



September 2020

## FUTURE-PROOFING PENSIONS:

### INTEGRATING THE WISDOM OF JOHN MAYNARD KEYNES AND PETER DRUCKER

*“I have pointed out that under a system of ‘laissez-faire’, there is no means open to a government whereby to mitigate economic distress.....But if nations can learn to provide themselves with full employment by their domestic policies, there need be no lasting domestic economic distress or forces to set the interests of one country against that of its neighbours.”*

John Maynard Keynes, 1936

*“No book of mine was ever more on target than “The Unseen Revolution” (1976). And no book of mine has ever been more totally ignored. The book reported that institutional investors, especially pension funds, have become the controlling owners of America’s large corporations.....and that through this ownership, the means of production has become socialized without becoming nationalized.”*

Peter Drucker, 1996

#### Why Do Pensions Need ‘Future-Proofing’?

Wikipedia defines ‘future-proofing’ as the process of anticipating the shocks and stresses of future negative events, and of developing methods to minimize their impacts. What future shocks and stresses lie ahead for pension systems around the world? A new paper by Wharton’s Olivia Mitchell titled [“Building Better Retirement Systems in the Wake of the Global Pandemic”](#) provides a ‘shocks and stresses’ update: aging populations, insufficient retirement savings, insufficient investment returns, and ineffective risk framing and management.

This *Letter* will address the third and fourth items on Mitchell’s future pensions challenges list: insufficient investment returns and ineffective risk framing and management. It will do so with the help of two of the greatest thinkers of the 20th Century, John Maynard Keynes on the fundamentals of successful long-term investing and mitigating the risk of extended periods of economic distress, and Peter Drucker on the institutional/organizational implications of the effective conversion of retirement savings into sustainable wealth-producing capital.

#### Raising Investment Returns

Albert Einstein is reported to have declared compound interest the 8th wonder of the world. Without it, affordable retirement savings rates today cannot generate adequate pension payments tomorrow. Twenty years ago, inflation-indexed bonds offered a real yield of 4%. Today their yield is not just zero, but actually negative. Thus inflation-indexed bonds are now dead-weight investments and can no longer be used to generate adequate pensions at reasonable contribution rates.

So what to do? Is there still a way to generate a real return of 4% in the coming decades? Let’s use an investment in Unilever stock as a thought-experiment to address this question. Why Unilever? It is a well-known, well-managed \$155B company selling a mix of well-known consumer products in the global marketplace. It has a dividend yield of 3.1%, paying an annual \$1.88 dividend on a stock price of \$60.

Following the Gordon Model ( $R=Y+G$ ), if we add a conservative 1% for future real dividend growth, its long-term prospective real return exceeds 4%/yr. So with real bond yields now negative, Unilever offers a material prospective 4+% risk premium over risk-free long-term inflation-linked bonds with negative real yields. Generalizing beyond Unilever, so does a well-diversified stock portfolio made up of well-managed companies yielding an average 3% with real dividend growth prospects averaging 1%/yr.<sup>i</sup>

The implication is that, rather than the traditional 60-40 stock-bond policy mix, such a well-diversified stock portfolio has become the reference portfolio for sustainable going-concern pension plans aspiring to deliver adequate inflation-linked pensions at affordable contribution rates into the indefinite future.

### **But What About Risk?**

*Wikipedia* defines financial risk as ‘exposure to loss’. But what does that mean in the context of a ‘sustainable going-concern pension plan aspiring to deliver adequate inflation-linked pensions at affordable contribution rates into the indefinite future’? The answer can be extracted directly from the Gordon Model: the relevant ‘loss’ here is a negative  $G$  (i.e., declining profits and dividends) for an extended period of time, as last occurred during the Great Depression of the 1930s. That was a long time ago, raising an important question: what has changed? Why have there not been any extended negative  $G$  periods in the 75 years after WWII? Have we just been lucky? Or have national economies consciously been managed to avoid extended negative  $G$  periods for 75 years now?

