Pension System's Divestment of Canadian Equities. The Policy Implications for Canada

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Abstract

In 1990, Canadian pension funds allocated close to 80%[1] of their equity investments to Canadian public equities. By 2020, this had fallen to barely 10%[2]. This decline has important policy implications for Canada as pension savings represent 30%[3] of Canadian savings and, contrary to bank and insurance company savings, are long-term and able to take equity risk. Who will determine Canada's future if Canadian savings do not play their essential economic role in funding Canadian investments and creating high quality jobs? What will be the impact on growth and incomes? This is only one of several issues that have risen in importance as a result of the shortening of the investment horizon that has been imposed on pension funds by changes to regulations.

Plan sponsors have reacted to their regulatory environment: they have sought to abandon a good retirement system, the defined benefit plan, in favor of a bad retirement system, the defined contribution plan; they have removed their assets from view and scrutiny by abandoning public markets in favor of private ones; they have increased their investments in low return assets with higher long-term volatility at the expense of higher returning assets with lower long-term volatility; they have become indexers or closet indexers; they have mostly allocated their assets not based on some careful forward looking analysis but rather on statistical historical analysis; they have left Canada, and they have added leverage. None of this is particularly good and is probably not what the regulator desired. Canadian investment managers are not badly performing their work but rather are responding to cues from the regulation of pension plans. These policy cues need to be revisited to restore healthy management of our collective savings.

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[1] Pension Investment Association of Canada. (n.d.) *Pension investment association of Canada*. PIAC 2022. http://piacweb.org/

[2] Pension Investment Association of Canada. (n.d.) *Pension investment association of Canada*. PIAC 2022. http://piacweb.org/

[3] Statistics Canada. (2022, March 11). *Table: 36-10-0580-01 National balance sheet accounts (x 1,000,000)*. Statscan. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610058001

Introduction

Letko Brosseau & Associates Inc. has more than 30 years of experience managing pension assets. In fact, the investment team of this firm have a combined experience of 118 years working in the pension fund industry.

What sparked this reflection has been the trend towards the investment of larger and larger amounts of pension savings outside of Canada. According to the Pension Investment Association of Canada (PIAC), the industry's leading body, the portion of equities invested in Canadian public companies has dropped from close to 80% in December 1990 to barely 10% in December 2020, representing only 4% of overall pension assets. Some of the largest funds in Canada hold only 1%[4] of their assets in Canadian public equities. This has many implications for economic growth and should be a major policy concern for Canadians and our government.

This is but one of several trends, some of which are Canadian in their origin and others are endemic to the industry.

In the 1990s, pension managers, sponsors and participants all argued for more investment freedom and with some resistance and time the regulator consented. Then came the bankruptcies of Nortel, Abitibi, and several others, which put the ability to pay their pensioners at risk. Infighting between plan sponsors and members on who should absorb the consequences of poor market returns arose, and later, on who should benefit from growing surpluses.

As a result, the regulator stepped in, allowing more freedom but also tightening the reigns: assets would have to be marked to market, and liabilities calculated more frequently. Gone were the

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[4] Pension Investment Association of Canada. (n.d.) *Pension investment association of Canada*. PIAC 2022. http://piacweb.org/

days where fluctuations in the market value of assets could be amortized or where actuarial deficit could be made up over 25 years.

Shortening of the investment horizon

This amounted to a shortening of focus of what should otherwise be a long-term project: saving for retirement. It changed everything.

It is well documented that equity investments give the highest returns over the long term, much higher than commodities, cash, or bonds. The volatility of equity returns over 20-year periods is even less than that of long-term bonds! However, over much shorter periods, the equity world looks more volatile. In March 2009, world stock markets had declined 50%[5] from their previous peak. In February-March 2020, they had declined 30%[6], but despite these enormous declines, portfolio returns have held up nicely over the last 15 years.

Unaccepted stress

The short-term focus of regulation and the fluctuations of public markets have caused a lot of stress for plan sponsors and typically at the worst of times. The dynamic is simple, poor economic conditions lead to declining equity markets and asset values. At the same time, central banks lower interest rates to get the economy moving again. Pension liabilities rise because regulations require they be valued in reference to interest rates. As a result of declining assets and rising liabilities, pension deficits increase and need to be repaired by the plan sponsor or guarantor just when their business is suffering. In such times, money would be much better invested elsewhere to help the business. The result is a lot of stress!

