Lessons individual investors can take from the world's leading pension funds
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As we enter 2020, several questions are on investors' minds. Among these are whether equity markets can continue to generate strong returns (the MSCI World Index posted a 28.4% return in 2019 and 10.1% annualised returns over the last decade), whether investment grade bonds still offer value (an estimated $11 trillion of global bonds offered negative yields at the end of 2019), and whether potential policy experiments enacted by governments and central banks will lead to higher inflation and/or a debasement of fiat currencies.

Worried about rising inflation and the potential for governments to eventually monetise portions of their debts, some investors have begun to add gold, inflation-linked bonds and even crypto currencies into their portfolios in an attempt to insure against a loss of future purchasing power. While gold and inflation-linked bonds may offer insurance against rising inflation, some crypto currencies may vanish into the ether—caveat emptor!

The world's major pension funds too are grappling with many of these questions. Pension funds that are obligated to pay out defined benefits to retirees, in particular, are concerned about whether the investment returns they achieve will be sufficient to finance the cost of their obligations. The fall in global interest rates over the past two decades has placed pension funds under increasing pressure to find ways to achieve sufficiently high returns to meet their obligations (i.e., no longer can pension funds rely on finding low-risk long-dated government bonds yielding more than 5% as they once could).

One way that pension funds monitor their ability to finance their projected obligations is by computing discount rates and using them to calculate the present value of their liabilities—an important practice that individual investors can adopt.

Discount rates help pension funds determine whether they are underfunded, or in other words, whether the fair values of their assets are worth less than the present values of their projected liabilities. A Milliman study of the 100 largest defined benefit (DB) pension plans sponsored by US public companies shows that the discount rate of these plans fell from 7.7% in December 1999 to 3.2% in December 2019 (the lowest discount rate recorded in the study's 19-year history). In other words, if these pension funds were unable to achieve 3.2% investment returns, they would find themselves less able to meet their obligations.

To illustrate how discount rates could be useful for individual investors, imagine if a parent plans to invest in her child's university education and sets aside an investment portfolio that is expected to grow to $100,000 in 10 years. A discount rate of 3.2% would imply that she must set aside $73,000 today. Contrast that with the $48,000, or $25,000 lower, balance she would need to set aside if she used a higher discount rate of 7.7%. While a higher and potentially unrealistic discount rate may be tempting, the discount rate is meant to reflect a realistic assumption of what returns can be generated over a relevant time period.

While a 3.2% investment return seems to be small in comparison with the blockbuster equity returns achieved last year, several leading investment firms including Blackrock, GMO, and Vanguard predict annualised US equity returns ranging from negative returns (i.e., losses) to returns upwards of 6-7% over the next 7-10 years. Add fixed income instruments into the mix and expected investment returns can drop. Morgan Stanley anticipates a standard 60/40 equity bond portfolio will earn 4.1% over the next decade. Thus a 3.2% discount rate, while conservative, is not unfathomable.

In addition to projecting discount rates, projecting out annual liabilities is another important lesson that investors can take from the world's leading pension funds. When forecasting liabilities, individual investors should consider including rising health care costs as well as sufficient retirement incomes—especially if they do not have the fortune of belonging to well-funded DB pension plans that offer inflation-indexed retirement benefits. In doing so, investors will have a more realistic picture of whether they can meet their obligations.

For underfunded investors, other lessons from pension funds also apply. Pension funds that find themselves underfunded have explored increasing both the contribution rates paid by their members as well as the retirement age at which full benefits can be paid out; in some cases, they are also cutting expenses and reducing benefits for new members. For the individual investor, the lessons learned include saving more, expecting to work longer, and/or being realistic about what type of lifestyle to accept in retirement. Unfortunately, in the case of the French government, protestors in early January successfully protested against one of President Macron's pension reform proposals of increasing retirement ages for receiving full pension benefits from 62 to 64.

If saving more or retiring later is not an option, a final lesson to draw from pension funds is to find ways to increase investment returns without taking undue risk. To aid in this effort, pension funds are increasingly seeking out exposures to diverse asset classes. Examine the annual reports of the world's leading pension funds, and one finds exposures to global equities, inflation-linked bonds, commodities, emerging market assets, and increasingly private investments. When matching liabilities 30 years into the future, for example, it can make sense to expand into less traditional asset classes and accept both higher return volatility and lower liquidity in exchange for higher expected returns.

In the current environment where US equities and investment grade bonds are overvalued by many measures, relying solely on US equities and investment grade bonds to bolster returns will likely not be sufficient. An investment portfolio that is globally diversified and takes into account forecasted liabilities with suitably chosen discount rates is a practice that individual investors should consider.

Sources: Bloomberg, CNBC, Financial Times, Knowledge @ Wharton, Milliman, Morningstar, MSCI, OECD

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