Time to Push the Reset Button on Pension Fund Investment

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The global economy is on life support, and the best that can be expected for the next five to ten years is to get out of the ICU but not off the critical list. Slow growth, low interest rates, serious unemployment levels, marginalised activity in the growing informal sector, sovereignty as a defensive strategy and democratic volatility – these realities are not conducive to the management of workers' capital for stable retirement funds in the current dominant market frame.

Whether you accept the analysis 'Modern Portfolio Theory' or consider the unfunded liabilities of defined benefit schemes or the inadequate returns to retirement benchmarks of defined contribution schemes, the reality is we need a different future for workers' capital – this requires us to push the reset button.

Yesterday I made the argument for leadership. The significance of pension funds cannot be underestimated, and thus the capacity to lead rather than follow investment activity, to establish demands on governments and markets, is possible if there is the will to do so.

Growth of Pension Funds: Assets under the management of pension fiduciaries have grown from an insignificant part of economies to huge pools of capital. Total pension fund assets now exceed national GDP in the Netherlands, Switzerland, and Iceland. Across all countries in the Organisation for Economic Co-operation and Development (OECD), the average ratio of pension assets to GDP in 2009 was 67%. In the United Kingdom, it was 81%; in Australia, 82% (OECD 2010). Institutional investors collectively own 73% of stock issued by companies in the Fortune 1000. Pension funds alone hold the largest ownership block, with around 30%.

I would also add developments in China to this mix with the extraordinary potential for rapid growth of investment funds with the pace and scope of the role out of a three-tiered contribution structure of social protection.

Pension funds need to shift toward **'patient capital'** strategies and away from short-termist behaviour characterised by high turnover of assets, allocations to speculative hedge funds and the acceptance of products that are overleveraged such that risk and hedging risk becomes a vicious cycle.

If Wall Street, the City, mainstream media and many of the governance systems in use throughout society are still operating with 20th-century market-economy assumptions, what will it take to engineer some fundamental shifts for both sustainable investments and outcomes for workers' capital.

Let me address this through the lens of risk and climate risk in particular. No matter how remote they might seem when viewed through prevailing short-term perspectives, the long-term ramifications of climate change, income inequality, pollution and ineffective allocation of capital are real, are staggering and are a fiduciary concern. It has been asserted that blind reliance on out-dated assumptions and resistance to change have turned the application of reasonable 20th century prudent fiduciary practices into a 21st century "Lemming Standard". Even if you don't agree with this, there can be no argument that copycat investment behaviour drives creation of additional market volatility – making bubbles and busts more severe and generating systemic risks.

As significant partners in the architecture of the pension funds, unions must face significant questions – hard questions that should drive significant shifts in focus if we get the answers right. As capital owners and /or trustees, labour certainly needs to look at our role in generating preventable crises and destruction of capital for which we have a collective stewardship responsibility.

At what point did we allow our funds to become captive of the dominant market frame without question?

Have we lost a perspective of the original labour rationale for bargaining for deferred wages into retirement income and/or advocating for the legislative/regulatory guarantees for dignified retirement incomes?

What is a dignified retirement income as a percentage of salary and how do we drive that base for all people with a mix of deferred wages (employer and worker contributions), state pensions and annuities etc.? In Australia, for example, we set out to both ensure retirement incomes that at least meet the ambition of 65% of salary at 65 and to take some or all (depending on salary base) of the burden off state funds given the demographic realities.

What is the actuarial figure of investment returns over the long term (patient capital) that will best guarantee an agreed retirement benchmark?

Can we generate an alternate framework of guaranteed returns for at least certain portfolio shares without relying in total on the ravishes of the speculative market with the costs of hedging and the deepening of a failed economic model? Can we and should we disaggregate young client capital for intergenerational shift in the investment culture? Do we need to carve out the distressed group of emerging retirees and treat the threat as backs have with their demand for recapitalisation? I know that this is artificial in terms of portfolio percent investments, but as a communication strategy and a rationale for much greater attention to 'patient capital', it speaks to workers.

What would it take to get 6% returns from infrastructure investment over five to ten years if we rethink the role of the state and the private sector. Can we look at government and or multilateral institutional backing for moderate percentage returns to drive diversification into developing and emerging economies?

These issues are on the radical edge of the discussion here, but let me look at some of this through the lens of low-carbon, climate-resilient projects in green economy investments including transport, housing, and energy infrastructure, etc. – long-term projects that fit well the **liability profile of pension funds** which spans over 20-30 years.

This is something labour unions are increasingly committed to, and some changes are already taking place. **Current pension leaders** in green investments are increasingly originating from collective agreements and/or have trade union pension trustees: Danish ATP, US CalPERS & CalSTRS, Dutch ABP and PGGM, Swedish APs and several industry funds in Australia to mention a few.

The recent decision by the South African Government Employees Pension Fund to invest R1bn in green bonds is a good example.

But how do we move further and **change scale?** Our own calculations suggest that pension funds could raise the share of green/low-carbon assets of their portfolio from a shocking low level of 2-3% to **5% in the next three years, which would unleash some USD300bn annually** in the years following. This benchmark is the base we understand is around the tipping point of market maturity.

To reach that figure, the barriers are not on the demand side; they are on the **supply side**, and in the **lack of readily available green financial products** that combine performance and security.

Let me suggest some **distribution of roles** for that to happen:

Asset managers have a responsibility to develop transparent products that can combine performance and security while ensuring transparency and traceability of investment into low-carbon projects. They need to be accountable to asset owners on the financial and ESG performance of the products they deliver.

