Portfolio strategy: Ken Fisher

Forbe's Magazine's Portfolio Strategy columnist and Fisher Investments chief executive KEN FISHER says that current assumptions that stocks will be hurt by the underfunding of pensions plans are wrong – and he remains convinced that 2003 will exceed all expectations

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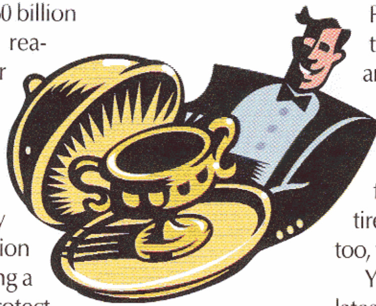
Reasons to be bullish in 2003 (part two)

You read it here first – 60 billion unexpected sterling reasons, right under our noses, why stocks should exceed common expectations this year. You've read how stocks will be hurt by falling earnings caused by defined benefit company pension plans being underfunded, forcing a diversion out of earnings to protect present and future pensioners.



This is half-sighted and wrong-headed. First, yes, caused by the bear market, pensions are underfunded. Yes, cash will be diverted to replenish them. In the US, UK and Canada the total approximates £30bn more in 2003 than 2002. But, to think this is bearish is wrong-headed. It is money directly used to buy stocks and bonds. It is a direct increase in demand for securities, which is bullish.

It is half-sighted because just as much will be legally forced into buying stocks and bonds from the US's municipal and state pension plans. They will be legally forced to buy another £30bn more stocks and bonds in 2003 than they did in 2002 – again, a direct increase in securities demand. No one knows this. You've read it nowhere. It's big and it's unexpected.

Consider how these plans work. They have assets with known worth at a given time, but volatile. So, plans calculate them on a smoothed average basis, usually three years. As a long bear market evolves, calculated asset values shrink, even after a bear market bottom.

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Pensions have liabilities, too – what they must pay out now to pensioners and also what today's employees must eventually be paid in retirement, before death. Plans can only estimate liabilities based on multiple future assumptions – inflation, retiree life span and so forth. Assets grow, too, with markets but how much?

Yearly, the pension's actuary calculates asset values and estimates of future liabilities and returns. By matching them against each other it calculates what must be paid now and in future years to meet all liabilities. Then, the corporation or municipality must pay the pension plan that amount. Slight changes in estimated future returns vastly impact current payments.

Common sense might suggest that as a long bull market progresses, pensions would slowly temper their future estimated returns – because they will now proceed from a higher base. And that as a bear market progresses they might slowly boost their future estimated returns, proceeding from a lower base. But they never do.

Quite the contrary – so now, on cue, pensions everywhere are lowering estimated future returns. The bear market made them more bearish. Recent estimates have averaged about 9% a year – some as high as 10% – a few as low as 6.5%. Most plans globally, with fallen asset levels, are also lowering their estimated future returns, at least incrementally, which forces up the 2003 cash contributions. In the US, it is the number one legal liability of any public pension plan.

A few big corporations are visible. General Motors will be several billion dollars of increase. But public pension plans will do as much. How much will they buy of stocks versus bonds? It's impossible to know. Public plans will largely issue municipal bonds to pay for all this. On average, their pensions buy about half stocks, half bonds.

Corporations usually buy about 60% stocks, 30% bonds and 10% a flotsam of miscellany. Suppose the £60bn of increased buying was simply half stocks, half bonds. Compare that to 2002's all-time record £35bn of outflows from US mutual funds and UK unit trusts. This is big stuff.

As I said last month, expect 2003 surprises to improve as the year rolls along. Some stocks to help the trend include two money managers, Alliance Capital Management from the US and Amvescap from the UK. Both are stylistically quite well diversified within the industry and have impressed me with their ability to market in a tough time.

Or, from the very beaten-down insurance sector, try Aegon or Allianz. Both are cheap and durable. Or one of the world's leading food processors, Archer Daniels Midland. Don't let the scandal from years past fool you. It's a great firm. Or the leading Hawaiian freight transporter, Alexander & Baldwin, which is also a leading maker and seller of coffee and sugarcane. Geesh! I never got past "A" in the alphabet. I must be bullish. BM

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The market predictions herein come from Ken Fisher's Bloomberg Money "Portfolio Strategy" column.
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