Abstract
This paper is the first that examines the impact of stock market performance on the investment policy of pension funds. We find that stock market prices influence the asset allocation of Dutch pension funds in two ways. In the short term, outperformance of equities over bonds and other investment categories automatically results in a higher actual equity allocation (and *vice versa*), as pension funds do not continuously rebalance their investment portfolios. Each quarter, pension funds rebalance, on average, around 39 percent of excess equity returns, leaving 61 percent for free floating. In the medium term, outperformance of equities induces pension funds to increase their strategic equity allocation (and *vice versa*). These findings suggest that the investment policies of pension funds are partially driven by the cyclical performance of the stock market. Pension funds respond asymmetrically to stock market shocks: rebalancing is much stronger after negative equity returns. On average, this strategy led to negative excess returns over the period under consideration. Investment policies of large funds deviate from that of small funds: they hold more equity and their equity allocation is much more strongly affected by actual equity returns, reflecting less rebalancing. The largest funds react highly asymmetrically to positive excess equity returns, adjusting their portfolios by significantly more than 100%, reflecting ‘overshooting’ of free floating, or positive feedback trading. Apparently, managers of large funds demonstrate great risk tolerance, particularly in bull markets.