



“Herding” by pension fund managers threatens market stability, research shows
25-year study also suggests UK pension funds are failing to earn a long-run liquidity premium on investments

Pension fund managers are threatening the stability of financial markets by “herding” in and out of asset classes at the same time, according to a 25-year study.

New research reveals pension funds of a similar size and sector herd together in the short-term, potentially driving assets away from their fundamental values.

Market stability is also being put at risk as pension funds rebalance their portfolios to match their liabilities rather than in response to changes in the expected risks and returns on the assets in their portfolios.

The study by the Pensions Institute at Cass Business School, part of City University London, examined 108 corporate and 81 local authority pension funds between 1987 and 2012. The sample amounts to one third of the value of the UK pension industry.

Entitled *‘The market for lemmings: Is the investment behaviour of pension funds stabilising or destabilising?’*, the study is the first to reveal pension fund behaviour is less stabilising than previously believed.

Dr Gabriele Zinna, co-author of the report, said: “We find that pension funds herd and, in particular, they herd in subgroups defined by size and sector type. Public sector funds follow other public sector funds of a similar size and large private sector funds do the same. The effect is less clear cut for smaller private sector funds. This could clearly be destabilising if pension funds were also to follow the same positive-feedback strategies, such as momentum trading.”

The authors also found the short-term objective of pension fund managers is to automatically rebalance their portfolios when valuation changes violate short-term investment mandate restrictions, while their long-term objective is to systematically switch from equities to bonds as their liabilities mature.

Professor Lucio Sarno, added: “As a result, the average pension fund’s investment behaviour can be destabilising, since it does not respond to the release of new information. This mechanical rebalancing risks driving prices away from, rather than towards, equilibrium prices.

“The good news is that pension funds are not momentum investors, and hence, do not contribute to asset price volatility. The bad news is that the herding behaviour of pension

funds, combined with their automatic rebalancing, which is driven by their liabilities rather than by expected risk and return, can prevent asset prices reaching their fundamental values.”

The authors also examined the liquidity premiums earned by pension funds over 25-years. The long-term nature of pension funds’ liabilities and their predictable cash outflows should allow them to earn higher net investment returns by investing in illiquid securities at times when other investors are facing liquidity shortages.

However, the study found no evidence of a positive liquidity premium in the pension funds’ total return in excess of the peer group return, which itself was similar to the market return as measured by external indices.

Director of Cass’s Pensions Institute, Professor David Blake, said: “The bottom line is that, although they are long-term investors, UK pension funds have not earned a positive long-run liquidity premium on their investments. This is because their behaviour is driven by different incentives. Pension fund managers fear relative underperformance against their peer-group, which encourages them in the short-term to herd around the average fund manager, who turns out to be a closet index matcher.”

The market for lemmings: Is the investment behaviour of pension funds stabilising or destabilising? by Professor David Blake and Professor Lucio Sarno, Cass Business School, and Dr Gabriele Zinna, Bank of Italy. The paper is available here: www.pensions-institute.org/workingpapers/wp1408.pdf. The authors are grateful to State Street Investment Analytics for providing the data set used in this study.

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Notes to Editors:

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