

Conference on Public Pension and Sovereign Funds

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

November 21, 2019

The Italian Academy, Columbia University



Back from left: Sudhir Rajkumar, Keiko Honda, Koji Nakamura, Gauti B. Eggertsson, Patrick Bolton, Lukasz Pomorski, Patricia Mosser, Eric Ngiam; Front from left: Takatoshi Ito, Hugh Patrick

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On November 21, 2019, the Chairman of the Center on Japanese Economy and Business (CJEB), Professor Hugh Patrick, welcomed attendees to the fourth annual Conference on Public Pension and Sovereign Funds. Professor Patrick introduced Professor Takatoshi Ito, professor at Columbia University's School of International and Public Affairs (SIPA) and Director of the Program on Public Pension and Sovereign Funds (PPPSF). Professor Ito briefly explained the functions of the PPPSF and outlined the agenda for the conference. He subsequently introduced the first keynote speaker of the conference, Ms. Keiko Honda, former Executive Vice President and Chief Executive

Officer of the Multilateral Investment Guarantee Agency (MIGA) and incoming adjunct professor at SIPA, Columbia University.



Takatoshi Ito



Hugh Patrick

Keynote: ESG in Public Pension and Sovereign Wealth Funds

By Keiko Honda, Former Executive Vice President and Former Chief Executive Officer, Multilateral Investment Guarantee Agency (MIGA); Incoming Adjunct Senior Research Scholar and Adjunct Professor, SIPA, Columbia University (As of January 2020)

Ms. Keiko Honda noted that Environmental, Social, and Governance (ESG) investing has become very popular in recent times but is at a very nascent stage. However, it has become important to address ESG when making investment decisions.

Ms. Honda expounded on the work done by MIGA, which is providing \$55-billion worth of guarantees across over 114 developing countries, as well as acting as the world's largest multilateral development bank. She continued that climate change is important to the World Bank and MIGA; climate impact could push hundreds of millions to poverty by 2023. She stated that MIGA's climate finance portfolio lies at an enormous 5.3 billion dollars. Additionally, MIGA supports renewable power generation, public transportation, and green-building in order to mitigate climate change.

Ms. Honda posited that in the past, MIGA was in need of a standard for ESG to conduct due diligence and monitor progress for numerous projects around the world. MIGA's ENS performance standard was thus established, providing help to governments and the private sector with useful

guidance on how to identify ENS risks and make investments in a sustainable way. The standard has an extensive reach as it also indicates best practices for child labor and pollution-prevention, among other social issues.

Speaking about the history of ESG, Ms. Keiko Honda explained that ESG-based investing gained prominence globally in 2004 when Kofi Annan, then Secretary-General of the United Nations, sent letters to 50 CEOs of major financial corporations, asking them to include ESG in their business decisions. This consequently led to the establishment of the Principles of Responsible Investment (PRI).

Ms. Honda observed that ESG is gaining popularity among Public Pension and Sovereign Funds. For instance, the New York City Pension Fund recently announced plans to divest from companies that own fossil fuel reserves. In this way, Public Pension and Sovereign funds are willing to work towards ESG investing, but there are several challenges. The three biggest issues include a lack of consensus on the definition of ESG investing, its costliness, and the dearth of enforcement mechanisms.



Keiko Honda

Elucidating further on the biggest hurdles for ESG investing, Ms. Honda said that ESG must be clearly defined to allow for positive change. Moreover, ESG investing is very expensive, especially for small and medium-sized industries where the cost of data collection is too high. Additionally, there is a lack of enforcement mechanisms due to which improvement in ESG investing has not occurred.

Concluding her speech, Ms. Honda expressed hope that pension funds, sovereign funds, private sector, and international financial institutions would bring innovative solutions to issues like climate change. She continued that academia could also contribute knowledge on how public pension and sovereign funds could introduce new products in order to help individuals, households, and companies tackle social issues.

Session 1: ESG Investment: Will It Make Returns Higher?