The Keynes quote on the front page provides a plausible answer. In his 1936 book “The General Theory of Employment, Interest, and Money” he argued that the ‘laissez-faire’ mentality embodied in classical economic theory and policy through the 19th Century and the first four decades of the 20th Century were just plain wrong. Economic depressions were not inevitable events that simply had to be endured. Instead, serious macro-economic distress could be mitigated through corrective fiscal and monetary actions by governments and central banks. President Roosevelt’s ‘New Deal’ was the first example of Keynes’ views in action. Post-WWII, Keynes was a key catalyst in the creation of an extensive international socio-economic infrastructure designed to mitigate economic distress, largely in place to this day (e.g., the UN, World Bank, IMF, BIS). So yes, Keynesian economic stabilization policies and infrastructure have indeed been important contributors to keeping post-WWII national economies depression-free.

But what about asset value volatility? Does it not create ‘exposure to loss’? The answer is ‘yes’ for investors who may have to sell tomorrow to meet payment obligations, or to investors who must meet regular mark-to-market solvency tests.<sup>ii</sup> But what about long-term going-concern investors who do not have to sell tomorrow and do not have to meet regular mark-to-market solvency tests? Going back to the Unilever example, should they have cared that Unilever’s stock price fell from \$25 to \$19 during the Dot.Com Bubble, from \$39 to \$20 during the Global Financial Crisis, or from \$60 to \$44 during this year’s COVID Crash? Or instead, should they celebrate the fact that Unilever’s dividends have grown steadily decade after decade with very little volatility, and are likely to continue to do so in the decades ahead?

The implication is that for long-term going-concern investors, diversified stock portfolios of well-managed, sustainable, dividend-paying businesses are far less risky than their stock price volatilities suggest.<sup>iii</sup>

### **Keynes and Long-Term Investing**

Keynes was not just a great economist, but also an important contributor to our understanding of long-term investing. In Chapter 12 of his 1936 “The General Theory” book he shared his views and experiences as manager of the King’s College/Cambridge University Endowment Fund from 1921 to his death in 1946:

- Most investors (including professionals) are short-term ‘beauty contest’ investors, meaning they try to guess which stocks ‘the market’ will find most attractive six months hence. While this game may be entertaining, it cannot possibly be profitable for the asset owners.
- He himself preferred to “carefully select a few investments having regard to their intrinsic value for a period of years ahead....”.

- A recent academic study of the King’s College/Cambridge Endowment Fund over the 1921-1946 period calculated Keynes outperformed a risk-equivalent passive strategy by 8%/year over the 25-year period.

In short, Keynes intrinsically understood ‘investing’ to be what Benjamin Graham and David Dodd laid out in their 1934 text “Security Analysis”. He also understood the principal-agent problems embedded in diffused ownership of the means of production set out by Adolph Berle and Gardiner Means in their 1932 treatise “The Modern Corporation and Private Property”. Together, these two books have become the intellectual foundations on which today’s emerging long-term investment practices are built.

This is not to say the journey to long-termism has been completed. There is plenty of evidence that ‘beauty contest’ investors continue to try to outguess each other over short investment horizons (some masquerading as long-term investors). At the same time, a recent WSJ article by Lucian Bebchuk and Roberto Tallarita titled “[‘Stakeholder’ Capitalism Seems Mostly for Show](#)” cites research suggesting there is still a considerable gap between what corporate CEOs say they want to achieve for their stakeholders and what they actually do.<sup>iv</sup>

### **Drucker on Managing Society’s Retirement Savings**

In round numbers, global pension fund assets currently amount to some \$30 trillion. On top of that, a significant proportion of the \$50 trillion in global mutual fund assets are also retirement-related. At the same time, the global market value of listed stocks amounts to some \$90 trillion. These figures provide context for what Peter Drucker meant when he wrote that retirement saving pools have become controlling owners of the means of production.

Ever the management philosopher, Drucker reflected on the organizational implications of making the most of this ‘controlling owners’ reality. His conclusions were three-fold:

- Create stand-alone pension organizations with clear missions.
- Ensure these organizations have strong conflict-free governance functions.
- Ensure these organizations are not constrained from accessing the resources they need to be successful.

