Foreign Pension Fund Investments in the United States

Foreign pension funds are investing sizable amounts in the U.S. securities and real estate markets. These pension funds, which supplement government social security systems, are growing, as are those in the United States, at a rapid rate. The annual flows into the funds constitute a large part of national savings, and their deployment accounts for an increasingly significant share of total new investments in the capital markets of the respective countries. At the same time, however, international diversification has become an important feature of pension fund management, with U.S. assets generally accounting for a major portion of the foreign investments.

This article focuses on U.S. investments by the pension funds of four foreign countries—the United Kingdom, the Netherlands, Canada, and Japan—which together comprise all but a small portion of total foreign pension fund holdings in the United States. The first three are countries whose fund managers began to invest abroad many years ago.[1] In Japan, international diversification got under way more recently, and U.S. holdings are still quite small. However, Japanese funds are in an early state of development, and their portfolios will be expanding particularly rapidly. U.S. assets also make up significant portions of the pension funds of some countries not covered in this article but, due to the comparatively small size of the labor force in those countries, the totals invested here are not substantial. Some larger countries do not have funding requirements; consequently, accumulated reserves are relatively insignificant.[2]

The flow into the United States from the foreign funds has risen significantly in recent years, reflecting both the swelling of the funds and the increase in the share allocated to foreign investment. Of all the world's capital markets, those in the United States have stood up over the long run as the most attractive. During the past few years, growing uneasiness about various political and economic developments in home countries and elsewhere has strengthened the interest in U.S. assets. At the same time, however, a trend has been developing toward broader geographical diversification by pension funds in countries where foreign holdings have heretofore consisted overwhelmingly of dollar assets.

The author is greatly obligated for information used in this article to a host of individuals, too numerous to mention, from various foreign entities, including government agencies, central banks, corporate pension funds, financial intermediaries, and national organizations of pension fund managers.

[1] This is in sharp contrast to developments in the United States, where international diversification began only in the late seventies. The movement into foreign assets by U.S. pension funds, and its implications, were examined in detail by the author in "International Diversification by United States Pension Funds", this *Quarterly Review* (Autumn 1981).

[2] In *Italy*, less than 20 percent of the working population is covered by private plans. Although reportedly a majority of the firms that do have plans choose to fund them, thereby deriving tax benefits, Italian foreign exchange regulations inhibit foreign investments. In *Germany*, almost all business enterprises with pension plans carry their plan liabilities on their corporate balance sheets instead of setting aside separate reserves. The only firms whose pension plans are funded are affiliates of companies headquartered in other countries. In *France*, private pension plans are mandatory but operate on what is, in effect, a pay-as-you-go system, with current workers paying for current retirees.

Table 1

Funded Pension Plans—1981

In billions

Country	Accumulated reserves as of end-1981 Trusteed funds	Accumulated reserves as of end-1981 Insured funds	Growth of reserves in 1981 Trusteed funds	Growth of reserves in 1981 Insured funds
Canada*				
Canadian dollars	60½	15	10	1
U.S. dollar equivalent	51	12½	8½	1
Japan†				
Japanese yen	6,500	3,200	1,100	700
U.S. dollar equivalent	29½	14½	5	3
Netherlands‡				
Dutch guilders	92	32§	10	3½
U.S. dollar equivalent	37	13§	4	1½
United Kingdom				
Pounds sterling	64	33	7	3½
U.S. dollar equivalent	122	63	13½	6½

Some reserve figures are market value, others book value. Reserve growth figures for 1981 are mainly book value. Most of the figures on insured funds are estimates. U.S. dollar conversions are at end-1981 rates.

* Reserves for Canadian Government Annuities, a holdover from an earlier pension era, comprise an additional Can.$500 million.

† Data as of March 31, 1982, the end of the fiscal year.

‡ Excludes the General Public Service Pension Fund, the country's largest fund (assets at the end of 1981 totaled Fl 83 billion), since the only foreign assets it is allowed to acquire are foreign government bonds listed on the Amsterdam stock exchange.

§ The insurance companies are used almost solely for guaranteed contracts, primarily by the smaller pension funds. The volume of foreign investments was insignificant.

Sources: United Kingdom: Central Statistics Office, *Financial Statistics*; the Netherlands: De Nederlandsche Bank, *Annual Report;* Canada: Statistics Canada, *Trusteed Pension Plans Financial Statistics* and *Financial Institutions Financial Statistics;* and Japan: The Bank of Japan, *Economic Statistics Monthly*. Also, unpublished information.

Despite the scarcity of hard data, information gathered for this article suggests that the amount of foreign pension money that has been coming here during the last three years may have grown from perhaps $2½ billion a year to approximately $4 billion. This range constitutes roughly the same order of magnitude as the estimated outflow of U.S. pension money into investments abroad. It seems likely that a near balance will continue to be the situation for at least the next five years. One can therefore conclude that the increasing internationalization of pension fund portfolios is occurring without significant effects on the value of the dollar in the exchange markets. In addition, the overseas investors are adding to the depth and the liquidity of U.S. securities and real estate markets. Moreover, both the foreign and the U.S. pension funds are able to develop portfolios that their sponsors and managers regard as better than could be achieved if they were restricted to purely domestic investments.[3]

Pension fund reserves and government regulations

The actual volume of investments in U.S. assets depends upon a large number of variables. The potential volume, however, depends basically on (1) the size of the accumulated pension fund reserves and of the ongoing additions to these reserves, and (2) government regulations concerning portfolio investments.