Takatoshi Ito, Keiko Honda, Patrick Bolton, Lukasz Pomorski, Sudhir Rajkumar

Professor Takatoshi Ito thanked Ms. Keiko Honda for her speech and moderated the first panel discussion on the financial incentives of ESG investment. The panelists included Ms. Keiko Honda; Professor Patrick Bolton, the Barbara and David Zalaznick Professor of Business at the Columbia Business School; Dr. Lukasz Pomorski, Managing Director of AQR Capital; and Mr. Sudhir Rajkumar, Representative of the Secretary-General (RSG) for United Nations Pension Fund Investments.

The first panelist narrowed their definition of ESG to climate change and finance. They continued that ESG is unavoidable and is relevant for the next decades to come. The panelist observed that a sophisticated strategy can bring about high returns, citing a sovereign wealth fund that accumulated a 13% return. However, explaining why this is the case would be a



Patrick Bolton

difficult task. The panelist's independent research showed that if other company characteristics are

controlled, investors demand higher returns for holding companies with higher emissions, as investors are beginning to believe there are risks associated with carbon emissions.

Another panelist argued that ESG, albeit difficult to define, gives different perspectives or 'lenses,' guiding investment decisions and protecting future returns. Prices reflect taste, and in the future, metrics could appear so appealing to people that their sentiments may raise ESG stock prices.



Lukasz Pomorski

All the panelists, echoing similar opinions, posited that there are possibilities for significant returns on ESG investments. Based on research from the United Nations Pension Fund Investments, it was found that incorporating ESG factors in portfolio construction reduced portfolio volatility, increased the 'Sharpe ratio,' and reduced the probability of suffering large drawdowns during times of market stress. Moreover, they observed that stocks with high and rising ESG factors had a high probability of outperforming stocks with low and falling ESG factors. Additionally, going 'long' on low carbon-intensity firms and 'short' on high carbon-intensity firms also produces superior results. Overall, the ESG footprint has a high predictive power in ten out of eleven equity market sectors.

Professor Ito asked the panelists why ESG factors sometimes led to contradicting results. He observed that investment in (sin stocks of) high-carbon emissions commands higher returns. Some investor's disregard of ESG and demand for higher premiums may offset ESG efforts. And so, in the short run, sin stock returns are high, but in the long run, the company may face difficulty due to regulatory changes. Professor Ito also expressed his request that the panelists explain the workings of 'green bonds'. Wanting to continue the debate over whether ESG investing entailed high returns or not, Professor Ito asked the panelists to explain what they felt was the most suitable answer to the question. One of the panelists said that many firm characteristics have to be held constant in order to assess whether ESG investing results in higher returns. However, when this is done, usually the alpha (profit) disappears in the short run. The same panelist also added that ESG investment

brings about benefits in the long run because of changes in societal norms and standards over time, concluding that ESG Investment would reap dividends if the world looks far enough into the future.

A second panelist commented that there are increased inflows in the ESG space and that these undoubtedly have an effect on prices. Having said that, this effect on prices would not necessarily be beneficial in terms of investment potential. A third panelist noted that the cost of data collection is not too high. The cost of data collection for ESG investment depends on investment horizons. In this way, longer-term investment horizons have greater returns compared to short-term quarterly or year-to-year horizons. High and rising ESG factors have more potential compared to low and falling factors.

Another panelist detailed how an increasing number of large multinationals were divesting from fossil fuels. However, some countries are less sensitive to ESG factors and may not feel the need to account for them.



Sudhir Rajkumar

Speaking about green bonds, the panelists stated that green-bonds are an evolving product. There is also significant demand from investors because of the rise in sustainable investing. When asked by Professor Ito about whether green bonds had high-interest rates, the panelists replied that green bonds do not have higher returns since they are highly demanded by investors. Green bond prices may rise to a point where yields become compressed. Additionally, the proportion of green bonds in the market is less than 1%, meaning that there is unlikely to be a 'green bond bubble' in the near future.

