

Departing Japan GPIF Director Advocates True Long Term Approach for Global Stability

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Note from the Editor

Nobusuke Tamaki left his role as Director General of the Planning Department at Japan Government Pension Investment Fund (GPIF) last week in order to take up a new academic post as a Professor at Otsuma Women's University.

As he leaves the \$1.3 trillion pension giant, he asks IIN members to consider how much responsibility large institutional investors should take for macroeconomic stability. Writing here with *IIN*, Tamaki:

- Assesses the role that institutional investors played in the creation of the financial crisis;
- Argues that macroprudential regulation should be applied to them, now that more and more financial intermediation takes place in the open market;
- Proposes reasons why the GPIF was able to invest in a genuinely countercyclical way.

Kathryn Saklatvala
ksaklatvala@iilondon.com

Macro Prudential Responsibility

Just as the economic crisis of 2008 humbled the financial world, so the Japanese disaster of 2011 reminds us that humanity and its technological sophistication can be humbled in the face of natural events.

Human tragedy on this scale should also remind us of the responsibilities that we all have to each other. So perhaps there can be no better opportunity than a time like this to consider the macro prudential responsibilities that should be taken by large investors like us in order to safeguard the stability of the economy, which is so closely related to human wellbeing.

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There is a long list of good reasons why commercial banks have been made subject to prudential regulation for decades. Governments and central banks have provided them with enormous assurances of sovereign credit. The state, as the government and the central bank combined, is the lender of last resort, the ultimate insurer of deposits and the emergency supplier of capital injections.

The Lehman shock changed the regulatory landscape. The pre-crisis ethos of "micro prudence" - the idea that the system is fine if individual banks are fine - died in the upheaval of 2008. There is now a global consensus that governments need to build a regulatory and supervisory frameworks that take account of the soundness of the whole financial system.

What is less clearly defined is the responsibility that large institutional investors should now take for macro prudence.

Commercial banks provide settlement and financial intermediation functions which are clearly essential for the macro economy. Institutional investors do not take deposits or provide settlement services in the way that commercial banks do and this is the main reason why micro prudential regulation and supervision were not applied to them.

However, more and more financial intermediation now takes place in the open market in the form of investment banking. As a result, institutional investors play a much greater role. Their risk appetite and their evaluation of risks de facto increasingly determine how well or how badly the financial intermediation system works.

The markets of CDS and synthetic CDOs in 2006 provide a good example of this problem. Institutional investors' appetite was very strong and they did not know the risks they were taking with their clients' money. The market did not allocate enough resources and energy to evaluate risks of AIG or a Californian mortgager with a lower FICO score. The outcome was a huge misallocation of resources and risks. Macro prudence was lost. Too many houses were built. Too much risk was taken by wrong persons. Too much money was put in financial transactions that were assumed to be safer than they were.

There is a case for arguing that large institutional investors should bear a responsibility for macro prudence that is proportionate to the influence they exert on the functioning of financial intermediation.

Large institutional investors are clearly vital to financial stability. They are supposed to be, and in fact they are, risk averse. While each of them is professional in dealing with volatility, they, "on a collective basis," from time to time increase it, which is highly ironical. In addition, most long-term institutional investors agree that the best way of achieving long term investment success is to invest in a countercyclical manner. So the question is: why don't they?

An investor who pursues a higher return in every quarter cannot be a long term investor even if it manages a fund for fifty years. To be a long term investor, long term patience buttressed with a long term investment belief is necessary. Many of the investors who keep their money in the market for a long time are not in fact genuinely "long term."

In part, the governance structure plays an important role. This is particularly true where decision-makers are not sophisticated enough to understand investment bubbles or possibilities such as a CDS contract with triple-A rated AIG being incorrectly priced. The governance structure should encourage a more thorough scrutinizing of the risk-return profile of the transactions that the investor is entering.

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In order to encourage institutional investors to live up to their macro prudential responsibilities, their interests have to be well aligned with those of stakeholders. For a pension fund, this means the future pensioners. A reasonable person at the age of 55 working for a company with a defined benefit pension plan would not want his or her retirement money put in the hands of a hedge fund whose leverage ratio is 30, even if it is the right strategy to earn 400 bps above the benchmark. In my view, the board of the pension plan must not allow this sort of investing to happen unless it is justifiable from the viewpoints of diversification and cost effectiveness.

One important consideration should be the degree of informational imperfection of a market. In a conventional and developed market such as US treasuries market, information is shared and market dysfunction is not likely. On the other hand, in a less developed market such as the CDS market of 2006, dysfunction is more likely because of very imperfect information. Nobody knew how much risk was being taken by AIG. Nobody knew what was going to happen to the products traded there if the housing bubble should burst. In these markets, institutional investors should be exercising extra caution. If enhanced disclosure is not enough, additional measures will have to be taken.

The GPIF did manage to act as what I call a genuine long term investor, which operates in a truly countercyclical way. The reasons for this are the legal requirements which govern the investment approach, the very long term culture and perhaps the sheer size of the fund.

The Fund was created by the law as a long term investor, in that it is legally required to determine the policy asset mix that is to be maintained in the long run. Just after the Lehman shock of September 2008, stock markets plunged

all over the world and the Fund's actual allocation to domestic and international equity fell well below the policy asset mix. Then, using new money coming into the Fund, the GPIF purchased a large amount of domestic and international equity every month until March 2009. This action was not pro-cyclical.

As for newer and alternative investments, GPIF studied the possibilities at length. We had to consider the gain in terms of diversification and the implications given the size of the fund. Diversifying into newer and alternative markets in any meaningful way poses a unique problem for the GPIF on account of its size: one per cent of the assets would equal \$13 billion. In the end, the fund decided against entering the alternatives arena.

As global pension assets and the wider institutional investor community continue to grow in size, perhaps it is time to consider how genuine countercyclical approaches might be made possible. Let us consider the aspects of governance, regulation and culture that enable true long term investing in reality."

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