Volume of reserves

The size and rate of growth of pension funds reflect, among other factors, the number of people covered and the liberality and maturity of the plans. They also

[3] For details on the motivations for U.S. funds' diversification, see article cited in footnote 1.

reflect government funding regulations—*i.e.*, the extent to which actuarially determined reserves must be accumulated. Figures showing the amount of reserves accumulated by the end of 1981 in funded pension plans in the four countries discussed, and the 1981 growth of reserves, appear in Table 1. Because investment regulations and policies differ between insurance companies and other types of intermediaries, the table divides the data into two components, insured and trusteed. "Insured" funds are those handled by insurance companies, often on a guaranteed income basis. "Trusteed" funds are those managed either internally, *i.e.*, by the firm sponsoring the pension plan, or outside by noninsurance company intermediaries, including banks, trust companies, brokerage houses, and investment counselors.

The mass of reserves accumulated by *United Kingdom* pension funds was by far the largest, as was the annual reserve growth. To some extent, the rate of growth in recent years has reflected new tax incentives introduced in the 1970s, which stimulated an increase in funding.[4] The smallest accumulation was in *Japan*, where funded plans covered about the same number of active workers as in the United Kingdom but accounted for a much smaller percentage of the labor force. Additional plans are being established at a rather substantial pace, partly because of recently heightened favorable tax treatment.[5] Partly as a result of this increase in plans, the liabilities and reserves of the pension funds are climbing steeply. Also contributing to the swelling of the funds are improvements in benefits and a rise in employee and retiree ages because of a sharp increase in the Japanese life span.

In all four countries, the large wage increases that accompanied the high inflation rates of the past decade contributed importantly to sharp upward pressures on required reserves. However, in some countries actuarial assumptions were, or are being, modified to allow for anticipation of higher portfolio returns, thereby reducing for some funds indicated increases in employer-employee contributions. Moreover, due to the difficult financial situation in which many firms have found themselves because of the worldwide recession, some employers' contributions have been temporarily cut back. The contributions are expected to be restored to their previous levels, however, as soon as financial conditions permit.

Investment regulations

Government regulations concerning pension fund investments vary widely. They are very liberal in both the *United Kingdom* and the *Netherlands*.[6] In *Canada*, however, the government regulates investments both by type and quantity. And in *Japan*, where flexible Ministry of Finance guidelines substitute for regulations, the guidelines are more restrictive of investments handled by trust banks than those by insurance companies.[7] Everywhere, including countries not covered here, local government employee plans are usually more conservative in their investments than are other funded plans, sometimes because of regulation, sometimes because of custom. This has resulted—at least until very recently—in their making comparatively small, and even no, foreign investments.

The basic national regulatory attitudes carry over into the foreign investment sphere. The pension funds of *British* private and nationalized industries are allowed to invest abroad freely. The only restraints, as with domestic investments, are those imposed by fund trustees. The local authority pension funds still have some constraints, but these are currently under review. Also, the investments of pension funds managed by insurance companies as part of their long-term funds are subject to the general restriction that 80 percent of an insurance company's assets must correspond to the particular currencies in which its liabilities are expressed. In the *Netherlands*, foreign investments are similarly free of formal government restrictions. The Chamber of Insurers, which supervises the private plans but makes no general rules, may offer comments regarding a plan's investment policies. Reportedly, however, it seldom does this before an investment proves to have been ill-advised.

In *Canada* and *Japan* the situation is very different. Canadian tax regulations effectively limit foreign investments to 10 percent of the book value of total assets. Any entity exempt from income taxes becomes subject to a monthly penalty on foreign investments in excess of the prescribed 10 percent. This ceiling becomes especially restrictive when a manager wants to realize a capital gain and to reinvest, since the transaction immediately increases book value. Within the overall 10 percent ceiling there is a further restriction of 7 percent on foreign real estate. In Japan,

[4] See the article beginning on page 13 of this *Review* for a discussion of the relevant British government steps to shift the burden of pension provision from the public sector to the private sector.

[5] Tax revisions in the 1960s encouraged firms to start funded plans. Previously, retirement plans were mostly unfunded and provided only lump sum severance payments. In 1981, complete tax exemption was provided for all funding contributions.

[6] The British government has established an interdepartmental working group to look into all laws and conventions affecting pension funds. Their report, due this year, could lead to some changes.

[7] The trust banks and insurance companies are the only two kinds of intermediaries allowed to manage Japanese pension funds. The single, important exception is the Daiwa Bank, a commercial bank that in this context is treated by the government as a trust bank.

Ministry of Finance guidelines permit pension funds to be invested in foreign-currency-denominated financial assets only up to 10 percent of total portfolios. The insurance companies are permitted to make additional pension fund investments in foreign real estate, but only within the 20 percent limit prescribed for aggregate real estate investments. Moreover, informal agreements with the Ministry of Finance at times restrict the amounts of foreign investing that banks and insurance companies may do currently.

Investments in U.S. and other foreign assets

The aggregate numbers

The major foreign financial assets in the pension fund portfolios of the four countries are estimated, on the basis of comparatively firm data, to have amounted at the end of 1981 to the equivalent of about $20 billion (Chart 1). This figure reflects conversion of foreign currency values into U.S. dollars at end-1981 exchange rates. The assets comprised practically all of the foreign financial investments but not any foreign real estate holdings (which the author believes may have totaled at least $4 billion).

