Conference on Public Pension and Sovereign Funds

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

November 30, 2023
Geffen Hall, Columbia Business School

Speakers Lunch

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

On November 30, 2023, David Weinstein, the Director of the Center on Japanese Economy and Business (CJEB) at Columbia Business School and Carl S. Shoup Professor of the Japanese Economy at Columbia University, welcomed attendees to the sixth annual Conference on Public Pension and Sovereign Funds. He introduced Takatoshi Ito, Professor at Columbia University's School of International and Public Affairs (SIPA) and Director of CJEB's Program on Public Pension and Sovereign Funds (PPPSF). He then turned it over to Professor Ito, who briefly explained the functions of the PPPSF and outlined the agenda for the conference.

Panel I: Macro Environment for Long-Term Investment

Professor Ito initiated the first panel's discussion on the macro environment for long-term investing.

The panelists included Richard Clarida, C. Lowell Harriss Professor of Economics and International Affairs at Columbia University; Patricia C. Mosser, Director of the MPA Program in Economic Policy Management and Senior Research Scholar at SIPA; and Junko Nishioka, Chief Economist, Managing Director and Deputy General Manager of the Treasury Unit at Sumitomo Mitsui Banking Corporation. The panelists were joined by discussant Hiroshi Ugai, Chief Economist and Managing Director at the University Fund of the Japan Science and Technology Agency, and the discussion was moderated by Professor Ito.

From left to right: Richard Clarida, Patricia C. Mosser, Junko Nishioka, Hiroshi Ugai

One speaker began their remarks by providing context for the post-pandemic surge in global inflation and the corresponding central bank policy responses, highlighting that the United States, the United Kingdom, Australia, the Euro area, Canada, and others all saw year-over-year core inflation above four percent. They noted that among the common drivers behind this surge was the pandemic's negative effect on aggregate supply, the subsequent boost in aggregate demand, and the expansion of global central banks' balance sheets as their fiscal policy responded to the pandemic.

Next, the speaker provided data showing that, while the economy was in fact comparatively productive and innovative in 2020, this changed throughout 2021 and 2022, when productivity growth was negative and the economy went through a period of technological regress. At the same time, the speaker said, there had been substantial shifts in the composition of demand relative to supply in the global economy, including an understandable increase in demand for goods and an understandable decrease in demand for services, triggering an increase in the price of goods compared to services.

The speaker then pointed out that no central bank began hiking rates until inflation in the respective country was already above target, a delayed response attributable to the fact that the rate increase had to be implemented in a very challenging period of supply and demand shocks. Since then, the Federal Reserve has raised rates in the U.S. at the most rapid pace in 40 years, though it is now widely expected to be finished or close to finished with its hike.

The next speaker began their presentation by discussing several risk factors in the current financial environment, first citing the number of unrealized losses that have resulted from the rapid rise in interest rates. While most fixed-income portfolios in the U.S. are marked to market daily or weekly, the speaker pointed out that there are some securities that are held to maturity and are never marked to market, including approximately $400bn of unrealized losses presently sitting on the banking industry's balance sheets. The speaker argued that this represents a potential drag on the banking system, citing the collapse of Silicon Valley Bank and First Republic in early 2023 as examples. Not marking assets to market is also common in real estate and private credit, so there may be large unrealized losses in those sectors as well.

Next, the speaker discussed risks in the treasury market, noting that the trading depth in U.S. treasuries is relatively low, which leaves little space for high transaction levels. In the market for the five-year treasury note, for instance, market depth currently is one fifth of its 2019 levels. They added that this suggests a market that's poorly positioned to take big shocks—a serious risk given the safe haven role the U.S. treasury market typically plays during times of turmoil.

Investors ought to consider other risks that stem from digitalization and innovation, the speaker continued, with bank runs, for instance, having become drastically faster in the age of social media and near-instantaneous payments. In this era, uninsured bank deposits in the U.S. are a significant liability in the financial system, with the government—generally considered the ultimate financial safety net—not equipped with a sufficient policy toolkit to handle the potential risks in the market.

The next speaker began their remarks by arguing that current money market conditions, despite the rapid increase of the policy rate, are actually not very tight when compared to the pre-pandemic period four years ago. With regard to inflation, the speaker said they expect a gradual improvement of the rate in 2024 and beyond. However, they also pointed out that there's been a divergence in the response from economies, with some economies showing weakness and others resilience over the past years.

The speaker then focused on Japan, which entered deflationary conditions in the late 1990s and has since been in an era of very easy policy conditions by the Bank of Japan (BOJ). However, the increasing richness in cash holding in the country's private sector has somewhat diminished the efficacy of the BOJ's monetary policies. They added that in countries with ample cash liquidity on hand, the private sector generally tends to become less sensitive to the impact of monetary policy, making it harder for central banks to control inflation in advanced economies.