Professor Ito asked the panelists whether they thought the governments of the world were cognizant of the plight of people vis-à-vis climate change and would take action proactively. The panelists noted that governments are no longer perceived as the conduits that can bring about change. They also remarked that pro-climate policies are not popular in many countries because they affect the poor. A case in point would be France, where attempts to introduce a carbon tax

have failed twice in recent history. Educated intervention by the government, on the other hand, will be more successful relative to the radical imposition of taxes.

Professor Ito then opened the panel to a Q&A session with the audience. One attendee asked if any research was being conducted to include ESG indices in the same standard in order to clearly define what ESGs are. The panelists generally stated that these indices are disparate, with the constituents of an ESG score dependent on the company that defines it, e.g. Bloomberg, MSCI. The person also commented that most private investors, including those not calling themselves ESG, have already excluded companies in sectors like tobacco, guns, and others because they would not like to be associated with those industries. Another audience member asked if, through the stock market, investors were inadvertently giving funds to dictators and tyrannical regimes when they buy sovereign bonds. The panelists generally said that these issues are addressed through investment guidelines by many firms because of the UN charter and World Bank Group strict standards. Panelists also stated that ESG integration shows much better results than ESG exclusion. A panelist raised an issue of measurement, arriving at ESG scores. The correlation of ESG indices is low among index providers. To prevent greenwashing, the marketing of greens without practicing them is also important. A different audience member asked what role funds had in shareholder activism when working with companies. In response, the panelists posited that instead of simply raising funding, building coalitions, voting on shareholder resolutions, and disclosing how one votes is a great way to leverage engagement.

Keynote: Key Requirements for Sustaining the Global Expansion

By John Lipsky, Peter G. Peterson Distinguished Scholar, Henry A. Kissinger Center for Global Affairs, Johns Hopkins University; Former Deputy Managing Director, International Monetary Fund (IMF)

Professor Takatoshi Ito introduced the second keynote speaker, John Lipsky, the Peter G. Peterson Distinguished Scholar at the Henry A. Kissinger Centre for Global Affairs at Johns Hopkins University. Dr. Lipsky spoke about how it was important to ask how sustainable the current situation

is. These remarks were inspired by annual IMF meetings. World Economic Outlook states that the pace of economic activity remains weak. A sense of conflict replaces the era of global cooperation, with the G-20 summit process losing relevance. It is not seen as a forum for agreeing on multilateral actions. Moreover, technology is perceived to be creating conflict, not opportunities. A clear sense of fragility persists. Nevertheless, the economic outlook is better than the current gloomy situation.



John Lipsky

With the help of charts available on handouts to the audience, Dr. Lipsky explained that the hole in the global economy left by the 2007 recession has not been filled. Additionally, the long-term average rate of growth has not recovered. The slow rate of advanced economies' growth is above the trend, which is shown by the reduction in unemployment among advanced economies. Growth in emerging economies, namely BRICS, has settled down to the long-term average. The narrowing of the per capita income gap between emerging and advanced economies will thus be delayed or protracted.

The IMF has said that there are three downside risks to trade. These are geopolitical impediments to trade, the upcoming Brexit, and financial vulnerabilities. It is more important to look at the fundamental surprises that brought us to where we are today. Is our current environment of low inflation, moderate growth, and low unemployment a new normal or a fool's paradise? For many years, the inflation rate has seemed impervious to deviations in the Non-Accelerating Inflation Rate of Unemployment. Expected Inflation is very well-behaved in all advanced economies. We have lower inflation rates than expected, but people want this to remain.

On the topic of productivity growth, it would be foolish to try to interpret quarterly productivity statistics. It is better to look at the long-term figures. Accelerated technological change is expected based on new 5G technology. There are many reasons to expect a significant improvement in productivity. Although the labor share of GDP was decreasing overall, it was increasing in all the advanced economies.

The auto and energy sectors have weakened significantly. For instance, a decline of 7.5 % was observed in auto sector earnings last year. This has been a blow to overall GDP growth. A decline in energy prices has dented investments in the energy sector.