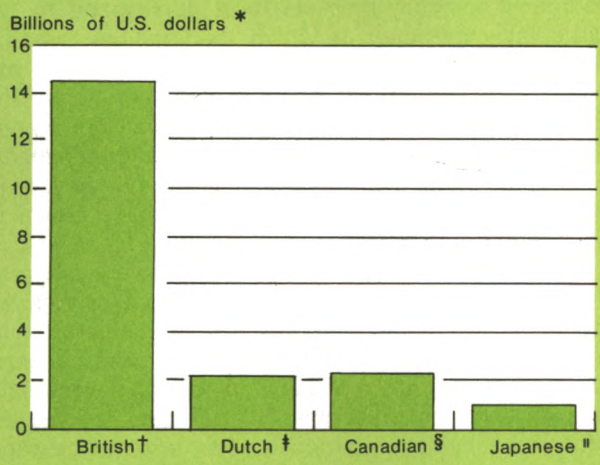
Total U.S. assets held by the funds of the four countries amounted, by very rough estimate, to about $13-14 billion (Chart 2). U.S. financial assets accounted for about $11 billion,[8] or slightly over half of all foreign financial investments. U.S. real estate investments are estimated to have been about $2½ billion, with United Kingdom holdings constituting approximately 60 percent of this aggregate.

A substantial portion of the *United Kingdom* pension funds' foreign assets was acquired in the two years after exchange controls were lifted in October 1979. These controls had greatly curtailed foreign investments because of the very high premium that had to be paid for dollars. The removal of controls released a large pent-up demand, and purchases of foreign assets, especially corporate equities, jumped. In 1981, close to 25 percent of the trusteed funds' net additions to their securities portfolios consisted of foreign

Chart 1

Foreign Financial Assets in Foreign Pension Fund Portfolios

End-1981



* Converted into U.S. dollars from foreign currency figures at end-1981 rates.

† Foreign assets of trusteed funds and of relevant portion of life insurance company long-term funds.

‡ Foreign assets of trusteed funds only. Foreign assets at life insurance companies were negligible.

§ Foreign assets of trusteed funds and of relevant portion of life insurance company segregated funds.

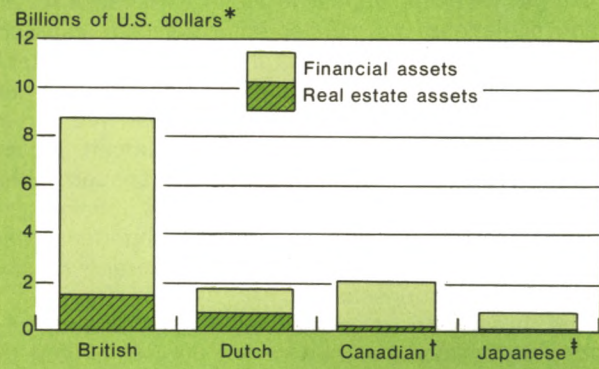
‖ Foreign assets of trusteed funds and of relevant portion of life insurance company assets.

Sources: See Table 1.

Chart 2

Estimated U.S. Assets in Foreign Pension Fund Portfolios

End-1981



* Converted into U.S. dollars from foreign currency figures at end-1981 rates.

† Real estate holdings may be no more than $100-200 million.

‡ Real estate holdings may be only about $50 million.

Source: Author's estimates, based on data in Chart 1 and unpublished information.

[8] Includes a small amount of Eurodollar bonds.

securities, and at the insurance companies the share rose to almost 20 percent (Chart 3). By the end of that year, approximately 10 percent of the accumulated financial assets were foreign assets. Probably about half of these were U.S. assets.

Foreign investments by the *Dutch* pension funds picked up strongly in 1979, with bonds being favored over equities. By 1980 and 1981 about 5 percent of the annual additions to their financial investments were foreign investments and, at the end of 1981, foreign assets represented 6 percent of total financial assets (Table 2). The writer estimates that U.S. holdings accounted for somewhat less than one third of these investments.

For both the *British* and especially the *Dutch* funds, investments in foreign real estate were also significant. U.S. real estate investments, shown in Chart 2, may well have represented at least 75 percent of the foreign real estate held by the United Kingdom funds but probably no more than 40 percent of that held by the Dutch funds.

Pension funds in *Canada,* as already noted, are expected by the authorities to hold their foreign investments to a maximum of 10 percent of portfolio. In *Japan,* a similar 10 percent restriction applies to foreign-currency-denominated assets, but insurance companies can put additional money into foreign real estate. Virtually all of the Canadian investments are in corporate shares, and more than half of these were acquired during the three years 1979-81 (Table 2). Although only 4 percent of the end-1981 trusteed pension fund portfolios (including local government funds) consisted of foreign assets, many pension plans of the larger business firms and Federal Crown corporations were at, or very close to, the maximum 10 percent.[9] In Japan, even though only one year had elapsed since the banks were allowed to put pension fund money abroad, by the end of 1981 they already had an estimated 2 percent invested overseas. The insurance companies, which had been investing abroad for several years, are believed to have had about 3 percent of their aggregate portfolios in foreign holdings. U.S. assets clearly accounted for all but a very small fraction of the Canadian foreign holdings, and apparently they represented approximately 60 percent of the Japanese foreign holdings.

