The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

September 2021

BUSINESS STRATEGY FOR PENSION ORGANIZATIONS:

PRIORITIES FOR THE NEXT DECADE

*"**Strategy**: A plan to achieve one or more long-term goals under conditions of uncertainty."*

Wikipedia

"Knight and Keynes lost the battle to put radical uncertainty at the heart of economic analysis….. so instead, organizations are run with reliance on models which claim knowledge of the future that we do not have."

John Kay and Mervyn King
From their book "Radical Uncertainty"

"The reasonable man adapts himself to the world. The unreasonable one persists in trying to adapt the world to himself. Thus all progress depends on the unreasonable man."

George Bernard Shaw
From his play "Man and Superman"

Placing 'Strategy' in Today's Context

Last month's *Letter* showed 'strategy' to be the fifth and final topic in a pension organization's Annual Report based on the *Integrated Reporting Framework*. 'Strategy' logically follows the topics of organizational purpose, governance, business model, and performance. This sequel *Letter* addresses the question: how might pension organizations tackle that final 'strategy' topic in their next Annual Report?

Following the advice of authors Kay and King quoted above, we address that question by posing another question: 'what is going on out there?' Three narratives come to mind:

1. 'Mature Capitalism': Long-time readers of this publication know we have addressed the 'what is going on out there?' question for decades with short narratives that capture 'the essence of the times'. Starting after World War II, 'Pax Americana I' (1950-1970) evolved into the 'Scary Seventies' (1971– 1980), into 'Pax Americana II' (1981-1999), into 'Double Bubble Blues' (2000-2009), and then into the current 'Mature Capitalism' era (2010-?). This current era has been characterized by changing geopolitics (e.g., the rise of China competing for superpower status with the USA), aging demographics, slowing GDP growth, low inflation, low interest rates, and rising asset prices in the public and private corporate equities and real estate sectors. As a result, retirement savings are at all-time highs, but so are the reserves needed for retirees to maintain their living standards in the years ahead. The legal standing of these reserves in Pillar 2 pension plans has been changing, moving away from sponsor-issued guarantees in DB plans, or no guarantees at all in DC plans, towards collective risk-pooling arrangements.
2. 'The Covid-19 Pandemic': this major health crisis evolved rapidly from a few cases in Wuhan, China in November 2019 to a global pandemic by March 2020. With the 4th wave now

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underway, over 200M cases and 4.5M deaths have been confirmed thus far. Actual numbers are likely considerably higher. The pandemic has caused severe social and economic disruptions, supply shortages, misinformation, and social tensions. On the positive side, effective vaccines are reducing the severity of the global health impact, and effective governmental fiscal actions cushioned the pandemic's economic impact. After a short bout of panic selling, many security markets prices have recovered to pre-pandemic levels or better.

3. 'The Global Climate Crisis': two catalysts have elevated the 'climate' issue to crisis status. First, the latest Report of the *Intergovernmental Panel on Climate Change* (*IPCC*) confirms that human activity is causing global warming, by +1C degree thus far, and heading for +1.5C degrees by 2050. This dynamic will make abnormal weather events more frequent, and will produce more severe impacts on land, oceans, and the atmosphere. The second 'crisis' catalyst is news from around the world that these severe impacts (e.g., fires, floods, droughts, and record temperatures) are already here. The Report has more bad news. The best we can hope for post-2050 is to stay at +1.5C if we achieve the difficult challenge of global 'Net-Zero' GHG emissions by then. If we fail to do that, the frequency and severity of climate events will continue to escalate. In this context, it is hard to overemphasize the importance of the upcoming COP26 meeting in Glasgow in November with its goal to devise a global plan that achieves 'Net-Zero' emissions by 2050. Required actions by institutional investors will be an important part of that plan.

How should these three 'what is going on out there?' narratives impact the business strategy of pension organizations for the next decade? That is the next question to address.

Seven Strategic Questions Requiring Attention

To start, it is worth repeating that the fundamental purpose of a pension organization is to deliver adequate pensions to its members/clients at an affordable contribution rate. Then logically, a key responsibility of its board and management is to ensure the organization has the resources and the requisite strategies to achieve that goal. The devil, of course, is in the details. Consider these seven questions, for example:

1. What is an adequate pension……and an affordable contribution rate?
2. How and by who will investment and longevity risks be borne?
3. What is the relevant time horizon for assessing investment risk?
4. What would an adequate payoff be for bearing investment risk over that horizon?
5. Is that adequate payoff a plausible expectation for the next decade? Why?
6. Should the answers to these questions be shaped by the three 'what is going on out there' narratives set out above?
7. Does the organization have the human and technical resources to seriously address these questions in the 'what is going on out there' contexts?

In fact, many pension organizations may be short on the human and technical resources required to seriously address these strategic questions, shaped by the three 'what is going on out there' realities. It is possible that these resource shortfalls will increasingly be seen as fiduciary duty breeches as this decade unfolds.

Searching for Strategic Answers

While this *Letter* cannot provide universal answers to all seven strategic questions, it can make a start. For example, the answer to Question 6. is a resounding 'YES'. Good strategy reflects the best possible assessment of current realities….and should not be based on the simplistic assumption that past experience offers the best estimate of future experience. The referenced *IPCC* Report on climate change offers a good example of this reality. Its key message is that our climate future will definitely NOT be like the past.

