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Pension solution lies in long-term thinking

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A lack of infrastructure spending, ageing populations and savings gluts in China are just three of the factors bringing low rates

If low investment returns are here to stay, those responsible for pension plans have a choice: wring their hands or fulfil their fiduciary duty by rethinking what it means for the design of their schemes.

Doing nothing is not an option. From 1871 to 2014 US equities produced an investment return, after inflation, of 6.7 per cent a year. Treasury bonds were good for 3 per cent.

In contrast, the Gordon Model — which calculates prospective returns from assumptions about growth and yields — suggests much lower returns are in prospect, a real equity return of 3.6 per cent and 0.6 per cent from Treasury bonds.

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A recent Bank of England report, *Secular Drivers of the Global Real Interest Rate* , also supports this idea of the new normal. It shows the current low return regime correlates strongly with slowing economic growth, ageing populations, savings gluts in Saudi Arabia, China and other developing countries, declines in infrastructure investing, rising income and wealth inequality, and falling capital good prices.

Lower returns, meanwhile, make pensions more expensive. As rule of thumb, for every 1 per cent drop in annual returns contributions must rise 20 per cent. So how to squeeze higher long-term returns out of pension assets, while still providing retirees reasonable safety of payment?

Dutch economist and Nobel laureate Jan Tinbergen answered this question decades ago: achieving two economic goals requires two instruments, not one. For pension design this means separate instruments for achieving the higher long-term returns and the payment safety goals.

So the Tinbergen rule exposes a fundamental problem with traditional pension design, which attempts to meet both goals with one instrument. A confounding factor is the common practice of treating volatility in returns as a proxy for risk.

For most individuals, the dominant risk is the long-term rate of return will be too low. What is needed are sustainable long-term cash flows, such as dividends, which compound and grow over time.

Pension organisations that understand the need to distinguish between this long-term risk, and the danger of short-term fluctuations in asset prices, will split the assets in their care: into long-term return compounding and short-term payment-safety sub-pools.

Still, this is only the start of a solution. A big question remains about whether many pension managers truly understand pension economics.

The glass half-empty answer is that many organisations do not have the capability of finding long-term assets due to lack of scale, poor governance and improper staffing.

The glass half-full response is that there is a still small, but growing group of pension organisations with the requisite capabilities and the scale to exploit them. They have what Peter Drucker, the inventor of modern management, described as the dictates of organisational effectiveness: mission clarity, strong governance and the ability to attract talent.

Arguably, the reorganisation of Ontario Teachers' Pension Plan in 1990 started this Drucker movement, from where it spread to other large Canadian funds and, more recently, around the world.

Today, these "Drucker funds" are poised to deliver an extra 2 or even 3 per cent per annual investment return on their long-term return compounding assets.

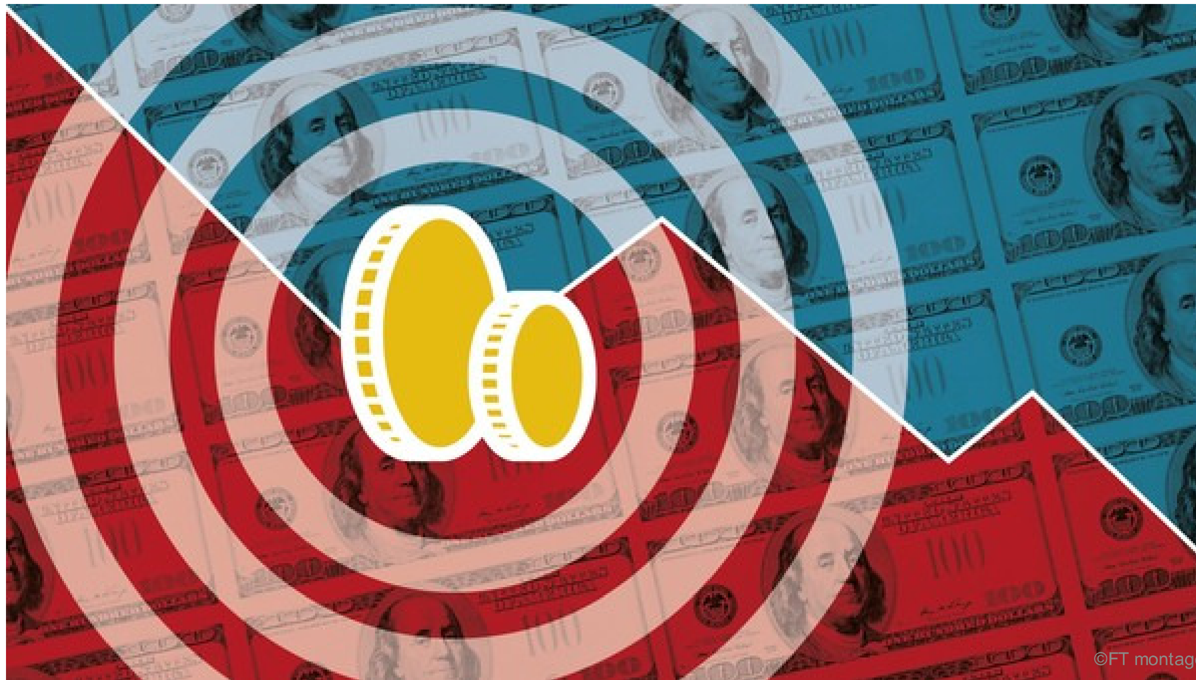
The rethink also made the old new again, recalling John Maynard Keynes 1936 attack on the destructive effective of short-termism when investing. Then managing the Cambridge university endowment fund, he wrote in his *General Theory* the behaviour of long-term investors will seem "eccentric, unconventional and rash in the eyes of average opinion".