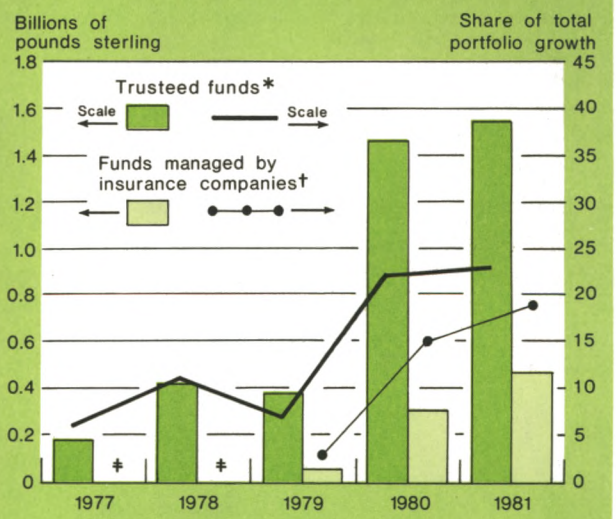
The U.S. attractions

Although the concentration in U.S. assets began to decline during the seventies in some of the countries, the flows into the United States have continued to rise along with the growth of the pension funds. The sheer size of the U.S. securities markets, their high degree of liquidity, the variety of economic sectors represented, and the vast array of securities issues from business firms and government entities have all contributed to this drawing power.

Investments in U.S. real estate are also growing. The Dutch and British funds had started to acquire real estate in Europe during the 1960s in response to inflationary pressures on pension plan costs and to declines in equities prices. By the mid-1970s their investments had extended into the United States. The Canadian and Japanese pension funds, in contrast, began to invest even in domestic real estate only very recently. Again market size has been among the U.S. attractions for investors. One reason is that small real estate staffs can develop broad holdings while concentrating limited energies on a single country.

Chart 3

British Pension Funds' Annual Net Additions to Foreign Financial Holdings



* Foreign financial investments by trusteed pension funds of private and nationalized firms and public authorities.

† Estimated at 55 percent of the foreign financial investments by insurance company long-term funds.

‡ Not available.

Source: United Kingdom Business Statistics Office, Business Monitor MQ5.

[9] Among the largest Federal Crown corporations are such companies as the Canadian National Railway, Air Canada, and the Canadian Broadcasting Corporation.

The U.S. markets are also more liquid than most other real estate markets.

In more recent years, the apparent hardening of political and military positions between the Soviet Union and the United States, the unstable political situation in several European countries, and the nationalization of important industries in some countries have made the U.S. financial and real estate markets appear particularly attractive. Fund managers place a high value on the relatively safe geographical location of the United States, its free market orientation, its reliable legal system, and its tremendous natural, industrial, technological, and manpower resources.

Despite these perceptions, the emergence in the postwar years of Japan and then of a number of other countries as successful industrial producers inevitably caused attention to be more broadly focused. These investments have been aided by the rapid de-

Table 2

Dutch Private Pension Funds: Foreign Net Acquisitions

In millions of guilders

Year	Bonds	Private loans	Shares	Total	Total as share of year's aggregate net acquisitions
1977	−70	292	−214	8	*
1978	44	196	−226	14	*
1979	320	30	− 6	344	4
1980	299	82	219	600	5
1981	306	90	136	532	5
Addendum: Accumulated foreign holdings					Total as share of all assets
End-1981	1,721	1,471	1,935	5,127	6
U.S. dollar equivalent (millions)	697	596	784	2,077	6

Canadian Trusteed Pension Funds: Foreign Net Acquisitions

In millions of Canadian dollars

Year	Bonds	Shares	Total	Total as share of year's aggregate net acquisitions
1977	1	19	20	*
1978	0	134	134	2
1979	3	516	519	7
1980	7	517	524	6
1981	17	535	552	6
Addendum: Accumulated foreign holdings				Total as share of all assets
End-1981	38	2,616	2,654	4
U.S. dollar equivalent (millions)	32	2,206	2,238	4

Table does not include minor amounts of other types of foreign financial assets or any foreign real estate.

* Less than ½ percent.

Sources: De Nederlandsche Bank, *Annual Report,* and Statistics Canada, *Trusteed Pension Plans Financial Statistics.*

velopment of capital markets outside the United States, which has reduced the share of U.S. equities in the world market from almost 70 percent a decade ago to only a little over half of the world total today. The world role of the U.S. bond market has similarly declined relative to national bond markets in other countries and, especially, relative to the Eurobond market.

Thus, there are two basically opposed developments affecting the foreign investment decisions of the foreign pension fund managers. The net effect has been an increase of investments in third-country assets but at the same time investments in U.S. assets continue to expand. Moreover, the interest in real estate as a long-term investment is supporting the flow into the United States. In sum, although the dominance of U.S. assets in the foreign sectors of pension fund portfolios has declined, U.S. assets still constitute by far the largest foreign component.

Investments in U.S. securities

During the 1960s and well into the 1970s the United States was the leading foreign location for *United Kingdom* pension fund financial investments, which were almost entirely equities. The U.S. investments accounted for perhaps as much as 80 percent of the total. However, during the seventies, funds began to be placed increasingly in Japan and in small amounts in areas formerly part of the British Empire. Investments were also made in continental Europe. A sluggish U.S. stock market contributed to a slow growth of U.S. holdings. By 1981, U.S. assets probably were down to approximately half of the total. Nonetheless, they had increased in absolute volume. Moreover, during 1982 a swing from Japanese investments back to U.S. investments got under way.