The speaker concluded by cautioning investors regarding the rapid increase of market volatility, the persistent impact of financial tightening on global investors' risk appetite, and indications that stock prices are, from a macro point of view, overvalued in the S&P 500. They also urged investors to pay attention to the vulnerability of the financing of government bonds, not just in the U.S. but also in several other advanced economies. In the United States, 40 percent of the U.S. treasury bills are currently held by the Fed, the speaker added, but with the Fed gradually stepping out of its commitments, in the long-term, the market needs to find other stable buyers of those bonds.

The next speaker discussed Japan's coming tightening of monetary policy, stressing that Japan is on the verge of exiting its long-standing deflationary environment. In light of this, the speaker expects a rise in Japan's nominal GDP growth after 30 years of near-stagnation, ringing in a new cycle of the economy. However, they also cautioned that the Japanese household sector's income was still weak as a result of many firms having passed on rising import costs to consumers as demand surged after the pandemic.

The speaker explained that, ultimately, the BOJ likely won't tighten its policy until spring wage negotiations have shown whether there is a rise in wage growth, and until the two percent inflation target is sustainably in sight. However, once the BOJ decides to exit its yield curve control scheme and negative rate policy, the speaker said a more rapid policy rate increase than market expectations to some extent likely will be imperative, and the 10-year JGB yield likely will ultimately rise to slightly less than 2 percent.

The speaker also agreed with an earlier speaker that the rising interest rate in the United States and the past expansion of the Fed's balance sheet had left the financial sector more sensitive to potential liquidity shocks, citing the spring banking crisis in the U.S. as an example. In Japan, however, banks so far have had the loss-absorbing capacity to cope with interest rate risk phases, but nevertheless should manage liquidity risk prudently as the duration gap between their assets and liabilities has become wider than in the past, according to the speaker.

The panel concluded with a brief question-and-answer session with the audience, followed by a coffee break for participants.

Panel II: The University Fund of Japan

Professor Ito also moderated the second panel on the University Fund of Japan. The panelists for the discussion were Mark Anson, CEO and CIO of Commonfund; Masakazu Kita, Vice President and CIO at the University Fund of the Japan Science and Technology Agency; Naoya Sugimoto (CFA, CAIA, FRM), Managing Director and Co-CIO at the University Fund of the Japan Science and Technology Agency; and Maria Vassalou, Head of the Pictet Institute.

From left to right: Mark Anson, Masakazu Kita, Naoya Sugimoto, Maria Vassalou

Professor Ito explained the difference between Japan's Government Pension Investment Fund (GPIF) and the country's University Fund, which hold 230 trillion yen and 10 trillion yen, respectively. While the University Fund has to distribute funds to Japanese universities, GPIF has very little to cash out for now, which explains the difference in the two funds' portfolios. The University Fund's reference portfolio is split 65-35 between global equities and global fixed income, while GPIF's policy portfolio is less risky, with a 50-50 split between the two asset classes. Furthermore, GPIF's mandate is to earn long-term returns equating to wage inflation plus 1.7 percent with minimum risk, while the University Fund is supposed to maximize returns as much as possible, with controlled risk.

One panelist elaborated further on the history of the Japanese University Fund, noting that the fund was established within the Japan Science and Technology Agency with the mission to counteract Japan's declining international competitiveness in technology- and science-related research by providing an additional funding resource for universities' operating revenue, which has hardly grown in recent years.

The panelist then went on to explain that the fund is a sovereign wealth fund rather than the endowment fund typical for U.S. universities and that the fund only started investing in March 2022. The fund's long-term target return, based on the expected returns of a balanced portfolio, is 4.49 percent or higher, with investments being managed both in-house and by outside asset managers. As for the fund's governance and organizational structure, the panelist noted that there is an executive committee in place to decide on the most important matters, while the fund also has an investment committee and a risk-management committee. In total, the fund presently has 50 employees at its headquarters, 30 of which are investment professionals.

As for the fund's investment management approach, the panelist said that the goal is to achieve global diversification from a long-term perspective, including by using alternative investments such as private equity, private credit, real estate, and infrastructure, as well as a combination of passive and active management in public equity markets. While they echoed Professor Ito's comments regarding the portfolio's target return and target asset mix, they added that the fund is not strictly tied to the reference portfolio's asset mix but can also branch out into alternative investments. For now, however, during the fund's transition period, initial portfolio allocations are being made in a special risk-controlled manner until returns accumulate and allocations can be closer to the fund's actual risk tolerance.

The panelist then commented on the market conditions at the beginning of the fund's investments, in fiscal year 2022, where global equities and bonds, due to high inflation and continued interest rate hikes by Western European and U.S. central banks, posted negative returns, leading to a weighted fund performance for fiscal year 2022 of -2.2 percent. As of now, the full 10 trillion yen has been injected, with the government expecting to see investment gains of 300 billion yen to research universities in five years.

