invest in the United States rather than with United States institutional investors who are putting money into foreign assets.

A handful of firms have found a very special niche for themselves in providing advice to pension plan sponsors regarding international portfolio managers and other matters relevant to foreign diversification. Most expanded into the international field after experience of a similar kind in the domestic area. Intersec Research Corporation, however, was established in 1975 as a new firm; the first United States counselor in the international area, it also advises portfolio managers. Among the services generally rendered by these counselors are: assessment of a pension plan's objectives and needs and the appropriateness of foreign investment for that plan, analysis of the foreign investment "style" or "philosophy" of managers, monitoring the performance of managers, and recommendations regarding retention or discharge of existing managers and/or the choice of new managers

The foreign investment services offered by the independent managers have paralleled those by banks and insurance companies with regard to handling pension funds as separate accounts or combined with other accounts, although the latter are actually mutual funds. However, in a recent development that is contributing to the ongoing blurring of lines between traditional types of financial institutions, several independent managers, as well as consultants and brokerage firms, have established or taken over state or national chartered trust banks. These will enable the firms to set up commingled funds and provide custodial services in exactly the same way banks can.

The increase in international diversification

The number of companies that have put some portion of their pension funds into foreign assets has grown dramatically during the past few years. A recent survey of almost eleven hundred of the largest American corporations found that, of those companies interviewed that ranked among the *Fortune* top 100 industrials, the number holding foreign assets had increased from 17 percent in 1977 to 34 percent in 1980; among *Fortune's* second 100, the number had grown from 7 percent to 29 percent. Interest had intensified most among firms responsible for funds with assets of over $250 million, but smaller pension funds had also become much more involved Fully 11 percent of all the firms surveyed had some portion of their pension fund reserves in foreign assets at the end of 1980, and another 18 percent said they were planning to start investing internationally during 1981 or 1982.[10] Thus by the end of next year almost one third of the surveyed firms may have become international diversifiers.

The "style" of investment

Many of the pension plans that are prepared to place a fairly sizable amount abroad apportion the funds among more than one manager, sometimes including different types of intermediaries as well as both United States-based and foreign-based managers. If a sponsor has only one manager, which would be generally the situation for smaller investors, this would be a "global" or "international" manager, responsible for investments in many countries all over the globe, either through a commingled fund or otherwise If there is more than one manager, there might be a global manager, and/or a "regional" manager (or managers) responsible for investments in only a part (or parts) of the world. Sometimes a sponsor may choose "specialist" managers limited to a specific type of investment such as equities or bonds, or characterized by a specific way of approaching the markets such as market "timing". Finally, some of the managers are given permission to invest part of their international allocation, when they consider it desir-

[10] Greenwich Research Associates, *Large Corporate Pensions 1981 Report to Participants* The approximately 1,100 companies surveyed ranked among the 1,600 biggest firms in the country

able, in dollar-denominated assets either in the United States or in the Eurodollar market. In other cases, however, the sponsor's guidelines allow dollar-denominated assets to be held only for liquidity purposes.

The sponsor also has a choice of several types of commingled funds. Some are index (passively managed) funds; others are actively managed funds. The index funds are regarded as a way to obtain widely diversified foreign assets for a relatively low management fee. They also have been utilized as a yardstick against which to measure the performance of a plan's other portfolio managers. However, the index funds are much less popular than the other international commingled funds. Among the actively managed commingled funds are a few that are limited as to type of enterprise and number of countries in which they invest, often blue-chip companies in the most advanced industrialized countries. These are sometimes characterized within knowledgeable circles as "closet index funds". Other commingled funds may emphasize growth companies or some particular type (or types) of industry or, at a given time, may even have a majority of assets in only one favored country. Still others, in contrast, choose broad diversification, either by type of firm or industrial sector or national economy, with investments in some cases being made in as many as twelve or more countries. While a few banks and other management firms offer just one international securities fund, a number offer several different funds that vary as to type of security or currency. This provides a sponsor with greater flexibility in allocation choices as well as greater ease of guideline modifications.