An important foreign investment vehicle for all but the larger pension funds has been the British tax-exempt unit trusts (similar to closed-end mutual funds in the United States) set up by merchant banks, clearing banks, and large stockbrokers. The merchant banks have the biggest share of the business, while the trusts run by the stockbrokers have as their clients primarily small pension funds. Small funds also acquire foreign assets through insurance companies, which make foreign investments for their general funds—although some insurance companies also use the unit trusts. There are a number of international unit trusts that can invest anywhere, but more recently some have been established to invest in specific geographic areas. Apparently a considerable part of the non-U.S. investments is being channeled through these specific area trusts, including investments by large pension funds that do not have in-house expertise for certain countries.

Although foreign financial assets constituted about 6 percent of *Dutch* pension funds at the end of 1981,[10] holdings of U.S. financial assets probably comprised less than half. Fixed-income assets accounted for approximately 60 percent of total foreign financial investments, but U.S. assets were perhaps only a third of these. Private loans constituted close to half of the interest-yielding assets and were almost entirely in other countries. Of the equities, however, apparently more than half were U.S. securities, and the percentage clearly increased during 1982.[11]

Until recently, almost all of the foreign investments of the *Canadian* pension funds were in the United States. At the end of 1981, corporate shares comprised close to 99 percent of their total foreign investments; all but an insignificant portion consisted of shares in U.S. companies. The United States is so comfortably close and the choice of equity issues so vast compared with Canada's primarily resource-based activities, relatively few funds have invested in other markets. Some funds are even being sent below the border in the form of venture capital. The funds have not invested in U.S. bonds because Canadian yields have been much higher. A few of the larger funds have been making direct loans to U.S. firms; these are on a floating-rate basis, against mortgage security, and with final maturities that go out to twenty-five years. Nonetheless, the great majority of pension funds among both trusteed accounts and insurance company segregated accounts that have foreign assets hold U.S. corporate shares as their sole foreign investment.[12]

The Canadians' almost exclusive concentration on the United States is changing, however. In the last year or so, some fair-sized amounts have been placed elsewhere, principally in Japan and Europe. Some large funds are investing directly, using investment advisers in London or the Far East. In addition, Canadian investment counselors have set up mutual funds for offshore investment, and Canadian trust companies have established pooled funds for the same purpose. There are already a few funds designed solely for investing in non-U.S. equities.

The *Japanese* pension funds hold the bulk of their foreign investments in dollar-denominated securities.

[10] This excludes pension funds with insurance companies, which until recently had invested only a minute amount abroad.

[11] Some of the largest foreign investments are by the several Dutch-based multinational companies. Their foreign holdings reflect to a minor extent anticipated foreign liabilities to provide pensions for staff members who expect to retire overseas. Often dollar assets are held even when pension liabilities are expected to be in other foreign currencies, especially currencies of countries that do not have important securities markets.

[12] In many cases, however, the holdings are limited to shares of a U.S. parent company.

Equities comprised only 3½ percent of their foreign holdings at the end of 1981; almost all, both at the trust banks and the insurance companies, were shares of U.S. corporations. The fixed-income securities were more widely distributed. At most banks and insurance companies the majority of such holdings were dollar denominated, including large amounts of Eurodollar bonds as well as bonds issued by foreigners in the U.S. market, the so-called Yankee bonds. At a few banks, Canadian dollar bonds were dominant or almost equal in importance to U.S. dollar securities.

By 1982, as the Japanese funds continued a rapid buildup of foreign investments, diversification became increasingly evident. Some portfolios had securities that were denominated in about eight additional currencies. These included sterling, several Continental currencies, Australian dollars, and some East Asian currencies.

Investments in U.S. real estate

The U.S. real estate investments of foreign pension funds have been primarily in commercial buildings. Office buildings are particularly popular. One reason is that it is easier for foreigners to determine the value of such buildings than of other real estate since customary office needs of U.S. and foreign users are more similar than are the ways in which other types of buildings are used. Moreover, office rentals are the most easily indexed to take account of future inflation. There has also been a good deal of investment in shopping centers, although the recession dampened the attraction of such properties (and also of warehouses) sooner than that of office buildings. Oil and gas properties have been of interest to some funds, but the recent weakness in the oil sector presumably affected such investing. Finally, a few funds have invested in apartment buildings, although in comparatively small amounts, and some hold parcels of as yet undeveloped land.

Pension funds in the *United Kingdom* are very heavily into real estate. Many of the large funds have as much as one quarter of their assets invested in real estate, and investments by other funds generally range between 15 and 20 percent. This contrasts with about 3 percent for U.S. pension funds. The principal impetus to diversification into foreign real estate came from the skyrocketing of prices of British properties during the seventies as a result of inflation and a flood of competing institutional investors. By the early eighties, first-year returns on London prime properties (which are in very limited supply because of government planning controls that severely restrict the demolition of old buildings) reportedly were only one half those of unleveraged U.S. properties. Another motivation for investing abroad was that many large funds whose property holdings were heavily concentrated in London felt that prudent management required them to diversify.