The next panelist began their remarks by commenting on the inversion of the U.S. treasury yield curve during 2022, and the subsequent increase of the yield curve from January 2022 to November 2023. A yield curve with such a downward slope, the panelist added, is usually associated with a recession, feeding ongoing discussions on whether there will be a soft landing from the Fed's policy or not. The yield curve in Japan, meanwhile, looks very different, given that Japan has stayed consistent with an easy monetary policy while the U.S. has tightened conditions, even though that era may soon be over in Japan.

Next, the panelist provided data to demonstrate how much of a historical outlier 2022 was in terms of market performance. For instance, both in 2001, when the tech bubble burst, and in 2008, during the Great Financial Crisis, stocks took a sharp nosedive, but bonds usually went up.

In 2022, however, both asset classes dipped, leaving investors with no immunity from the losses. Then, in 2023, equity markets were up in the first three quarters, but the rally was almost solely carried by the "Magnificent Seven" stock group, consisting of Apple, Amazon, Alphabet, Nvidia, Meta, Microsoft, and Tesla, pointing to a very narrow market that's difficult to manage for any active asset manager.

The panelist then emphasized that equity valuations in the United States are slightly overvalued, while equities in Europe, emerging markets, the United Kingdom, and Japan are all better valued than in the U.S. right now. At the same time, the liquidity premium for investors to hold private equity over public equities, with a long-term average of about 3.4 percent, has dipped to 2.3 percent, showing that this premium is not as beneficial for investors as it once was.

Another panelist began their comments by noting that the reference frame for the macroeconomic environment since the financial crisis has changed dramatically, with the global economy being at an inflection point. The panelist then went on to define the five themes of this inflection period: the shift from fossil fuels to green energy, the deglobalization trend, digitalization, changing geopolitics, and demographic shifts.

In light of these changes, the panelist argued the playbook of managing money needs to change, questioning whether a long-term 60-40 benchmark was still a good way for endowments and similar funds to manage their money. Rather than a 60-40 benchmark, the panelist proposed that funds should think about their portfolios by separating them into a part with which risks can be taken, and a part where investments are on the safer side. Another way to look at portfolios during this transition period was to target volatility, allocating portfolios based on how much volatility an investor is comfortable with and managing the assets based on that.

In this transition environment, risk management and protecting the downside are crucial, the panelist emphasized. Investors should also consider that many companies are staying private for longer and that digitalization, crypto, and decarbonization play an increasingly important role. Since the Great Financial Crisis, markets have been in an environment of high leverage and low volatility, but that period, the panelist noted, is now over.

Takatoshi Ito

Professor Ito then began moderating the discussion by asking all panelists what it takes, in today's environment, for investors like the University Fund to achieve a long-term return of 5 percent. One panelist responded by clarifying that because the University Fund injected its cash into markets over a short period of time, there was significant timing risk—if the fund, for instance, had invested in the high asset prices of late 2021 or the beginning of 2022, the timing of market entry would've had a significant negative long-term impact on the fund's return capabilities.

Another panelist stressed that, while the liquidity premium has somewhat decreased, investing in private assets—as is commonly done by the investment teams of U.S. pension funds, endowments, and foundations—was still useful for investors to achieve long-term returns of 5 percent or higher. One panelist added that investors need to consider which volatility level they're comfortable with to achieve a long-term 5 percent return; for U.S. pension funds, for instance, volatility levels are generally around 10 percent, while endowments' volatility targeting tends to be much lower.

Next, Professor Ito asked the panelists whether they think investors should hedge for currency risk, given that the Japanese University Fund, for instance, is accounted for in yen even as many great private equity and infrastructure investment opportunities are in the U.S. and thereby in dollars. One panelist responded by noting that investors should ask themselves whether they are hedging to reduce their risk profile or implementing hedges to boost returns, with only the former being appropriate. A second panelist agreed by emphasizing that investors should differentiate between hedging and speculation. Another panelist added that investors should also consider whether currency risk is a minor or major portion of the portfolio and decide accordingly.

Professor Ito then asked panelists about the differences in pension funds and endowments as they pertain to payouts, with one panelist clarifying that the cash-outs depend on the respective national regulations. Another panelist added that many U.S. pension funds are underfunded and thereby have different challenges in terms of producing returns. One panelist also noted that for large U.S. pension funds like CalPERS, the liabilities that have to be paid every year are very clear and, therefore, offer little flexibility. In contrast, endowments and foundations have more flexibility with their payout levels.

Lastly, Professor Ito commented that one challenge the University Fund faces is that it has to build out its portfolio over time to get to its ideal balance between global fixed income and equities. Professor Ito then asked the panelists how long it would take the fund to get to this optimal portfolio. One of the panelists responded by noting that the fund hopes to reach its optimal portfolio in 10 years. However, the time frame depends somewhat on the level of volatility in the market and any possible economic changes.

The panel ended with a brief question-and-answer session with the audience. Professor Ito then concluded the sixth annual Conference on Public Pension and Sovereign Funds by thanking the speakers and the audience for their time and participation.