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[5] MSCI. (2022, March 1). *Real time index data search*. https://www.msci.com/real-time-index-data-search
[6] MSCI. (2022, March 1). *Real time index data search*. https://www.msci.com/real-time-index-data-search

Six responses to stress

So, what do people do when their stress levels rise? Well, they respond in many ways, and they have to.

First, they try to walk away from the situation. This has happened and is ongoing. Defined benefit plans are closing to new members or simply winding up in large numbers, to be replaced by defined contribution plans. Nobody thinks that defined contribution plans are better than defined benefit plans for plan members in the long term. In fact, calculations indicate that the same level of lifetime contributions should lead to less than half the retirement income because of differences in costs and the inability to pool life expectancy risk. The long-term impact of this trend should not be underestimated.

Second, they deal head on with the cause of the problem: the importance given by regulations to short term asset volatility. The volatility is most visible in public markets where equities are transacted every minute of every day but is hidden away in private markets where transactions are less frequent and require the opinion of an appraiser. Some recent studies indicate that the volatility of private equity is much less, possibly half of that of public equities. Few really believe that the volatility of private equity is less than that of public equities, but the perceived volatility is an artifact of how private equity returns are valued: few transactions, little data available, infrequent assessment, and subjective valuations. Proper studies indicate that private equities are more volatile, not less, principally because of a lack of liquidity, and today, because of high leverage. Valuing an investment once a year instead of daily is very useful in reducing the perceived volatility of assets.

Third, they deal with another problem head on: the effect of short-term interest rate variations on pension liabilities. To solve this issue, buying assets that fluctuate in the same way as the fund's liabilities can neutralize the variations. This is referred to as asset/liability matching. Today this means buying long-bonds and to some extent real-estate. There is a problem however with this strategy because of today's very low interest rates: the spread in the expected long-term return from bonds versus equities is probably near an all-time high favoring equities. So, rather than invest in the asset that will generate the higher return, pension funds are investing in an asset that returns 2%. Not only is the 2% low, but it is not likely to match inflation over its lifetime nor satisfy the fund's long-term return requirements. As for real-estate: how many office buildings, high rise apartment buildings and shopping centers does the country need?

Fourth, they protect themselves. Just like the zebra that does not want to be separated from its herd for fear of becoming the target when the lions attack, plan sponsors have paid much more attention to what others are doing and making sure they are investing in the same asset classes, and in the same proportions as others. It is not rare to hear a sponsor change their asset mix because their current one is an outlier rather than because of a view they may have on expected returns. This is indexing.

Canada represents 3-4%[7] of World equity markets, so to index, they conclude that they should invest 3-4% in Canadian equities. The logic behind this confounds.

Smaller economies will always represent a smaller share of the world economy than larger ones. Does this mean that the smaller the economy, the less it should take of its already smaller savings and invest them in its own economy? Should small economies principally invest in larger ones? Americans invest 75%[8] in their own economy, should Canadians make do with 3% and leave it to others to forge their future or should they also invest 75% in Canada?

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[7] Sponsored Content. (2021, September 16). *A complete geographic breakdown of the MSCI ACWI IMI*. Visual Capitalist. https://www.visualcapitalist.com/a-geographic-breakdown-of-the-msci-acwi-imi/

[8] Board of Governors of the Federal Reserve System. (2022, March 10) *Financial accounts of the United States - Z.1.* https://www.federalreserve.gov/releases/z1/

Indexing also presumes that investors all have the same risk profile. But can domestic content be replaced by international investments including emerging market equities, on a dollar for equal dollar basis, ignoring a variety of risks that come from currency, taxation, political and legal environments?

