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Are market values fair?
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Are market values fair?

- Yes, obviously!
- Are they always well-defined?
 - Illiquid assets: real estate, hedge funds, private equity
 - Non-traded assets: indexation to (sectoral) wages
 - Incomplete contracts: who owns the surplus?



Fair valuation causes DB plans to gradually disappear

- Fair valuation
 - ⇒ More transparency
 - ⇒ Firms realise that DB plans do not create value
- Alternative explanation: aging population with reduced base of active workers
 - Explanation matters for thinking about the way to go
- Empirical evidence
 - Less pure DB plans
 - Alternative pension schemes, mixed DB/DC



Do pension plans add value?

- Basic corporate finance argument
 - For firms pensions are equivalent to deferred wages (Sharpe, 1976)
 - Individuals can undo the pension scheme by private financial transactions
- When replication fails ...
 - 1) Taxes (Tepper, 1981)
 - 2) Basic minimum pension
 - 3) Indexation: real versus nominal
 - 4) Cost structure of pension funds
 - 5) Intergenerational risk sharing
 - 6) Behavioral biases



Pension funds have higher returns after costs

- Evidence in Bauer, Frehen, Lum and Otten (2006)
- Mutual funds underperform pension funds by 2.5%
- Explanation through agency costs
- More on this later this conference: Keith Ambachtsheer



Intergenerational risk sharing

- Quantitative evidence in Gollier (2007)
- Compare three pension schemes
 - Pure individual DC
 - Straightforward DB
 - DB with solvency constraint imposed by supervisor
- Certainty equivalent returns
 - DC: **3.3%**
 - DB: **4.4%**
 - Solvency: **3.8%**
- Results driven by equity premium of 3.9%



Can individuals take care of themselves?

- Behavioral biases
 - Massive inertia
 - Tired of making choices
 - Financial illiteracy
 - Procrastination, hyperbolic discounting
- Campbell (2006)
 - Mistakes by poor and low educated households
 - Mortgage refinancing as an example
 - Equilibrium?



Open questions

- Why are markets so incomplete?
 - Limited availability of index-linked bonds
- What is ideal pension plan?
 - What would a rational individual do?
 - Which individuals have unwanted exposure?
 - Human capital
 - Homeownership
 - Financial wealth