Currently, 90% of sovereign debt is trading at yields under 3%. Nearly 20% of sovereign debt is yielding at negative levels. This is hard to explain. If something changes the outlook of yields, it will have a broad effect. This has been a side-effect of low yields, with the public sector not creating burdens of debt service. Furthermore, public debt in advanced economies has had a very low burden on tax revenues. Unsatisfactory growth has resulted in record-high equity values.

A permanent set of unlimited swaps exist between the major central banks. Swaps necessary to provide temporary relief are already in place. In conclusion, there are substantial reasons for thinking that moderate growth may not be so unsatisfactory. Aspects most critical to sustaining expansion are low inflation, a sustained rise in labor income, corporate profitability, and increased capital spending in favor of productivity. Reduction of trade tensions and policy uncertainty will also improve the global economy.

Session 2: The Macroeconomic Environment: How Long Will Low-Interest Rates Continue?



Patricia Mosser, John Lipsky, Gauti B. Eggertsson, Noji Nakamura, Eric Ngiam, Maria Vassalou

Professor Takatoshi Ito thanked Dr. John Lipsky for his speech. He then introduced the moderator for the second panel discussion on the macroeconomic environment, Professor Patricia Mosser, the Director of the MPA Program in Economic Policy Management and Senior Research Scholar at SIPA. The panelists included Professor Gauti B. Eggertsson, Professor of Economics at Brown University; Mr. Eric Ngiam, Senior Vice President at GIC Asset Management; Mr. Koji Nakamura, General Manager for the Americas at the Bank of Japan; Dr. Maria Vassalou, Chief Investment Officer at Vassalou Capital Management; and Dr. John Lipsky.

One panelist explained that interest rates are important because slow rates impose major challenges to the global economy. The extreme volatility in long rates is more erratic than in previous years. This may be either a temporary or a permanent phenomenon, but there is a greater likelihood that it is the latter. This idea that low-interest rates are permanent is known as the Secular Stagnation Hypothesis. Interest rates have been showing a downward trend over the past thirty years. Fewer people want to borrow, putting downward pressure on interest rates. They instead want to save more, especially because of aging global populations.



Gauti B. Eggertsson



Koji Nakamura

Another panelist expressed cautious optimism about interest rates. The global growth of the past year was at 3%, lower than the long-term average of 3.5%. Several factors have brought about this relatively low growth rate. Financial tightening in China has caused a global slowdown. Secondly, increasing interest rates in the U.S. since 2016 have had a significant effect. The consequences of the slowdown were mostly seen in emerging economies. The U.S. has not suffered because of strong fundamentals and fiscal stimulus. Furthermore, semiconductor demand was too high and underwent adjustments, affecting the Asian region. Geopolitical tensions have also been an important factor influencing growth.

Nevertheless, global growth is expected to regain its momentum, rising to 3.4% in 2020 and 3.6% in 2021. Risks to the global economy exist; Brexit could be smooth, but other geopolitical tensions are more structural. High levels of corporate debt could cause downward pressure on the global economy. Symptoms of Japanization, a situation of low growth, as well as low inflation and low-interest rates, are being witnessed in European countries. The U.S. could also suffer from this in the future. Low labor input and low growth productivity may be two reasons for this. Regardless of advancements in information technology or human capital, improvements in management must occur to bring about growth. Learning new technologies and redirecting human and capital resources to cause structural reform should be the way forward.

A third panelist said that they observed interest rates as being mostly flat. A lack of jubilation about the economic recovery after the 2008 recession is because of what lies around the corner; fixed income allocation dropped because of low yields while equities allocation dropped because of negative returns from the financial crisis. A decline in fixed income has resulted in increased allocations to the alternatives. The alternatives are private equity, hedge funds, and real estate. The underlying theme is that they are rich in liquidity. Swedish central banks went to negative rates, and this created a lot of stress to the European Banking System. This money could have been put to better use.