Fifth, they share responsibility with an outside party: the dilution of agency and the rise of the asset allocator. When seeking expert advice, one that is widely used is best because if things do not turn out as expected, the group of those affected will be large. When a municipal counsellor sitting on the town's pension committee is told that their fund should seriously consider investing 10% of its assets in international real-estate, what should they do? Go out and get the lease roll of some offices in London, Frankfurt, or Tokyo? Look at the capitalization rates currently being used? Ask about the fees that are being charged? Or instead, read the table of returns and correlations that is presented and ask who else is doing this? Currently, most of the allocation analysis is based on statistical analysis of historical returns and cross correlations. There is little, if any, forward-looking fundamental economic analysis. Governments have wisely counseled against this method in requiring investment managers to stipulate in their promotional material that past returns are not an indication of future returns. Asset allocators are now making very detailed asset recommendations, but unlike investment managers, returns from these recommendations are not sampled and measured, after all, they are only recommendations. The final decision lies with the plan sponsor, who relies on these expert recommendations. All of which seem very reasonable but is not.

Sixth, they try to run away from the problem by pressing on the gas. How is this done? By increasing leverage. It would have been unheard of for a pension fund to borrow 40 years ago but now it is common. Many pension funds have substantial investments in derivative products, leverage often being an important component. People thought differently about risk back then.

Possible solutions

1 – Account for risks

Most would instantly recognize different levels of counterparty, governance, and currency risk between an Indonesian and a Canadian bank. Simply recording investments at market value when preparing the actuarial report assessing the solvency of a pension fund does not fully account for risk.

In a similar vein, an investment in an index fund where no analysis of the individual holdings is carried out by the investor, or the fund manager, probably does not represent the same level of risk as a portfolio of companies that are subject to detailed financial and business analysis.

Regulations require banks to recognize differing levels of risk by applying a reserve for riskier assets. A similar model could be considered for pension funds.

2 – Create an even playing field and lengthen the investment horizon

At the depths of the recession in 2009, when equity markets had declined by 50%[9] from their peaks, it would have been extremely difficult to sell even the best office properties in any major Canadian city, regardless of price. But no pension funds needed to, so building appraisals were not significantly revised.

Similarly, only those that needed to sell their public equities actually suffered from the low prices at that time. Permanent loss was avoided if no securities were sold. Yet, in contrast to the treatment of real estate assets, pension funds were forced to recognize the unrealized loss on their public equities. Rigor requires that private and public investments be appraised on the same unbiased basis to properly value pension fund assets.

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[9] MSCI. (2022, March 1). *Real time index data search*. https://www.msci.com/real-time-index-data-search

Judgement is required to assess equity values, just as it is to value other assets. Judgement needs to acknowledge that short term turbulence is just that, temporary.

3 – Increase transparency and accountability

Global Investment Performance Standards (GIPS) were created to provide an ethical framework for the calculation and presentation of the investment performance history of an investment management firm.

The investment community currently has great difficulty obtaining meaningful comparisons of the recommendations put forth by asset allocation advisors. Given that these advisors now play a major, and fine-grained, role in how pension funds are invested, it is important that unbiased standards also be established to ensure the accuracy, completeness, transparency, visibility, and comparability of the history of their advice. It should be possible to develop these standards, as it was, for the investment management industry. Accountability requires no less.

Conclusion

Plan sponsors have reacted to their regulatory environment: they have sought to abandon a good retirement system, the defined benefit plan, in favor of a bad retirement system, the defined contribution plan; they have removed their assets from view and scrutiny by abandoning public markets in favor of private ones; they have increased their investments in low return assets with higher long-term volatility at the expense of higher returning assets with lower long-term volatility; they have become indexers or closet indexers; they have mostly allocated their assets not based on some careful forward looking analysis but rather on statistical historical analysis; they have left Canada, and they have added leverage. None of this is particularly good and is probably not what the regulator desired.

There should be a greater public discussion about what has been done to our retirement system. Is this what was wanted? How can it change? Everyone is trying to do the right thing, but plan sponsors are reacting in very predictable ways to their regulatory environment and the only way to change this behavior is to change the environment. It is imperative to significantly lengthen the investment horizon, to remove this unhealthy focus on short term volatility, to increase transparency, to encourage active investment, and to ensure that Canadian savings play their proper role in forging Canada's future and create high quality jobs. Only in doing this do we have a chance to get back on the right path.

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