Sadly, the transparency call is not yet the case for existing investment in high carbon assets. Excessive product complexity, often opaque to trustees, does not help when you sit on the board of a pension fund.

The current **green bond market** (USD16bn, annual issuances in the range of USD1-2bn) is "a drop in the ocean" of the world bond markets. A lot could be done to develop green bonds, long-term bonds, as an asset class that is attractive for pension funds.

"Alternative assets", such as clean-energy **infrastructure funds** and other green private equity investment funds, as well as **insurance-type derivative products** (traded through transparent exchanges), can also help pension funds diversify their portfolio and manage and mitigate risks that are specific to climate-resilient low-carbon projects, if – and that is a big if – they are properly **regulated and supervised** by authorities.

Policymakers and regulators must ensure a stable policy environment around carbon pricing, fossil fuels subsidies and other reforms that aim at **financial stability** to avoid unintended consequences that inadvertently discourage pension funds from investment in green projects.

But beyond that, **government guarantees,** or those of multi-lateral institutions, on green products will be needed, since private insurers, especially since the 2008 crisis, cannot generate the trust or the scope to fulfil that role. But despite, or maybe because of the massive transfer of public money into bank rescues or guarantees, **public money guarantees for private projects is a delicate issue**. The model needs to be designed for confidence with the right balance, the right risk- and reward-sharing between public and private finance, as experience with poorly designed Public Private Partnerships tells us. This, though, is critical work and is essential to building and re-building economies.

Finally, we need more **education** and dialogue that generates initiatives between institutional investors, civil society and governments.

We have set a challenge for investment in the green economy, and in addition to the imperative for transition of investment to low carbon infrastructure for security, we also know that jobs, good jobs, will be delivered. Along with the projected demands for 50% more food, 45% more energy and 30% more food by 2050, demands that must be delivered within a green economy frame – jobs, jobs and jobs – are the upside return.

However, the shifts in attitude and design are significant, and fiduciary responsibility is significant amongst the challenges.

Many industry professionals also mistakenly believe that the duty of loyalty, which includes the sole purpose test, requires fiduciaries to maximise short-term returns without regard to the longer-term consequences and systemic risks generated by their behaviour. Nothing could or should be further from the truth.

In fact, governing fiduciaries are legally required to take a balanced approach that impartially balances the different short- and long-term interests of fund participants as human beings. The US Supreme Court for example has specifically held that the fiduciary duty of loyalty extends not to the plan itself but to the beneficiaries as individuals.

Under the duty of loyalty, fiduciaries cannot turn a blind eye to material risks and opportunities that are relevant to delivery of sustainable pension benefits to the human beings who are fund beneficiaries, especially if the fiduciaries' own management practices amplify those risks. Risks to the interests of beneficiaries in a sustainable retirement must be recognised and, to the extent reasonably practicable, must be managed in a way consistent with the interests of both current and future retirees. All those involved in making decisions about the investment of workers' capital must be mindful of the international legal framework in which investment decisions are being made, which includes respect of internationally recognised human and labour rights and standards.

The Asset Owners Disclosure Project (AODP), a project aimed at transparency and disclosure of high carbon and green economy assets held by our funds, today released a new report regarding fund trustees' fiduciary duty that indicates significant legal risks in the event of financial losses caused by climate change impacts, both physical and regulatory. The AODP commissioned leading global law firm Baker&McKenzie to study the evidence for trustee obligations over climate change, looking at developments and action since the Freshfields report of 2009. The AODP/Baker & McKenzie report has used the Australian legislative framework as a reference point having similarities with trust law in other major pension economies.

The AODP / Baker & McKenzie report referenced the evidence available and found that understanding of climate risks was reasonably advanced, but that action taken to manage climate risk had been very limited. It concludes that this gap between understanding and action represents a clear legal risk to trustees.

It is clear to us that a potential climate or carbon crash will smash portfolio values and frankly make the sub-prime crisis look mild. Unlike sub-prime, trustees have had ample warning, and members will turn to their trustees for answers and potentially legal recourse. It is clear that trustees must act on the convergence of both the demand for patient capital investments and the management of future risk as we recognise the imperative and the opportunity to participate in the transition to a low-carbon economy.

The reality is that there is some underlying value destruction already underway in high-carbon assets and transparerncy and redesign of patient capital strategies for security of retirement incomes, provision of decent work and the planet itself.

Thus, in conclusion, there are several key issues for labour as representatives of the workers' capital funds under management and the revision of fundamentals including principles of fiduciary responsibility.

1. What do we have to do to reset the investment frame for significant pools of 'patient capital' supporting the real economy and generating moderate returns over the long term?

2. The investment of workers' capital to rebuild economies and consider investment through a jobs lens requires dialogue and design initiatives agreed between labour, employers, institutions and the state.

3. Diversification must include green economy investment in the face of climate risk and be inclusive in design for secure investments in developing and emerging economies. As part of this design, surely it makes sense to have government guarantees back part of the imperative to meet today's and tomorrow's climate challenge – at least to leverage market maturity.

4. Pension funds exist for the social purpose of financing workers' rights to secure an adequate retirement income. Happily they also provide significant economic security. So, notwithstanding the capture of our funds in a dominant market model with obvious and ignored risk, the question should be asked as to why there is no demand for some recapitalisation given the equivalent transfers and guarantees provided for the banks.

Above all, greater transparency with greater simplicity and a decoupling of workers' capital from the irresponsibility of speculative greed requires both agreed principles, a moderation of expectation and urgent leadership.

We believe we can push the reset button – do you?

Agenda: http://www.fiduciaryinvestors.com/santamonica/agenda.html