Once a decision has been made to diversify internationally, a pension plan sponsor may rely on new cash flows as a source of funds for such investments. At some banks, however, when a client has agreed to allocate a given portion of its reserves to an international fund, the bank simply liquidates a corresponding amount of the client's domestic holdings. Many sponsors have built up foreign investments only when economic and financial conditions seem to favor such moves, but others have kept up their planned outflows regardless of the changing international constellation of interest, exchange, and inflation rates and of capital market conditions. For them, the basic, long-term considerations that led to their original decision to commit part of their funds abroad remain the determining investment motivation. Relatively few pension plans that have invested abroad have engaged in any net reversal of such investments. This positive attitude seems likely to continue. Of the *Fortune* top 100 industrial firms already investing abroad in 1980, over 75 percent have said they expect to increase such investments during 1981-82, and roughly 60 percent of those that rank among the next 300 firms have expressed the same intention.[11]

The amounts invested

Currently, relatively few firms have more than 5 percent of their pension fund reserves invested in foreign securities, but the number is rising, and some are shooting for 10 or even 20 percent in the not too distant future.[12] Moreover, as many as one in four of the respondents to a 1980 survey said that they expected to hold between 2 percent and 5 percent at the end of that year in contrast to the one in ten that were holding such amounts twelve months earlier.[13]

One can do no better than make an educated guess regarding the total amount of foreign securities already acquired for employee benefit fund portfolios. The Department of Labor, which obtains an annual financial report from all ERISA-covered employee benefit plans, does not require that foreign investments be reported separately from domestic investments. Thus, only by going through thousands of reports, and identifying all the securities listed, could the foreign investments be sorted out, but this is not being done. Furthermore, reports on purchases and sales of foreign securities filed on United States Treasury forms and used for United States balance-of-payments statistics do not indicate which of these are transactions for pension fund accounts and often do not include transactions for such accounts that are executed by managers from overseas offices or even by United States-based managers who transmit their transaction orders directly to foreign brokers. A few pension fund consultants try to keep tabs on the amounts invested, but none of these estimates are complete.

Banks managed $229 billion of employee benefit funds at the end of 1980.[14] Approximately $1.5 billion of this total was in the international commingled funds. The banks held additional foreign assets for the employee benefit funds either because of international diversification for separate accounts or because of foreign securities the banks purchased for commingled funds that were not international funds.[15] However,

[11] Greenwich Research Associates, *op cit*

[12] The two state retirement funds that hold foreign assets have 5 percent as their current allocations, and at least one would not hesitate to go as high as 10 percent

[13] *Institutional Investor* (April 1980)

[14] Federal Financial Institutions Examination Council, *op cit*

[15] Foreign securities purchases for "domestic" commingled accounts often are securities for which American Depositary Receipts are available, and therefore might frequently represent purchases from United States residents rather than new outflows

these latter types of holdings apparently did not exceed $1 billion, or $2 billion at most. This would imply that roughly 1-1½ percent of the employee benefit assets with banks was invested abroad, including investments in Canada and in United States dollar-denominated foreign issues. This compared with an estimated ½ percent a year earlier, when employee benefit funds managed by banks totaled $205 billion.

Life insurance companies, which had assets totaling $479 billion at the end of 1980, were responsible for the management of $165 billion of private pension plan funds: $33 billion in separate accounts and $132 billion in the general accounts Among the insurance companies' total assets, approximately $20 billion (4 percent) consisted of foreign securities. Debt securities, which always bulk large in life insurance company portfolios, accounted for $19 billion of the $20 billion. Most of this comprised Canadian paper (government, government agency, and corporate) and some small amount of international agency bonds, but there were also bonds of the governments of Mexico, Japan, France, Sweden, Israel, and some other countries, as well as debt of non-Canadian corporations.[16] Foreign-issued stock probably amounted to no more than $1 billion. Almost all the foreign investments were for the life insurance companies' general accounts, and only a very small part for the separate accounts. Since roughly 30 percent of the total general accounts consisted of pension fund monies, pension funds might be regarded as the source of approximately $6 billion of the foreign asset investments (compared with about $5 billion the previous year), even though the pension funds did not have the responsibility for stipulating how their funds were to be invested

