Conference on Public Pension and Sovereign Funds

The third annual conference of CJEB's Program on Public Pension and Sovereign Funds

December 6, 2018

The Italian Academy, Columbia University

This conference was held on background according to the Chatham House Rule; the following summary is primarily without attribution.

On December 6, 2018, the Director of the Center on Japanese Economy and Business (CJEB), Hugh Patrick, welcomed guests to the third annual Conference on Public Pension and Sovereign Funds. He introduced Professor Takatoshi Ito, professor at the School of International and Public Affairs (SIPA) and Director of the Program on Public Pension and Sovereign Funds at CJEB. Professor Ito greeted the attendees and outlined the agenda for the conference. He then introduced the first

Takatoshi Ito *Hugh Patrick*

keynote speaker of the conference, Former Commissioner of the Financial Services Agency (FSA) of Japan Nobuchika Mori, who played an instrumental role in reforming capital markets in Japan during his tenure in the Abe administration.

Keynote Speech: Nobuchika Mori, Former Commissioner of the Financial Services Agency of Japan (2006-2018); Senior Research Scholar and Adjunct Professor at SIPA; Professional Fellow at CJEB.

Mr. Mori discussed how financial market and asset management reforms in Japan not only hold great potential for increasing the national wealth of Japan but are also critical to protecting the savings of Japanese citizens in light of the country's rapidly shrinking labor force and aging population. He reviewed reforms and opportunities in the context of the Government Pension Investment Fund (GPIF), which is one of the largest institutional investors in Japan.

Mr. Mori observed that, in spite of Japan's consistent external current account surplus for 37 years, demographic shifts among the Japanese population have rendered the need to increase savings through proper management of pension reserves even more important. He noted that a large percentage of Japanese savings are still held in bank deposits despite the very low interest rate environment and that unduly cautious asset managers in Japan are contributing to low returns on pension funds. He identified several key reforms that can help maximize the benefits for pension

Nobuchika Mori

recipients in future years, including diversification of the investment allocation of GPIF to include different asset classes, the development of more specialized staff units to support alternative investment functions, and the creation of a compensation structure for pension managers that would attract the talent required to improve GPIF's management. Additionally, Mr. Mori stressed the importance of strengthening Japanese financial markets in improving the performance of pension funds.

Currently, GPIF is subject to numerous restrictions as a public entity, but Mr. Mori expressed the hope that a continuation of the GPIF reforms that began under the first Abe administration will promote the accumulation of the wealth of Japanese citizens in addition to contributing to the development of global asset management practices as a whole.

Session I: Macro Environment – Is There Any Macro Risk for Asset Management?

After thanking Mr. Mori for his speech, Professor Ito welcomed and introduced the Honorable Jacob J. Lew, Visiting Professor of International and Public Affairs at SIPA and the 76th Secretary of the U.S. Treasury. He moderated the first panel of the conference on the topic of the current global economic outlook and the subsequent implications for asset management. The panelists included Kee Chong Lim, Deputy Group Chief Investment Officer and President of the Americas division of GIC; Catherine Mann, Global Chief Economist at Citigroup; and Athanasios Orphanides, Professor of the Practice of Global Economics and Management, MIT Sloan School of Management.

The panel opened with an observation that there are more uncertainties facing financial markets today than prior to the global financial crisis. Not only does the Federal Reserve face the

challenge of rising interest rates in the context of a growing U.S. budget deficit, but additional pressures on financial markets have been created by increasingly high levels of corporate leverage, “self-inflicted inflationary pressures” due to expansionary fiscal policies, and the uncertainty of daily political events, such as the threat of a trade war between the U.S. and China, which have collectively generated significant volatility in financial markets. Although the rise of nationalist and populist movements across the world continue to define political reality and while the projected $1 trillion USD budget deficit will invariably constrain policy options for responding to the next economic downturn, it was concluded that it is still too soon to decide whether the developments of 2018 in financial markets are indications of an imminent recession. Much depends on the political developments in the approaching months.