For many of the big funds, foreign real estate now constitutes 2 or 3 percent of aggregate portfolio, and for a few funds more than double that share. The bulk of this investment has been in the United States. About thirty to fifty smaller pension funds and a few of the larger funds make their U.S. real estate investments through specially tax-exempt Property Unit Trusts (PUTs), almost all open ended. Several PUTs have been established specifically for investing in the United States. Some of these are joint British-American undertakings.

The half dozen or so large pension funds that have been the major real estate investors were active in buying, developing, and leasing properties in the United Kingdom for many years, and a few are doing the same in the United States. Most, however, are pursuing a low-risk policy for the present of buying only existing properties. Some funds have made joint investments with American institutional buyers, either because the price of the property is higher than the amount the pension fund wishes to put into any single investment (the upper limit usually is $50-80 million) or because the pension fund believes the American participants would have a better understanding of local conditions and property values. When there has been property development, the American partner has usually taken the development risk, with the British pension fund committed to buying the property after it is completed and partially rented.

The strong interest of *Dutch* pension funds in real estate is very obvious; it is not unknown for a large fund to have close to 40 percent of total portfolio in this form, while the more typical portfolio holds between 10 and 20 percent. Foreign real estate constitutes a major component of the funds' holdings, in part because there is very limited opportunity for increased investment in commercial buildings in the Netherlands. By the end of the seventies, U.S. investments had come to the fore. During the past two years there was a slowdown in such purchases but, as 1982 was drawing to a close, interest had begun to pick up again in anticipation of a U.S. economic recovery.

The Dutch have been, and remain, very much attracted to shopping centers. However, they buy buildings only after they have been erected. When new property development has been undertaken, it has always been on a joint-venture basis, with an American partner putting up the buildings. The small pension funds, which do not have the staff to go directly into foreign real estate, have been able to channel funds

through three large Dutch real estate investment trusts. Unlike British PUTs, none of these were established solely for tax-exempt institutional investors. The pension funds nonetheless use the trusts for a real estate play, since the income the pension funds receive is exempt from Dutch taxes.

Canadian pension funds have been permitted to invest in foreign real estate only since 1977. They can do so up to 7 percent of the total 10 percent foreign investment allowed. However, until recently only the larger pension funds held significant amounts of even domestic real estate. For pension funds in the aggregate, real estate comprised less than 2 percent of total portfolio assets, although for some large ones the ratio went as high as 10 percent. Now a few funds are starting to invest abroad, that is, in the United States.

The Canadian funds are not allowed to own either domestic or foreign real estate directly except for limited amounts. Several alternative routes have been chosen. One is through investment in shares or debentures of tax-exempt corporations set up under a special provision of the Tax Act that was designed to enable pension funds to make real estate investments. Other routes have included joint venturing with Canadian real estate development firms, investment through U.S. real estate pools set up by Canadian investment counseling firms, and investment through U.S. subsidiaries established by the pension funds themselves.[13]

As already noted, the only *Japanese* pension fund reserves that can be invested in foreign real estate are those managed by the insurance companies. As of mid-1982, their foreign real estate holdings totaled less than 1 percent of all assets (compared with 6 percent invested in domestic real estate), but almost all was in the United States. Only a few companies have so far purchased foreign properties, but they are planning to add to their holdings, some on a continuing basis. Moreover, purchases by other companies are in the offing. Half of the investments have been in existing buildings; in other cases, new properties are being developed. All of the investments so far have included an American partner. There are no official limits on the size of foreign real estate transactions, but the Finance Ministry has to be notified prior to every such deal. When the yen has been under strong pressure because of heavy outflows, administrative guidance has occasionally been used to influence the amount of capital being transferred abroad.

Many foreign pension funds were, and still are, strongly drawn to the sun-belt states. Others, believing that a number of such locations have been overbuilt, prefer other parts of the country. Many invest only in the downtown areas of big cities, while others see opportunities in "second-tier" properties in more modest-size communities, although often requiring higher returns from such investments.

Tax considerations have influenced some foreign pension funds in the choice of U.S. locations as well as of the institutional arrangements. For example, California real estate has been shunned by some because of the state's unitary income tax, which is based on a company's consolidated operations regardless of location. In part, their reaction reflects the belief this tax would result in a lower return than could be obtained from a similar investment in most other states. And to avoid U.S. Federal taxes, pension funds have sometimes been invested through specially established Netherlands Antilles subsidiaries. The dividends and interest paid out by these subsidiaries are exempt, under a U.S.-Netherlands Antilles tax treaty, from U.S. withholding taxes which otherwise can be imposed on the distributions from the profits of foreign corporations' U.S. branches. However, beginning two years hence, because of the 1980 Foreign Investment in Real Property Tax Act, these subsidiaries will no longer have the present additional exemption from taxes on capital gains from the sale of real property. This will reduce, although not eliminate, the advantage of investing through Netherlands Antilles subsidiaries.

Future developments

Pension fund growth

Pension fund reserves in the four countries are almost certainly going to continue to expand strongly throughout the mid-1980s and probably beyond, as net cash flows from contributions and from earnings on growing masses of investments rise. Increased pension fund reserves will be required to cover an expanding number of employees and improved benefits. The changes in benefits will vary, but among the goals sought in one country or another there will be higher retirement income, more generous disability and beneficiary treatment, more protection against inflation, and earlier vesting. The number of retired employees will of course be rising, and for some mature pension plans the payout to retirees will impose a considerable brake on net cash flow. However, this can have only a marginal effect on the growth of total fund assets during this decade.

