THE OBSERVER

How OPTrust is Continuing to Pay Pensions in a Low Interest Rate Environment

By James Davis, Chief Investment Officer, *OPTrust*

When I was in university in the early 1980’s we had just come through a period of high inflation and currency devaluation, especially for the US dollar, and long maturity bond yields were in the mid-teens. Paul Volcker, the then Chairman of the Federal Open Market Committee (FOMC) that sets interest rate policy for the United States, had decided to “wrestle inflation to the ground”. His extraordinary tight monetary policy led to a double dip recession, but he ultimately succeeded, and inflation peaked at 14.8% in March of 1980. I didn’t know much about investing then, but I can remember buying Canada Savings Bonds that yielded more than 19%. I certainly could never have imagined that one day in the future I would be investing at rates that were less than 1%. 1981 marked the beginning of the secular decline in bond yields that has prevailed for my entire investment career. What a remarkable journey it has been.

As countries and financial systems across the globe have evolved and matured over the last number of decades, central banks have played an increasingly important role in managing economic cycles. The primary monetary policy tool over this period has been interest rates. However, post the Global Financial Crisis of 2008, the risks of a return to inflation have been replaced by the threat of deflation. Lower and lower interest rates have not stemmed this threat, despite them having even gone into negative territory, something that I had been taught by my professors in university was impossible.

The COVID pandemic has exacerbated the deflationary threat. This likely means that interest rates will remain near zero for the foreseeable future and central bankers will need to continue their experiment with other unconventional tools, such as quantitative easing and yield curve control, to try and wrestle deflation to the ground. The reality is monetary policy alone cannot solve this problem; fiscal stimulus will be required and that is a realization that governments around the world are reluctantly beginning to acknowledge. I expect fiscal stimulus will come in fits and starts, adding to market volatility and keeping downward pressure on interest rates.

As long-term investors and stewards of our members’ hard-earned capital, it behooves us to contemplate the repercussions of policy uncertainty and the persistently low/negative interest rate environment on future investment returns and prepare for this as best we can.

The first order effect of perpetual low/negative interest rates is that it forces market participants compelled to earn a target rate of return (for example: Pension Funds) to move further along the risk curve, and accept greater risk to earn the same rate of return. The second order effect is that it causes asset valuations to significantly increase. In a world that is dominated by zero interest rates and excess liquidity, investors' perception of risk gets altered meaningfully. This creates a paradigm supporting asset price inflation as opposed to real economic inflation. One unintended consequence of this is that it becomes very challenging to use valuation as a meaningful tool to make investment decisions. This will have long term implications on fiduciaries' ability to manage the risks in their portfolios. Another unintended consequence is a widening of the wealth gap which contributes to the risk of social and political instability, which will ultimately impact risk premia and, hence, future investment returns.

As a defined benefit pension plan, our primary investment objective is plan sustainability. This means earning the return we need to keep our plan fully funded at the lowest risk possible, while keeping contributions and benefits stable. A sustained environment of low or negative rates makes it very challenging to earn the return we require to ensure sustainability and forces some difficult decisions. As a minimum, it calls into question the validity of continuing to hold bonds in our portfolio.

Most pension funds and institutional investors hold a sizable portion of their portfolios in nominal government bonds. It becomes exceedingly challenging to justify holding nominal government bonds as part of an investment program when yields are near zero or negative. Not only do they lose their ability to generate any meaningful return over the long-run, but more importantly, they no longer provide diversification benefits as there is very little room for their yields to go lower (and their prices to go higher) when equity markets are under pressure. Furthermore, the usefulness of having bonds in our portfolio as a liability hedging asset is reduced as they no longer can deliver sufficient cash flows to match our pension obligations in the long-term.

As policy makers continue to fight the deflation threat and fiscal policy begins to play a bigger role, inflation expectations will begin to move higher and assets will begin to reprice. We should see this in steeper yield curves, to the extent that central banks will not stifle the price discovery mechanism of markets through yield curve control. Assets that do well in this kind of environment will be desirable, such as real estate, infrastructure and certain commodities and equities. Notably absent from this list is nominal government bonds. That doesn't necessarily mean there will be a bond meltdown, as central banks can and likely will continue to buy them from their governments, but it certainly doesn't improve their attractiveness.

I see the investment environment over the next three decades being quite different from the three decades that I spent much of my career in. I think it will be more like what was experienced in the early 1940's through to the early 1980's. I believe we must reflect this possibility in our portfolio construction.

At OPTrust, our sole focus is paying pensions today and preserving pensions for tomorrow. Our mission is to fulfill a fundamental contract with our members so that they can count on the pension benefits we promise. Despite the challenges that 2020 has brought so far, I am incredibly pleased with how our portfolio has fared. We have come out the other side with our funded status not only intact but with a good return and an abundance of liquidity. This liquidity provides us with more than enough money to pay pensions in the near term and arms us with capital that can be deployed opportunistically, especially in assets that we expect will do very well in the coming years (and decades, because we are long-term investors).

One of my biggest learnings through 30+ years in investments has been to constantly surround myself with the best and the brightest and let them do what they do best. With the team we have built at OPTrust and our Member Driven Investing Strategy, I am confident we will be able to meet tomorrow's challenges head on, regardless of the direction interest rates take.

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James C. Davis is Chief Investment Officer of OPTrust, one of Canada's largest pension funds with net assets over $21 billion and investment professionals in Toronto, London and Sydney.

James joined OPTrust in 2015. He leads the organization's investment strategy and oversees its diversified portfolio spanning the globe with public market, private market, infrastructure, and real estate assets in North America, Europe, Developed Asia and emerging markets.

James has over 25 years of strategic investment planning and leadership experience, including proven results in liability driven investing and portfolio design. Most recently, he held the role of Vice President, Strategy & Asset Mix and Chief Economist at Ontario Teachers' Pension Plan (Teachers').

Before joining Teachers', James was President of FuturesTrend Capital Corporation in Prince Edward Island and Vice President & Head, Global Fixed Income & Currencies at RBC Global Investment Management in Toronto. James is widely recognized as an engaging speaker in a broad range of forums within the pension industry, and is known for his insights on global economics, portfolio construction and investment strategy. In addition to degrees in Mathematics and Meteorology, James holds an MBA in Finance from Dalhousie University and is a CFA charterholder.