Jacob J. Lew

The three panelists then provided their respective forecasts for the global economy in the coming 12-24 months. One panelist observed that 2018 was an extraordinary year with regard to financial markets and the political landscape. Approximately 90% of all funds demonstrated losses in terms of USD in 2018 and although U.S. funds outperformed global competitors, even U.S. funds suffered from 10% corrections throughout the year. The panelist agreed that the risks to the global economic outlook stemming from the late stage of the business cycle, tensions in Europe pertaining to slowed regional growth and political issues embodied by the Italian budget crisis, China’s attempt to increase growth while deleveraging, and the risks that tightening monetary policy by the Federal

Jacob J. Lew, Kee Chong Lim, Catherine Mann, and Athanasios Orphanides

Catherine Mann

Reserve have for the development of all of these scenarios. In such an environment, the panelist emphasized that returns for managed funds will be low and, thus, asset managers ought to refrain from excessive risk taking, focus on building more robust portfolios with greater awareness of tail risks, and adopt a heightened awareness of the time-varying nature of risk premiums. Another panelist drew distinctions in macroeconomic risks based on local versus global economic performance. Labor markets in advanced economies have been contributing an upward momentum towards domestic consumption and investment. Thus, local economies appear to be exhibiting domestic resilience to global headwinds, an observation which is supported by research illustrating that trade risks are only disproportionately affecting externally oriented firms that are engaged in financial markets, while minimally affecting domestically oriented firms that are not engaged in financial market activities. Thus, if domestically-oriented firms ignore financial volatility occurring in global financial markets, this will provide a counter-weight.

A third panelist remarked that uncertainty in and of itself has already generated adverse outcomes. Although the trade war and Brexit have not yet occurred, the uncertainties surrounding these events have led to the postponement of many investment plans. Other macro risks include the overheated U.S. economy, an overly-easy monetary policy mix due to the cautiousness of the Federal Reserve combined with an expansionary fiscal policy surprise, and the fact that European Central Bank actions may be too tight for the Euro area given slowed growth and below-target inflation.

Kee Chong Lim

Athanasios Orphanides

Professor Lew then asked the panelists for their perspectives on the preparedness of pension and sovereign wealth funds in response to a more negative economic outcome than expected given the present political and economic circumstances. Generally, all three panelists shared the consensus that pension and sovereign wealth funds, as well as governments, are ill-prepared for the next economic downturn. One panelist noted that the trends of de-globalization and decreased integration of financial markets since the global financial crisis in 2008 are actually the opposite of the developments required to increase productivity growth to the levels needed to benefit citizens across the world. Additionally, high levels of government debt preclude fiscal policy flexibility, indicating that monetary policy will be the most likely tool used in response to the next downturn. However, there is also limited flexibility with monetary policy and thus governments are not well prepared for the next recession.

Professor Lew then opened the panel to Q&A from the audience. One attendee asked about the systemic risks of cryptocurrency investments. The panelists generally agreed that the amount invested in cryptocurrencies does not presently constitute a system risk. Another audience member asked about any indications of bubbles in asset markets. The panelists identified risks in asset markets as the threats of adjustments in currently overvalued assets, mispriced debt, and changes in the investment grade quality of corporate debt issuances once the real interest rate increases to a new, higher equilibrium level. Panelists foresee a number of valuations decreasing and also debt issuances potentially dipping below investment grade ratings in a higher interest rate environment.

Keynote: Roger W. Ferguson, Jr., President and CEO, TIAA

Professor Takatoshi Ito then introduced the second keynote speaker, Roger W. Ferguson, Jr., the President and CEO of TIAA. Mr. Ferguson spoke about the potential of alternative investments and responsible investing (RI) approaches as new paths forward for large institutional investors to achieve returns in the long run. Mr. Ferguson opened his speech by surveying the current investment landscape.

Roger W. Ferguson, Jr.

While his firm recognizes that the economy is presently in the late stage of an expansion, their perspective is that a recession is not imminent. Large institutional investors such as insurance firms have received outsized equity returns for nearly a decade, but current investment overcrowding in liquid assets has contributed to the reduction in projected average returns for long-term investments. In the current economic and demographic landscape, Mr. Ferguson emphasized the importance of developing alternative investment and RI resources for large institutional investors seeking higher long-term yields. He noted that the extremely illiquid nature of alternative investments, which include private equity, distress debt, and natural resources, currently make the alternative investing field a difficult business.