The logic is not hard to follow. Hire skilled and motivated investment professionals, and tell them to focus on acquiring and nurturing sustainable long-term cash-flows in the forms of interest, dividends, rents and tolls in a cost-effective manner.

Indeed, eight decades later long-termism is again showing it can generate above-market returns. Keynes outperformed the market by 8 per cent a year between 1921 and 1946. On a much larger scale, Ontario Teachers' outperformed it by 2.2 per cent from 1990 to 2015.

Such crucial additional active returns will continue to be available as long as average opinion continues to think long-term investing is "eccentric, unconventional, and rash".

Keith Ambachtsheer is Director Emeritus, International Centre for Pension Management, Rotman School of Management, University of Toronto. He is the author of THE FUTURE OF PENSION MANAGEMENT, published by Wiley earlier this year.



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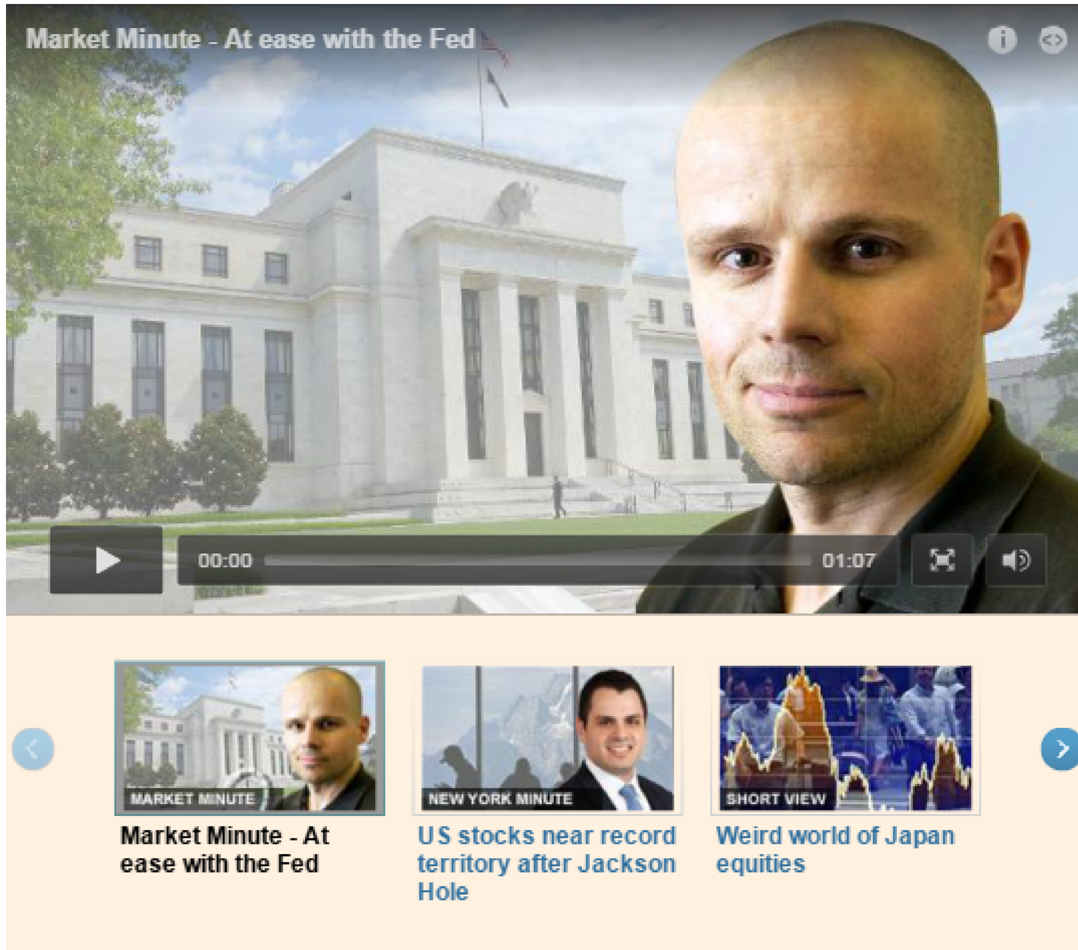

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