BS2551 Money Banking and Finance

Institutional Investors

Institutional investors – pension funds, mutual funds and life insurance companies are the main players in securities markets in both the USA and the UK. The growing dominance of institutional investors within the financial system makes their role fundamental in international equity markets.

Features of institutional investors

Diversification – Due to high trading volume, institutions get a better trade off of risk and return then is possible by direct holdings.

Long-term liabilities – they are able to hold high risk and high return instruments such as shares and financial options. They are not subject to runs unlike banks who have to match their assets and their liabilities.

Size – economies of scale lower costs of investment due to the following reasons:

- Sharing skills of expert managers

- Larger volumes of transactions giving lower commission charges.

- Ability to invest in large shares of stocks, such as block trades.

- Ability to offer insurance to investors by pooling individual risks, from high risk (options) to low risk (government bonds).

- Liquidity Preference – they prefer to invest in large liquid assets so they can diversify their risk at any given time. This is in contrast to commercial banks who are content in holding illiquid assets.

- Information – they have access to better information (analysts forecasts) than individual investors, and more resources to process publicly available information.

Main types of institutional investors

Pension funds – involved in pooling and investment of funds contributed by sponsors and members for future pensions. (1) Defined benefit, pension based on final salary (e.g. USS scheme) and (2) defined contribution, pension based on accumulated investments (e.g. Standard Life).

Insurance companies – life insurance (insurance against risk of death, and also form of saving) and non life (car, house insurance).

Mutual finds (unit trusts) – form of saving which are vehicles for pooling of assets to get a better risk/return trade payoff. Individual investors choose the type of asset they invest in and is free to buy or sell at current market prices (e.g. fidelity investments).

In the UK institutional sector features very large life insurers and pension funds, while the US is dominated by pension funds and mutual funds.

Risk bearing and nature of regulation

In defined pension schemes and life insurance, there are guarantees by the institution for a fixed return (e.g., the USS pension scheme is equal to the proportion of final salary). This means that the

institution itself bears some risk of bankruptcy, and they are regulated quite strictly.

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

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

For example, UK pension funds have 4% liquidity and 0% in loan, whereas Germany has 0% liquidity and 33% in loans.

Reasons for Growth of Institutional Investors

Supply Side Reasons

Economies of scale force reduction in transactions and management costs making them beneficial to investors.

Diversification and risk pooling. They have the ability to diversify risk away meaning that they provide less risky outcomes for investors.

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

Recent Developments

Deregulation of markets and portfolios, enable better diversification and more competition.

New instruments, ability to use derivatives such as futures and options.

Alternative products such as bank deposits are unattractive.

Demand Side Reasons

Demographic aspects

Existing fall in birth rates and rise in life expectancy (example in UK life expectancy increases from 72 years, 1970 to 78 years old in 2000).

Effects on the high savings group.

Prospective population ageing,

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

Pressures on public pension systems

Public pensions are usually paid direct to current workers from public taxes. Because of ageing population and greater life expectancy, we would expect rises in public pension expenditures, which cannot be financed without very high taxes.

This has coincided with reforms in public pensions, such as annuities, which have 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 Exp / GDP	1995	2005
UK	4.3	4.1
USA	4.9	6.3
Germany	11.7	16.6
Japan	6.8	8.2
Canada	5.3	10.4
France	12.2	15.8
Italy	13.4	15.7

Non Demographic Aspects- wealth accumulation. As people get richer they invest more in institutions.