
ASSET STRIPPING: ONE UK APPROACH

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“Asset Stripping”, in the sense I mean it, is probably far more familiar in the US than in the UK. What it comprises is separating out, in some way, the return to be enjoyed from a given asset, among different investors with their own requirements.

The intention of this article is to give a few examples of how this has been carried out in practice, and to suggest a particular application which, in my opinion, offers opportunities in the UK.

In 1982, Merrill Lynch offered \$500m of a new type of security, the Treasury Investment Growth Receipt, or TIGR. The brokerage had bought long Treasury Bonds and then offered, separately, a part of any coupon or of the capital.

These were “deep discount” bonds, to which the US Treasury strongly objected. In the first place, there was apparently no interest to tax. Secondly, it was claimed that the transaction was based upon a defacement of government property, but it appears that this was never pursued seriously.

In the same year, TEFRA (the Tax Equity & Fiscal Responsibility Act 1982) closed the loophole, by imputing interest. Although I am not a tax specialist, I understand that this provision is also contained in UK tax law.

Other brokerages followed, and “tigers” were followed by “teddy bears”, “lions” and “cats”. In all cases, investors were looking to the brokerage for their investment return, rather than to the US Treasury, which formally guaranteed the basic asset.

In 1985, the US Treasury joined in, by offering STRIPS (Separate Trading of Registered Interest and Principal Securities), but only to holders of Individual Retirement Accounts (US “personal pensions”). This is the type of application I first had in mind when I became interested in this topic.

To take a separate example, in 1983, AT&T was broken up. Before that, an organisation called Americus Trust bought AT&T common stock, which was then offered on, in units, to the next layer of investors. There were two types of unit. One unit had title to all (if any) capital appreciation beyond a predetermined fixed price. The remainder of the return (dividends plus possibly some capital appreciation) accrued to the other unit.

The units had a fixed life of five years when the final distribution would take place. Both types of unit are marketable. I understand that Americus intend to extend the approach to shares of other large US companies.

Coming back to the UK, so far as I am aware, there is nothing available in the market along these lines. One of the reasons for this is presumably the way in which tax is imputed upon notional interest. Also, in the past, many investors have been reluctant to try out radical ideas.

While the tax aspect (which will not be considered a problem by all investors) cannot be skirted, the second set of reasons is, I think, disappearing. Investment opportunities have become more sophisticated than would have been believed only a few years ago, as with, for example, the advent of futures and options. Further, there is an increasing trend towards the “securitisation” of assets which have not previously been marketed in such a form in the UK. For example, this is being attempted with large properties, and may soon be extended to mortgages.

In the light of the above, I have felt it worthwhile considering index-linked gilts from the point of view of “asset-stripping”. To define it, an index-linked gilt is a gilt-edged security, under which periodic income payments, and the capital repayment, are explicitly linked to a specified price inflation index.

It is nearly five years since they were first

introduced to tax-exempt UK pension arrangements, but they are now available to all. At the moment, there are 11 different definite maturity dates from which to choose, most coupons being 2.5%. Recently, they accounted for approximately 8% of all gilt-edged securities still in issue.

For some I have thought that the existing package is inflexible. This is simply because those who might like to purchase an index-linked capital repayment must also buy a stream of relatively small dividends, to be reinvested on unknown terms. Conversely, those who might like to acquire a series of index-linked income payments must also pay heavily for the capital repayment.

Is it possible however, to produce an equitable and practical pricing strategy for repackaging the return on an index-linked gilt? Within reasonable limits, I have concluded that this can be achieved, as explained below.

The subject of pricing index-linked gilts has already been considered in this journal by Pain and Bootle (TIA 69, 31). They showed that one needs both a nominal money yield assumption and a future inflation assumption to construct a sound model of real returns. The particular model I have used is what they call Variant 2 of Method A.

For a specified stock, at a given time, for a particular money yield assumption, I have calculated what inflation assumption is required to give the market price. The anticipated real return can then be calculated from this, under the important assumption of "buying and holding". Such a figure gives no reliable guide as to the real return enjoyed if the stock is sold before it matures. The real returns have been calculated on a true annual compound basis.

I have tracked two different index-linked gilts over the four years (48 observations at monthly intervals) from 30th October 1982 to 30th September 1986. These were 2.5% IL Treasury 2001 and 2.5% IL Treasury 2011, representing the "medium" and "long", respectively. Although the maturity period has shortened over

the period, I do not think that this has been a material factor.

In the first place, I have calculated figures using an arbitrarily fixed money yield assumption of 10% pa. However, this was for convenience, and not because I thought that interest levels had been level throughout the period.

Secondly, in order to allow for actual interest rate fluctuations over the period, I have also tracked the two stocks, using a variable money yield assumption. For the long stock, I took the average gross redemption yield on 25-year high-coupon gilts, and the corresponding 15-year figure for the medium stock. While I accept that these are not the only possibilities, they are convenient, and should, I feel, serve as a reasonable proxy.

Over the period, for the long [medium] stock, the variable money yield assumption has a "low" of 8.9% pa [8.9% pa], with a "high" of 11.8% pa [12.2% pa]. Using the "variable" assumptions, the anticipated real return ranged between 2.4% pa [2.4% pa] and 3.8% pa [4.2% pa]. This demonstrates that, over the period, there has certainly been some variability in returns, both nominal and real, as might be expected.

Despite this variability, on the basis of the analysis of other figures I obtained, I came to the following three conclusions.

1. The anticipated real return was virtually independent of the money yield assumption.
2. The percentage of price accounted for by the prospective capital repayment ("the capital percentage") was also virtually independent of the money yield assumption.
3. Even given changes in the anticipated real return of as much as 0.25% pa, the variation in "capital percentage" was considerably less than for the expected movement in price.

On the basis of the above, I have concluded that, over the last four years, it would certainly have been possible to define a repackaging pricing strategy, which was both equitable and practical for these two stocks.

Finally, the views expressed above are my own, and should not be attributed to my partners.