Through a series of fortunate events, Ontario Teachers’ Pension Plan (OTPP) became the first pension organization with its design based on the Drucker principles in 1990. Based on its successes, other Canadian funds began to adopt the Drucker model. More recently, the model has become globally recognized and referenced as The Canadian Pension Fund Model.<sup>v</sup>

### **The Canadian Pension Fund Model: Does It Work?**

But does the Model really work in practice? According to a just-released study involving 250 funds over the 2004-2018 period, the answer is ‘yes’. Titled “[The Canadian Pension Fund Model: A Quantitative Portrait](#)”, authors Alexander Beath, Sebastien Betermier, Chris Flynn, and Quentin Spohner reach five key conclusions:

1. For funds larger than \$10 billion, Canadian funds outperformed their peers on both a return per unit of return volatility basis, as well as on a return per unit of liability risk basis. These findings become more pronounced if the fund size cutoff is increased to \$50 billion.
2. They identified three success pillars: 1. Greater insourcing, 2. Greater resource support for the investment teams managing the insourced and outsourced investment programs (e.g., IT, risk management), and 3. Greater use of inflation hedge assets (e.g., real estate, infrastructure, commodity producer stocks).
3. The Canadian Model facilitates taking an integrated approach to spending more on productive resources, having greater allocations to strategic hedging assets, while still having lower overall management costs (57bps) than their peers (62bps) through greater insourcing.

4. They observed similar ‘Canada-light’ trickle-down patterns in the smaller funds segment (i.e., under \$10 billion) of the database.
5. Finally, they note that inflation-indexed pension liabilities are more cost-effectively hedged than nominal liabilities because having large positions in long-term nominal bonds leave less room for such hedge assets as real estate and infrastructure with materially higher return prospects.

Importantly, the cited ‘Canadian Pension Fund Model’ study was not designed to compare the mission clarity and governance effectiveness of the 250 funds in the database. Yet, Peter Drucker would argue, that is where the comparative advantage of the Canadian Pension Fund Model starts. Plan design and funding policy also fell outside the scope of the study.<sup>vi</sup> However, another new study by Clive Lipshitz and Ingo Walter titled “[Public Sector Pension Reform and the 49th Parallel: Lessons from Canada for the U.S.](#)” does integrate the mission clarity, good governance, plan design, and funding policy dimensions into its conclusions.

### Future-Proofing Pensions: What Will It Take?

To conclude, what does this *Letter* (with the help of Keynes and Drucker) have to say about future-proofing pensions? Six things:

1. With negative real return expectations, bonds currently have no role in the investment policies of going-concern retirement savings/pension plans.
2. The relevant reference portfolio today for such plans is a diversified portfolio of dividend-paying business organizations and inflation-sensitive assets managed to be sustainable into the indefinite future.
3. Such a portfolio is far less risky than what its short-term asset value volatility suggests. The reason is the post-WWII Keynesian economic policy revolution.
4. Keynes also showed that successfully managing long-term investment programs requires very different skill/experience sets and temperaments than for those engaged in short-term ‘beauty contest’ investing. It also requires proactive ‘future maker’ investor mindsets, addressing the climate, environmental and social challenges that impede a sustainable economic future through robust engagement.<sup>vii</sup>
5. Drucker taught us that designing and managing pension organizations for long-term success requires mission clarity, good governance, and no artificial resource constraints.
6. Two just-released studies confirm that the effective integration of these three success drivers does indeed improve the long-term performance of pension organizations, including improved matching to inflation-indexed pension payment obligations.

Do you agree? If you do, what is your next future-proofing step? If not, tell me why?

*Keith Ambachtsheer*

#### Endnotes:

- i. *The assumption here is that through a variety of channels (e.g., improving healthcare, addressing climate change, reducing inter- and intra-country income/wealth inequality) average global real GDP growth, profit growth, and dividend growth will continue to be modestly positive. At the same time of course, some businesses will perform much better than average, while others will disappear.*
- ii. *This is the problem the Dutch are now trying to solve with their new Pension Accord.*
- iii. *See our [June](#) and [August](#) 2020 Letters for more on ‘going-concern’ pension plan designs.*
- iv. *Just one example of corporate behavior that needs to change is to use free cashflow to pay dividends rather than for aggressive share buy-back programs and for accumulating excessive cash reserves.*
- v. *See our [August](#) 2017 and [December](#) 2018 Letters for more on The Canadian Pension Fund Model.*
- vi. *See Endnote ii above.*
- vii. *Collective action examples abound (e.g., ICPM, PRI, FCLT, Climate Action 100+), as do individual institutional investor action plans, see for example [CDPO](#)’s or [BNP Paribas AM](#)’s.*

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Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5  
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