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Pensions And Stock Selection

"Market Trends" by Larry MacDonald

Hundreds, if not thousands, of professors around the world conduct research into financial markets. The most visible manifestation of their endeavors is the five to 10 new papers published each month in dozens of academic journals.

It's a shame this outpouring of knowledge and insight is largely overlooked by the mainstream business press and investors. True, the jargon and formulas tend to put off lay persons, but most of the professors' message can be easily gleaned from the introductions and summaries to their articles.

To illustrate how an academic study can assist investors, consider a paper in an upcoming issue of the *Journal of Finance*. It concludes that companies with significantly underfunded pension plans tend to generate negative earnings surprises and poor returns to stockholders.

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Why so? A large pension deficiency is a sign of possible financial distress. The need to inject lots of cash into a pension plan diverts funds from initiatives that produce sales and earnings growth.

It's yet another exception to the efficient market theorem, say Francesco Franzoni and Jose Marin in their paper, "Pension Plan Funding and Stock Market Efficiency." Investors apparently fail to fully exploit publicly available information.

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Fixated on earnings per share, they usually overlook the footnotes of financial statements where information on pension plans is to be found.

Emerging markets

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Do any Canadian companies have substantial shortfalls in pension assets relative to liabilities? According to the Dominion Bond Rating Service (DBRS), there are several. Their latest available annual pension plan survey, "Issues with Pensions: On the Road to Recovery," lists these companies as having the worst records:

	Company	Percentage of Liabilities Covered
ARTICLES		
The Buffett technique	Jean Coutu Group Inc.	27.4%
Smart Money Indicator	Quebecor World Inc.	49.9%
Top investing tips	Bombardier Inc.	55.3%
Are you money normal?	Cogeco Cable Inc.	60.1%
Reading annual reports	Magna International Inc.	65.1%
Insider buying		
9-point stock test		
Top market forecasters		
Invest like Buffett		
COLUMNS		
Market Trends (Web)		
The Markets		
Getting Started		
The Contrarian		
Risk and Reward		
Value Hunter		
	These coverage ratios may have improved since the release of the DBRS study thanks to higher stock markets and cash injections. But a July 2005 report from Standard & Poor's notes that the financing of most Canadian pensions has not improved much over the last two years because declines in long-term interest rates have raised the present value of obligations.	
	But there may be one caveat to the Franzoni and Marin argument. Burton Malkiel, author of <i>A Random Walk Down Wall Street</i> , argues markets are efficient over the long run. As more and more investors catch on and take the pension variable into account, the anomaly should disappear.	
	That may be true, but until more of the crowd catches on, Franzoni and Marin would argue that investors in the know can enhance portfolio returns by keeping companies with severely underfunded pensions out of their portfolios. Value investors especially should pay attention: many bargain-priced companies could be value traps if they come with onerous retirement obligations.	
	September 29, 2005	

Larry MacDonald is the author of *Nortel Networks: How Innovation and Vision Created a Network Giant* and *The Bombardier Story: Planes, Trains and Snowmobiles*. He can be reached at mccolumn@yahoo.com.

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