

The Investment Case By Gregory Hinkson

In the commotion surrounding the potential NIS investment in the Four Seasons Resort and Private Residences some people have tried to instill a fear in the public that the NIS is being forced to make reckless investments that will harm their savings. But from the perspective of a large social security fund in a small country, fear, and the risk-aversion it promulgates leads to even bigger investment mistakes. The issue for the NIS is not whether assets are commonly perceived to be “safe” or “risky”, but what its obligations are (liabilities, in investment-speak) and what are the best investments (assets) to match those liabilities. To strip away the politics from this debate there needs to be wider public understanding of what social security funds should invest in – and it is definitely not cash under the mattress.

“Mature” funds, where members are retired or approaching retirement, where there are more payments to members than contributions, need to hold assets that provide safe income. This is best achieved by owning Government bonds. They are often the most stable, most liquid investment in the land. The more mature a fund the more Government bonds we should expect to see. We may also see some foreign Government bonds to diversify away local economic risks or high-quality corporate bonds to diversify exposure to the Government, like the investments in BL&P and the Hilton.

NIS Barbados is not a “mature fund” yet. Most members are still working and there is a surplus of contributions over payments on an annual basis. An over-concentration of Government bonds in a “young fund” would be inappropriate because today’s members would be “paying” expensively - in terms of lower returns and higher required contributions – for short-term income, stability and liquidity that they do not need. Young funds should include in their portfolio assets that trade-off short-term returns and liquidity today for higher, longer-term returns in 15 to 20 years time, say, when the fund is switching from surplus to deficit. These returns would be re-invested in Government bonds then.

Classic assets for young pension or social security funds are private equity investments in infrastructure projects like gas pipelines, new ports and new city developments where there are few returns in the early years as the infrastructure is being built and the debt is being repaid, but once the debt is repaid, equity investors earn a higher-than-average return. Although these are highly appropriate investments for social security funds, they are not generally liked by private-sector entrepreneurs who prefer fast returns - especially in these uncertain economic times. The notion that if the private sector does not like an investment, social security funds should not either, is a fundamental misunderstanding of social security investing. If Prime Minister Arthur had held that narrow view we would not have a rebuilt Hilton Hotel.

Stripped bare of politics, the Four Seasons investment appears to be the kind of infrastructure project exactly suitable for a young pension fund. The long-term IDB loan of BDS\$180m means the project now has a long-period with which to sell villas and deliver a future return. Moreover, by lending this amount over the long-term, the IDB is telling us that they are confident the hotel alone can fully repay their loan plus interest. Once this debt is repaid in 15 years, long-term equity investors would be getting an extra boost to their returns - just when the NIS will be needing the income. The main problem with the

Four Seasons Resort and Private Residences is that there are not enough of them to be a significant proportion of a social security fund and even fewer that have the backing of long-term funding from a AAA rated bank.

Gregory Hinkson is Managing Director of SAMDOR Services Limited, an investment consultant, and a former Manager Investments at NIS Barbados. Four Seasons Resort and Private Residences is a client of SAMDOR.