The evolution of Pillar 2 pension designs offers another example of the future NOT being like the past. There has been a steady shift from pure DB plans where employers underwrite all risks, to plans where plan members also bear risk. In some cases, it is part of the risk…in others, it is all of it. In the latter case, strategy must differentiate between workers accumulating retirement savings and retirees spending them. Their respective risk bearing capacities differ materially, and that should be reflected in plan design. All these considerations come to the fore in addressing Strategy Questions 1 and 2. See the **February 2020**, **June 2020**, **August 2020**, and **June 2021** *Letters* for more on these topics.

The likely largest strategic challenge facing pension organizations today is addressing Questions 3, 4, and 5 in the context of the three 'what is going on out there' narratives. The strategic time horizon for investment policy is at least a decade rather than just a few years. Within that timeframe, how are reasonable return prospects best developed……and risk exposures best articulated and addressed? Some thoughts on these questions follow.

Investment Strategy to 2030 and Beyond

There is an actuarial rule of thumb that retirement savings need to earn a net real investment return of at least 3.5% to generate a good pension at an affordable contribution rate. For example, under reasonable assumptions, an affordable 10% of pay contribution rate will replace 35% of final earnings on retirement in a Pillar 2 pension plan if retirement savings earn a net real 3.5%.[i] If a universal Pillar 1 plan also replaced 35% of final earnings, the combined 70% replacement rate would surely be deemed 'adequate' in most retirement contexts.

How reasonable is it to assume that retirement savings will in fact earn a net real 3.5% to 2030 and beyond? It was a certainty 20 years ago when default risk-free inflation-indexed bonds yielded 4%. Today, the yields on such bonds are marginally negative, and hence pension funds must look elsewhere to earn that net real 3.5%. Our **September 2020** *Letter* titled "Future-Proofing Pensions" addressed this challenge using the following logic:

- Financial markets offer a wide array of investment opportunities ranging from risk-free bonds at one end of the risk spectrum…..to 'concept' opportunities with no profits or even revenues at the other end.
- Between those two extremes lies a vast array of investment opportunities that do have revenues and profits, some of which is reinvested in the business, and some of which is returned to investors.
- We chose *Unilever* as a 'poster child' example of an investment opportunity that was not risk-free, but had a history of generating steady revenues, profits, and dividends with a clear business model. Could such an investment be reasonably expected to generate a net real 3.5% or better today?
- The Gordon Return Model {R=Y+G} provided the answer. With a stock price of $60 and an indicated dividend of $1.88, its Y was 3.1%. What about the real dividend growth rate G? Assuming a G of 1% for continuing to sell a broad mix of consumer essentials to a global consumer base seemed conservative. So *Unilever*, with its R=3.1%+1%=4.1%, passed the 3.5% test, as would many other investments with *Unilever* characteristics.
- What about equity risk? The *Letter* argued it was time to put the notion that investments like *Unilever* were risky because they exhibited short-term price volatility out to pasture. That kind of risk is relevant for short-term speculators…..not for long-term wealth creators. But what about the risk of an extended 1930s-type depression? There is a good reason why there has been no post-WWII recurrence: John Maynard Keynes showed us how to nip depressions in the bud with proactive fiscal/monetary policies. The most recent example of this phenomenon in action was the fiscal/monetary response to the COVID pandemic.

There is one final question for this *Letter* to address: how should the COVID and Climate narratives set out above impact the investment strategies of pension organizations today?

COVID, Climate, and Investment Strategy

The impact of COVID may already be reflected in securities price changes since March 2020. For example, the prices of travel and leisure stocks have been marked down, while the prices of e-commerce and pharmaceutical stocks have been marked up. As a counter to the 'poster child' *Unilever* example above, *Pfizer*'s stock price has increased by 1/3rd since March last year, but its Y is still 3.3%. So even with only a modest G assumption, it still passes the net real 3.5% return test.

In contrast, the impact of the Climate narrative is a very different kettle of fish. Keeping global warming to +1.5C, will require on 'all hands on deck' approach to achieve 'net-zero' GHG emissions by 2050 at the global level. Wholesale structural changes will be required to how we generate and use energy. At the same time, technologies to remove carbon from the atmosphere need to be developed and implemented. On top of the emerging physical impacts of climate we are already experiencing, there will also be material transition risks accompanying these structural changes (e.g., stranded fossil fuel assets).

The three macro 'net-zero' solution drivers are technology, politics, and finance. On the finance front, there are three 'R's: reporting, risk management, and prospective return assessment. Our **August 2021** *Letter* provided insights on the reporting dimension for pension organizations, with its five Report topics starting with purpose, then governance and organization design, business model, performance, and ending with strategy. Looking from back to front now, there cannot be a credible strategy discussion without a credible business model supporting it.

In the new 'net-zero' world, pension organizations must have the capability to perform 'bottom up' analytics, one investment at the time. Without such capability, it will be impossible to assess the transition risk embedded in potential investments, or to report on organizational progress made towards the 'net-zero' goal.[ii] A closely related business model dimension is incentive compensation. Stating the obvious, incentive compensation must align with achieving the 'net-zero' imperative. Finally, there is a 'fiduciary duty' dimension to all this. Arguably, boards of pension organizations are in breach of their fiduciary duties if they do not ensure that their organization has effectively integrated these 'net-zero' considerations into its business model. More on this in a future *Letter*.

The goal of this *Letter* has been to argue that the business model of your pension organization must have both the technical and incentive elements necessary to ensure it can meet the strategic challenges facing it between now, 2030, and beyond. Can your organization pass that test?

Keith Ambachtsheer

Endnotes:

i. *For example, see Hamilton and Cross (2018), "**Risk and Reward in Public Sector Pension Plans**", Fraser Institute.*
ii. *For example, see Van Clieaf and Close (2021), "**Climate Change and NetZero Transformation**", NetZero.*

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