More should be done to attract top talent in order to improve alternative investing practices. On the other hand, ESG investing, also a form of RI, holds enormous potential for public pension and sovereign wealth funds to achieve long-term returns with improved risk profiles. Furthermore, ESG investing can help protect the long-term assets of institutional investors, such as farmland, by helping investors focus on measures to address risks related to climate change. Mr. Ferguson believes that alternative investments and RI are the future of investing for pension and sovereign funds.

Session II: Public Funds Investment in Long-Term Investment – Benefits & Risks

Roger W. Ferguson, Jr., William Kinlaw, Sanjay Peters, and Geoffrey Rubin

Following his keynote speech, Mr. Ferguson served as moderator of the second panel and invited the next set of panelists to the stage to discuss the benefits and risks of common long-term investment strategies of public pension funds. Panelists for session two included William Kinlaw, CFA and Senior Managing Director at State Street Global Exchange; Sanjay Peters, Adjunct Associate Professor of International and Public Affairs, SIPA; and Geoffrey Rubin, Senior Managing Director and Chief Investment Strategist on the Canada Pension Plan Investment Board.

In terms of risks for public pension funds to consider when deciding on long-term investment strategies, the panelists raised issues related to the interim risks of long-term strategies, the opportunity cost of illiquid portfolios, and the difficulties of making realistic long-term commitments that will not be swayed by near-term market fluctuations and board pressures. Interim risks could be ESG, reputational, or financial risk factors accrued by investing in certain types of assets. Regarding liquidity, one panelist highlighted the importance of public funds having sufficient liquidity so that the option of rebalancing their portfolios in periods of market strength is available, thereby extending considerations of liquidity risk beyond cash flow needs. Additionally, another panelist emphasized the importance of creating governance objectives for institutions that align with and support the conviction to commit unwaveringly to a long-term strategy.

All of the panelists shared the view that public funds face challenges with expanding investment practices due to the tensions between monetizing liquidity position and increasing exposure to different assets, as well as fiduciary mandates that restrict the flexibility of public funds to pursue new types of investments. Although public funds tend to have strong liquidity positions overall, the desire to maintain a AAA rating and lack of access to external financing creates difficulties for funds who are interested in deploying their liquidity for higher returns. Additionally, legal mandates to generate higher returns often leave little room and support for fund managers to expand into alternative investments or ESG investing practices, even though such practices could provide many benefits in the long term for pension funds' risk profiles and returns. On the other hand, improved financial tools and resources supporting ESG investing might help with greater adoption of ESG principles in the portfolio management of public funds. Nevertheless, there are many reasons to believe that alternative investments and ESG factors will add value in the long-term for pension and sovereign wealth funds.

William Kinlaw

Mr. Ferguson then welcomed questions from the audience. One audience member inquired about the possibilities for saving the defined-benefit pension plan, a model which has come under fire in recent years due to demographic shifts in the proportion of workers to retirees in advanced economies. One panelist responded that while defined-benefit pension plans paradoxically tend to outperform defined-contribution pension plans due to the ability of defined-benefit pension fund managers to commit to long-term strategies, political and social forces are increasingly making defined-benefit pension plans less viable as employers have become less willing to sponsor

Roger W. Ferguson, Jr.

such plans. Another panelist added that given the predominance of defined-contribution plans today, a realistic solution could involve reforming the structure of defined-contribution plans to incorporate the best features of defined-benefit plans, such as annuities, in order to help defined-contribution plans to eventually generate a level of returns and benefits on par with defined-benefit plans. A second attendee asked about areas in which panelists are seeing valuation issues for illiquid assets as well as opportunities in secondary markets for investing in illiquid assets. One panelist responded that a number of adjustments to models for appraising the riskiness of the assets are required to approximate the value of these assets in public markets. Another panelist reaffirmed that he believes the opportunity to invest in illiquid assets at scale exists and that illiquid assets will eventually become a core component of the portfolios of large institutional investors. However, present challenges consist of the lack of adequate resources to effectively assess and deploy long-term investment strategies centered on illiquid assets.

Geoffrey Rubin

Sanjay Peters

Session III: Will Public Pension Funds Make an Impact on Environmental Sustainability?