The worldwide recession of the past two years has undoubtedly affected the rate of aggregate pension fund growth. Companies have gone out of business

[13] A new U.S.-Canadian tax treaty that is expected to be approved by the U.S. Senate this year will provide Canadian pension funds with exemption from the 15 percent withholding tax on dividends and interest that other Canadian investors must pay.

and unemployment has increased. In addition, a step-up in early retirements, initiated by some firms as one way of dealing with a surplus of employees, has had an adverse impact on the cash flows of some pension funds. Nonetheless, the number of active workers covered by pension plans in any one country may not have declined to any significant extent, where it has at all. Moreover, strongly rising yields on existing portfolios have partly made up for any slack in fund contributions. And economic recovery, unless it turns out to be very stunted, can be expected to lead over the years to further growth of plan membership.

In a country like *Japan,* where pension plans are still very young and limited in number, the increases in cash flow from widening coverage and better benefits should be especially large for many years. It is anticipated that pension fund totals there could easily increase by 20-25 percent a year. In *Canada,* annual additions to reserves of 15-20 percent are foreseen for the next several years.[14] In the *Netherlands,* annual net cash flows during the next five years at a rate of at least 10 percent of portfolio seem probable. In the *United Kingdom,* the rate of annual accumulations may be just about 10 percent. Overall then, by 1987 the Canadian funds may have at least doubled from their 1981 levels, while the Japanese funds, because of their exceptional rate of growth, may well have expanded to more than 2½ times their 1981 levels. The United Kingdom and the Dutch funds may each grow by approximately 75 percent.

The implications of such rapid growth for foreign investments seem clear. In none of the four countries does the domestic economy provide investment opportunities for the swelling masses of pension funds that are at a level of risk and sufficiently numerous, diversified, and profitable to satisfy the funds' prudential and earnings requirements.[15]

[14] A slowdown might develop in the second half of the decade. The Canadian and the Quebec social security retirement systems will be going into deficit by the end of this year, and mandatory contributions are expected to be doubled or more by the late 1980s. Many employers who operate voluntary pension plans reportedly might then find it financially necessary to reduce benifits, or even to terminate plans.

[15] Two years ago the Governor of the Bank of England made a comment in another context that is of interest here: "The equity capital of the larger British companies, accounting for perhaps three quarters of the output of our private-sector industry and commerce, is increasingly owned by the main institutional investors, above all the life assurance companies and pension funds. Indeed the cash inflow of these institutions and the relative shortage of equity available for purchases in the market may be an important element in the comparative strength of the equity market despite the poor profitability of much of British industry." (Reflections on the Role of the Institutions in Financing Industry, First 1981 Stockton Lecture, London Business School, January 22, 1981.) The second sentence points to one reason why British pension funds have felt a need to invest a substantial portion of their reserves abroad.

Investments in the United States

Although the *British* pension funds will grow more slowly than those in at least two of the other countries, the importance of the British funds as investors in U.S. assets remains great because of their volume and their inclination to enlarge the foreign portion of their portfolios. Those funds that may have reached their desired foreign investment limits would still be putting abroad sizable portions of their annual accruals. More modest-size funds, which have smaller shares invested abroad, may well continue to increase the place of foreign assets in their portfolios by investing through unit trusts, which are very actively marketing their services. Insurance companies, more than half of whose business comes from pension funds, have also begun to step up their foreign investments. In addition, there has been an easing of investment restrictions on local authority pension funds that is making it possible for them to place more of their reserves abroad. Given the current pace of foreign investing and the attitudes of investors, it would not be at all surprising if the foreign assets of British pension funds were to increase from the almost 15 percent of portfolio they had reached by the end of 1982 to 15-20 percent of the expanded aggregate reserves within another five years.

A good deal more than half of the increase is likely to be in U.S. assets. Since U.S. equities accounted for only about 50 percent of their total equities holdings in 1981, any substantial decline would imply a significantly unbalanced portfolio, measured by the share of U.S. equities in world equity capital. For this to happen, either the U.S. economy would have had to deteriorate very seriously, or currency developments would have had to improve greatly the prospective returns from investments elsewhere. The outlook for continued investment in foreign real estate, which in effect means U.S. real estate, is also good. The discrepancy between foreign real estate holdings of 2-3 percent of portfolio for some large funds and 8-9 percent for others suggests there is considerable room for expansion of even large funds' investments. The smaller funds, which so far have invested only a tiny percentage in foreign real estate, are likely to build up to a somewhat more significant level, primarily through the specialized PUTs.

The *Dutch* will certainly also continue to place a substantial portion of their accumulated reserves abroad. Some funds have considerably more than 20 percent invested abroad, while the foreign share for all funds is only 6 percent. This implies that most funds are below even this level. The share of foreign assets in each year's net investments has been creeping upward, pointing to an inclination to allocate a larger portion of reserves to such assets. Insurance com-

panies apparently have also started to invest abroad.

Recent developments suggest that perhaps half of the new foreign investments out of Dutch pension fund reserves will be in the United States. Most of this will be in equities, but real estate investments, which slowed down for two years, will again be important. The managers of some of the large pension funds that had stopped making such investments were in late 1982 again perceiving good real estate values as a result of the recession. Moreover, Dutch real estate trusts that invest in the United States have been intensively soliciting other Dutch pension funds also to invest here.