While intermediaries outside the insurance and banking communities have significant amounts of pension fund reserves under management, again only estimates are available concerning the foreign securities investments they managed at the end of 1980 One compilation suggests the total was almost $1 billion, up approximately $200 million from 1979.[17]

In summary, the foregoing estimates suggest that at the end of 1980 roughly $9-10 billion, approximately 2 percent, of private pension fund assets was held in foreign securities through all management intermediaries, including the portion of insurance company general account foreign investments allocable to pension funds The additional foreign assets managed internally by private corporations at that time apparently totaled less than $100 million. However, some large sponsors who now have their own staffs managing domestically invested pension funds anticipate they will be able to undertake internal management of at least part of their foreign investments in another five years or so, after the staff has gained more knowledge about foreign markets and foreign securities.

As pension funds continue to increase throughout the 1980s, a net outflow would have to occur each year just to maintain an unchanged foreign investment percentage—unless the market value of the existing foreign holdings took a sudden jump. Any growth of the portion allocated to foreign assets would expand the flow further, although it is likely that the annual increase in total allocations will slacken after a number of years. Part of the rise that must be expected during the eighties will undoubtedly reflect the very recent change in attitude of a number of big banks and life insurance companies that have decided to compete in providing new foreign asset investment opportunities for ERISA clients. The same is true concerning the entrance of independent managers, brokers, and consultants into the business of trust banking. With an increasingly active and diversified group of intermediaries available as foreign asset managers and custodians, it seems likely that additional pension plan sponsors will be attracted to international diversification.

Assuming that foreign diversification grows over the rest of the decade at a rate that raises the share of foreign assets in total private pension fund portfolios by an annual average of about ½ percentage point, by 1990 foreign assets would comprise roughly 7 percent of total private pension funds, with many large funds reaching well beyond 10 percent. On the basis of the forecasts of pension fund reserves made by ICF, 7 percent in foreign asset holdings in 1990 would amount to approximately $120 billion (in current, *i.e.*, inflated, dollars).[18] This would imply that during each of the next few years the outflow would remain below $10 billion and would rise above that level only some time in the middle of the decade. The amounts would be larger if a significant number of state and local pension plans were to start investing abroad.

Implications for United States markets

What might be the implications for the United States balance of payments and financial markets as pension funds increasingly diversify into foreign assets? The foregoing estimates suggest that during the first half of the decade net outflows might expand from the approximately $2¾ billion of last year to something short

[16] American Council of Life Insurance, *1981 Life Insurance Fact Book*

[17] Information from Intersec Research Corporation

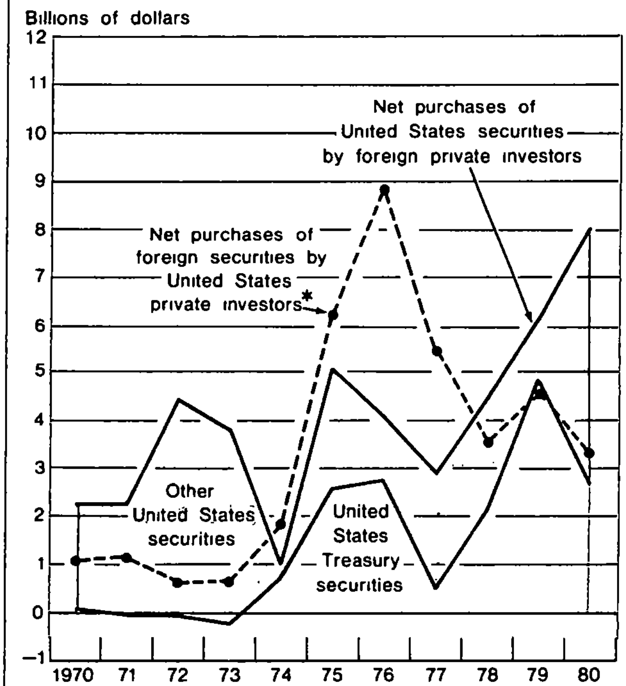
[18] The ICF "cyclelong" model on which this figure is based assumed the consumer price index would show a rise of 7 percent in 1986 and 6 5 percent in 1990 The ICF estimate of total private pension plan assets in 1990 came to approximately $1 7 trillion (ICF, *op cit*)

of $10 billion by the mid-1980s[19] These are not particularly large sums when compared with other types of capital outflows. For example, during the last five years, United States banks increased their dollar claims on foreigners (excluding claims on their own foreign branches) by an annual average of almost $18 billion. And new direct foreign investments by United States residents amounted to an annual average of over $4 billion. Inclusion of reinvested earnings would increase this figure to $16 billion [20]