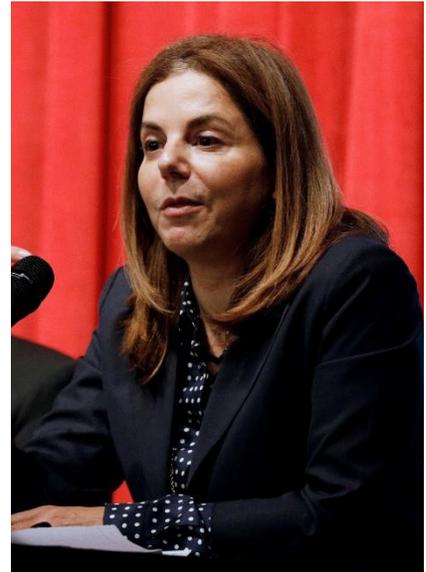
Eric Ngiam

Another panelist noted how a shallow recovery was recorded post-2008. It took ten years to get to the pre-recession economic pace. The expansion of globalization after 2010 has increased the digitalization of the economy. These forces are deflationary, and since 2000, an increased shift towards the IT-intensive industry has been observed. The implications are that in digitized industries, the amount of capital needed to increase productivity is much lower. Capital is not a scarce resource anymore due to the aforementioned changes. A ceiling on wages has also been reached, with access to technology lowering the demand for labor. The Fed cannot raise interest rates

because it distresses the consumer. A bifurcated economy is now prevalent where the consumer is sustained with little focus on attracting investments. Inflation cannot be built in the economy as the

inflation premium has been suppressed. Labor and capital are both in abundance. Inflation will therefore not rise in this situation. Productivity has not translated to wage growth, and in this way, the gains from productivity are not tradeable. This limits the usefulness of increased technological productivity on consumption.

The moderator of the second panel discussion, Professor Patricia Mosser, asked the panelists what fiscal policy could be used to combat modest growth and low inflation. The panelists recommended direct spending measures like building infrastructure and reducing sales taxes. The panelists further commented that weaker productivity growth must be tackled. Productivity tends not to move in a straight line, but rather in cycles. The world is in a position in which there is increased inclusion of technology in the service sector. Large fiscal stimulus does not make sense. In the case of a downturn, conventional approaches to fiscal policy using the power of automatic



Maria Vassalou, PhD

stabilizers is likely to be useful. Another panelist said that technology has eliminated the middleman and has not replaced it with anything. This is killing jobs without replacing them. Professor Mosser asked if the strategy should remain the same in terms of public investment and if people must learn to cope with the new environment. The panelists, in general, said that economics should be understood by politicians and bureaucrats. Otherwise, fund managers will take excessive risks.

Professor Mosser continued by asking about the risks of liquidity and its impact on the global economy. A panelist said that if low-interest rates persist, then governments will invest in riskier alternatives, which is good as it could potentially increase growth in the macro-sense. However, a side-effect is that this money could go into real estate, which is a problem.

Professor Mosser later opened the panel to questions from the audience. A member of the audience asked whether western pension funds would be willing to expose more to China markets, given Asian markets' further opening for pension funds. The panelists said that there will be greater participation in the future in China in the wake of its opening up to pension funds. A second attendee asked if countries should issue century bonds or 100-year debt in light of the view that they may

signify riskiness. The panelists answered that long-term debts do not pose a credibility issue since the inflation rate has been low, but rather, mitigate a problem of reinvestment risk. Another attendee asked about the panelists' view on how climate change affects risk. The panelists answered that it would definitely have an impact on future investments. Investors should worry about sudden changes in the value of orphaned assets in the future. An attendee asked about the impact of trade frictions on public and private fund investment in China in terms of capitalization rates, discount rates, and long-term treasury issues. A panelist predicted that the weight of trading goods will be less compared to digital trade, so the impact will be different from traditional trade wars. Another panelist mentioned that the government's restriction of investment in China will be ineffective and costly. A final question asked if there is a glut of energy. The panelists answered that prices would generally stay low, but investment will not decrease further, presenting a drag on overall output.

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