Pension funds in both *Canada* and *Japan,* despite the 10 percent ceilings, will be placing substantial amounts abroad over the coming several years. In the first place, total foreign investments are currently far below the ceilings. Secondly, fund reserves in each of the two countries are expected to climb rapidly, roughly doubling by 1987 in the case of Canada and even sooner for Japan.

In *Canada,* there is an increasing tendency to make use of the full 10 percent. The largest pension funds have been pressing against the ceiling for some time. Indeed, some have even chosen to invest as much as 15 percent and to pay the tax penalty. In addition, managers of other funds, who have in the aggregate used less than half of the allowable percentage, have recently become more outward looking. Although U.S. securities investments are unlikely to be as overwhelmingly dominant among foreign investments as heretofore, net U.S. securities acquisitions should continue to be strongly positive, with only temporary slowdowns when conditions in currency or equity markets appear to favor substantial increases in investments elsewhere. It seems likely, moreover, that U.S. real estate investments will expand. The importance of domestic real estate investments in Canadian pension fund portfolios is apparently on the verge of a significant increase. Foreign real estate investments will certainly grow along with the domestic investments, as they have in the past, and these will undoubtedly continue to be virtually all U.S. investments. Although some managers still feel the indirect route required to put money into foreign real estate is too troublesome, it is likely that, if investments already made show attractive returns, more investors will follow.

In *Japan,* pension fund managers had been seeking permission to invest abroad for some time prior to the recent Ministry of Finance approval. That approval was finally granted for several reasons, including such widely varying reasons as concern that reserves were growing too rapidly to enable a sufficient volume of good investment opportunities to be found at home and the always present possibility of a disastrous earthquake in Japan. Now the managers are eager to utilize the new opening to foreign capital markets as rapidly as they prudently can. During the last year alone, the trust banks increased the foreign investments in pension fund portfolios from 2 percent to over 3 percent, on average, and the insurance companies from 3 percent to almost 5 percent. As they increase these investments, they are going more heavily into equities, and interest-bearing instruments are declining from their early share of over 90 percent. This may not mean much change in the weight given U.S. securities. Dollar-denominated issues apparently constituted between one half and two thirds of the foreign bond holdings. Equity investments would be in roughly the same currency proportion as bond holdings have been, if the former are geographically allocated in line with the approximately two-thirds share that dollar equities currently constitute of the world's non-Japanese equities. Thus, a major part of the ongoing foreign investments would be channeled to the United States. Foreign real estate investments will also continue to grow as a share of insurance company portfolios. As with investors from other countries, the United States has been the preferred location for purchases already made and will almost surely remain so.

It would be unrealistic to try to quantify in detail the likely flows into U.S. assets sketched in the preceding paragraphs. Nonetheless, one can be bold and, on the basis of the many assumptions stated, venture some extremely rough guesses regarding the totals that might be entering the country during the six-year period through 1987.

For the *United Kingdom* pension funds, the anticipated rate of growth, and the likely allocation in the foreign investment share between U.S. assets and other assets, suggest that the flow into the United States could reach $18 billion.[16]

For the *Dutch* trusteed funds, which are only about one fifth the size to start with, investments might amount to about $4 billion. A comparatively small additional amount could come from the pension funds handled by the Dutch insurance companies.

The *Canadian* funds, because of the 10 percent limitation on foreign investments and the geographic diversification away from their now overwhelmingly U.S. holdings, might invest approximately $6 billion.

The *Japanese* funds, also limited to only 10 percent of portfolio plus some real estate investments, will be growing more rapidly than the Canadian funds and will continue to place a major share in the United States. Over the six-year period, Japanese investments could aggregate about $7 billion.

[16] This and the following figures are in current dollars.

Conclusions

The indicated figures suggest that flows into the United States from these pension funds during the six years ending 1987 could aggregate roughly $35 billion. There will also be some comparatively minor flows from other countries. On an annual basis, total flows from abroad might increase from about $4-6 billion in the first years to $6-9 billion in the later years. Most would go into equities, some into interest-yielding investments, and some into real estate. While actual developments might well prove to be significantly different from these guesstimates, the figures nonetheless provide some conjectural amounts against which to pit the outflows into foreign assets from U.S. pension funds.

In an earlier *Review* article, it was suggested that outward flows would gradually increase over the current decade from the approximately $2¾ billion estimated for 1980 but would remain below $10 billion into the middle of the decade.[17] Information on outflows since then indicates that thus far this prediction has been borne out. The estimates of flows into the United States developed above therefore point to the probability of a fair degree of balance between capital inflows from foreign pension funds and capital outflows from U.S. pension funds. The impact on U.S. markets should consequently be close to a wash in dollar terms, but the inflows should also have the beneficial effects of adding depth and liquidity to capital and real estate markets because of the larger number of participants and the different considerations that often motivate foreign investors. Moreover, the foreign and domestic pension funds should each be securing a portfolio that, according to their managers' respective perceptions, is a better portfolio, that is, one that will provide higher yields and/or be subject to less risk in terms of volatility.

Finally, the present analysis indicates that during the foreseeable future the international capital transactions by these particular institutional investors will remain small relative to total U.S. international capital flows. The findings also suggest that the transactions will tend to produce, over reasonable intervals of time, roughly equal supply and demand for the dollar. They should, therefore, not have any long-term destabilizing effect on the dollar exchange rate.

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[17] Article cited in footnote 1.