A growing international orientation by United States pension funds will presumably affect to some extent the location of their short-term liquid reserves, the volume of which can fluctuate considerably. For example, since 1978, "cash and deposits" of private noninsured pension funds have accounted for 4 percent of total assets after having constituted only 2 percent for many years, and at the end of 1980 such liquid assets amounted to $9.3 billion[21] This undoubtedly reflected the diversion of funds from long-term investments in 1978, due to the drop in bond and stock market prices and the surge in short-term interest rates. Thereafter, liquid reserves were kept at high levels presumably because of uncertainty about the outlook for capital market developments and the continuing attraction of short-term rates. In the future, at similar junctures, when short-term rates abroad are also attractive, pension fund managers may pay increased attention to the alternative foreign liquid investment possibilities (as perhaps indicated by the establishment of an international cash division in the Bank of America's new international commingled fund). A persistent trend toward greater international diversification of *short-term* investments would introduce the possibility that the management of such investments would contribute to exchange market volatility. However, these flows would be just one stream in a multitude of many fluctuating sources of supply and demand in the huge short-term financial markets

At the same time that United States investors have begun to look abroad, the incentive to diversify and the breadth and depth of United States capital markets have led additional numbers of foreign investors to look to the United States Indeed, throughout the past decade, except for a bulge in outflows during the years 1974 through 1977 resulting from the elimination of the interest equalization tax and the reemergence of the Yankee bond market, foreign private inflows into the United States securities markets were considerably greater than outflows into foreign securities markets by *all* private United States investors—pension funds, foundations and other institutions, businesses, and individuals (chart).[22] Thus, any diversion to foreign markets of pension fund resources that might otherwise have been invested in domestic capital markets has in most years been much more than offset in amount by inflows from private foreign residents. In addition, there have been considerable investments in United States private securities by foreign official agencies

Net Foreign Securities Purchases by Private Investors



* No data available on components of net purchases by United States private investors

Source United States Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, June 1981

[19] It is to be noted that, even when foreign fixed-income investments are United States dollar denominated, as the bulk of the insurance company investments have been, the borrowers generally convert the funds into foreign currencies, resulting in flows through the exchange markets

[20] Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, and the United States Department of Commerce, *Survey of Current Business*

[21] United States Securities and Exchange Commission, *SEC Monthly Statistical Review* (May 1981)

[22] Some penison fund outflows are not recorded in these figures, particularly, as noted above, when managers are operating out of overseas offices and/or foreign brokers are being used

The clear-cut existence of a two-way flow of funds in an increasingly interdependent world, but one where the United States continues to exert an extraordinarily strong pull on foreign investors—not only into the securities market but also into real estate and direct investments—makes it appear improbable that the rise in investments abroad by United States pension funds (and other institutional investors) will lead to a secular downward pressure on the United States dollar. The current Administration's general attitude concerning the need to encourage investment, and its budget and tax policies, may reinforce foreigners' interest in investing in this country. Moreover, the longer term foreign investment strategies that United States pension plan sponsors have by and large followed, and the relatively low weight most of them give to short-run exchange market conditions, means that the management of these funds is not likely to be a significant source of instability in exchange markets. Indeed, the presence of more international capital flows that are governed by a longer view could actually be a source of stability.

Thus, the growing international diversification of United States pension fund portfolios seems, from the vantage point of 1981, to be a development that is capable of providing benefits for both pension plan sponsors and pension fund beneficiaries—if the sponsors are sufficiently knowledgeable to make the proper choices concerning guidelines and managers. Moreover, the expanding diversification appears unlikely to have any noticeably adverse effects on the exchange rate for the dollar or any perceptibly negative effects on United States financial markets. The outflows will not be particularly large, compared with other capital outflows, and investments in this country's markets by foreigners will probably continue to be much greater.

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