

FROM: [REDACTED]
DATE: 13 November 1987

CC: [REDACTED]

MARKETS

I attach Alastair Ross Goobey's latest circular which has some very timely footnotes to points made in our note for the Prime Minister. Particularly interesting is his suggestion that a number of UK companies already have authorisation to buy back up to £800 million of their own shares, and more are considering such a move. We are doing some more work on this. Alastair also takes the general market view that UK institutional portfolios were pretty fully stuffed with equities by the beginning of October, both relative to past experience, and relative to institutional portfolios elsewhere.

As you know both the Bank and the DTI are doing further work in this area, though I have not yet seen the results. I think the DTI may have it in mind to offer their own comment on [REDACTED] remarks to the Prime Minister.

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The key point, it seems to me, is not that the institutions were or are ~~short~~ particularly short of "liquidity", but that in comparison to overseas institutions they are very short on fixed interest securities and property. I find it hard to summon up much sympathy for that: their reluctance to buy gilts has been reflected in high real borrowing costs for HM Govt over a number of years.

SO CHEAP, I CAN'T AFFORD IT

One of the problems faced in a bear market is that there are plenty of natural sellers but not many natural buyers. In the US in recent years there has been a substantial source of buying which other markets have not seen: the corporate sector. Since the end of 1984, it is estimated that over \$150 billion of equity has been bought back or authorised to be bought back by US corporations. In the same period in the UK, there has been net investment of about £19 billion in UK equities and £12 billion in overseas equities by institutions and although £5 billion of Government bonds have been purchased, since the fourth quarter of 1986 up to £2 billion of that paper has been sold net.

The consequences for portfolio distribution in the two markets is strikingly different. In the US, that doyen of investors, Warren Buffet, was pointing out in September how the craze for buybacks had reached epidemic proportions and that the process was not being conducted for logical reasons, even those as basic as increasing earnings per share. Some companies were buying in their own shares despite the fact that the pre-tax return which they were buying was less than the cost of money, and the earnings and assets per share of the company were actually *falling* as a result. The cash flow of the US institutions has perforce been channelled into bonds, and, to a lesser degree, into foreign equities. Since no net cash flow was flowing from the institutions into domestic equities, it was primarily the corporations who were driving up the market at the margin. Even after the recent initial fall, the market was steadied by further announcements of repurchase programmes; the deep-pocketed buyer was still present. The average US pension fund has no more than 60% in equities, about 25% in bonds and the balance in real estate, venture capital and buyouts. In addition, it has not been apparent that the US institutions have undertaken a wholesale flight from bonds which would have left them open to criticism and defensive action after the dramatic reversal of fortunes between bonds and equities of the past month.

In the UK, all these factors are transposed. The corporate sector, and the Government, has taken every opportunity to sell stock to the institutions, while the institutions themselves have reacted to this potential crowding-in by shunning the domestic bond market. As a result, the balance of UK institutional portfolios has reached an historic high level of equity exposure. The reversal of this trend will be uppermost in the minds of investment managers before 31 December; even a modest switch of portfolios towards bonds will involve some fairly hefty equity sales. The CAPS survey of UK pension funds at the end of 1986 showed the distribution of the average UK pension fund as follows:

	%
UK equities	55
Overseas equities	24
Index-linked gilts	2
UK fixed interest	12
Property	4
Cash	3

100

Making fairly modest assumptions about the year up to the beginning of October, the equity share at the peak was 82% of the total; the subsequent market fall will already have reduced this to 76% and increased the bond share to 15%. The attempt to achieve a 20% bond percentage would involve a further switch of up to £10 billion from equities, or a fall in equities of a further 35% forthwith, or investing all pension fund cash-flow in gilts for a year. Put in the context of total

Institutional cash flow, including unit trusts, running at an annual rate of £26 billion in the first half of 1987, this would substantially limit the money going into equities from UK investors. In addition, the strong cash flow of the unit trusts has already been materially curtailed.

Such a rebalancing of portfolios would be typical of bear markets, and will probably be undertaken through a combination of switching, cash flow investment and relative asset performance; it will be easier to do when we are in a rally, which will make it more difficult for that rally to be sustained. It is also worth noting that, as a consequence of continuing pension contribution holidays and the increasing influence of unit-linked business in life assurance, 1987 may see the cash flow of insurance companies overtaking that of pension funds for the first time in many years; life offices tend to be more predisposed to investing in fixed interest stocks than are the pension funds, although if the growth really is attributable to unit-linked funds, this may be changing.

We have looked at the potential scope for buybacks in the UK market. The 1981 Companies Act enabled UK companies to engage in this process for the first time, and this is the first real bear market since the provisions came into force in 1982. There are technical problems for the companies: in order to prevent the creation of capital distributions out of income, the tax laws treat buyback sums like a dividend for the company and Advanced Corporation Tax is payable. This may be used to offset excess mainstream corporation tax, but many companies do not have such an excess. Even those companies in a tax position which enables them to consider buybacks may be loath to act: their shareholding structure, or the fact that they have just had a rights issue not far above this level may constrain them. Nevertheless, we see the first inklings of a potential buyer of last resort. Of the FTSE 100 Index constituents, we have already identified companies who have authorisation to buy up to £800 million of their own stock, and more are considering such a move. This represents 11% of the money poured into UK equities in an average year over the past two-and-a-half years. Naturally, not all this stock will in fact be purchased, but it indicates the potential size of the buyer of last resort.

Institutional liquidity has been adversely affected by the string of recent rights issues and privatisations. The good news is that there is no necessity for a new privatisation for a year or so. Calls on British Gas, BP and BAA together with the probable redemption of British Telecom preference shares already add up to £4,957 million in the bag for 1988/89. Institutional liquidity will take time to build up, and meanwhile only small portions of cash flow will end up in equities, particularly overseas.

We now seem to be in the good tradeable rally I had hoped for in last week's note, (how I hate journalists, yes, and stockbrokers, who say "I told you so", but only selectively), but this should not be confused with a new bull market; we might expect the rally to continue to a point at which the market's valuation will again give us pause, at around 1850-1900 on the FTSE Index. Stocks are currently still cheap, but not many shoppers feel they can afford them.

FT Actuaries All Share Index:	817.83
S&P Composite Index:	241.90
Tokyo New Index:	1730.59

12 November 1987

The publication day for this document is being brought forward by a day to prevent the probability that it will be made of nugatory value by events over the weekend.