In the final panel of the day, moderated by Professor Takatoshi Ito, the panelists were invited to discuss the potential of public pension funds and other large institutional investors to positively impact environmental sustainability. In a lively discussion, panelists surveyed and debated the merits and challenges of incorporating ESG principles into investment strategies for public pension and sovereign funds, in addition to discussing peer-reviewed research supporting different views on ESG investing. The participants for the third panel were Ekaterina Gratcheva, Lead Financial Officer in Finance, Competitiveness, and Innovation Global Practice at the World Bank Group; Lukasz Pomorski, Managing Director at AQR Capital; Norihiro Takahashi, President of the Government Pension Investment Fund of Japan; and Ayako Yasuda, Professor of Finance at University of California – Davis's Graduate School of Management.

Norihiro Takahashi

Overall, the panelists cited a large amount of evidence supporting the financial benefits of ESG investing and indicating that such practices are only likely to expand in the future. Increases in the issuance of green bonds at international financial institutions, for example, have been driven by investor demand as green bonds have demonstrated the same return as non-green bonds with reduced risk. Increasingly, there are also more funds with targets based on generating social impact in addition to financial impact. Studies using discrete choice modeling methodology have also provided compelling evidence that investors are willing to accept slightly lower returns in exchange for investments with higher public good externalities, such as having a positive social impact on the circumstances of women, minorities, and populations living in poverty around the world.

These arguments in favor of incorporating ESG principles were challenged by an asset management representative who raised the issue of the immense pressure placed on fund managers to generate returns. The panelist acknowledged that while firms with better governance also tend to have better financial returns, it may not be realistic to demand that asset managers reject investments with a large carbon footprint if they are tactically attractive investments for a portfolio. Professor Ito then raised the question of reverse causality and whether only companies or funds with strong performance could afford to integrate ESG principles. In response to this question and also in response to the purported pragmatism of pursuing possibly environmentally harmful investments for their returns, another panelist responded that investors "cannot diversify from the state of the world". The panelist emphasized that there are numerous channels through which environmental, social, and governance principles impact the assets of pension funds as well as the quality of life for all people on this planet. In considering the long-term, investing in highly-polluting firms is simply not a sustainable investment strategy, even for funds seeking high returns. A third panelist added that firms with a greater focus on corporate social responsibility tend to suffer fewer losses during economic downturns. A panelist then countered that regardless of social impact, the current structure of funds does not allow for fund managers to underperform for 4-5 years consecutively.

Ekaterina Gratcheva

Ayako Yasuda

Takatoshi Ito, Ekaterina Gratcheva, Lukasz Pomorski, Norihiro Takahashi, Ayako Yasuda

Overall, the tension between pursuing risk and returns versus and adapting practices that can make the world a better place remains a difficult challenge for public funds.

Professor Ito then opened the panel to Q&A from the audience. One audience member asked about the best way to evaluate the prospects for long-term investments given the pressures of fund managers to meet short-term goals. A panelist responded that given defined expectations about future developments, such as the expectation of the introduction of a carbon tax on certain industries, modeling the implications of such an event for asset prices would be fairly straightforward. However, variations between the predicted and actual time horizon for such an event could influence the accuracy of such predictions in a way that could cause funds to generate significantly higher or lower returns in the short term as a result. Thus, fund managers should be especially mindful of predicted time horizons when factoring anticipated outcomes in the process of evaluating yields for long-term assets.

Lukasz Pomorski

In their concluding marks, a panelist emphasized the power that large institutional investors have to create momentum for making a positive impact on environmental sustainability and society as a whole by setting the tone and providing a leading example for incorporating ESG principles in their investment practices. Thus, the role of pension and

sovereign wealth funds in contributing to environmental sustainability is enormous. Another panelist added that given the heterogeneity of investors based on fund type and their diverse presence across asset markets, different investors could contribute to furthering different aspects of environmental sustainability.

Professor Takatoshi Ito concluded the 3rd annual Conference on Pension and Sovereign Funds by thanking the panelists and the audience for their time and participation.

Back from left: *Lukasz Pomorski, Ayako Yasuda, Norihiro Takahashi, Kee Chong Lim, Athanasios Orphanides, William Kinlaw, Sanjay Peters, Ekaterina Gratcheva, Jacob J. Lew*

Front from left: *Takatoshi Ito, Hugh Patrick, Catherine Mann, Nobuchika Mori*