MEKETA
INVESTMENT GROUP

A Conversation About the Future

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A Meketa/practitioner roundtable: considerations for investing in a low interest rate environment

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The challenge

Heading into 2020, significant concerns were already being expressed regarding the long-term direction of the US and global economies, and specifically, the seemingly persistent decline in global growth rates over the last few decades.

This secular decline has meaningfully impacted global interest rates, and driven them to record low levels (including negative levels) across some of the world's largest economies. With the onset of the Covid-19 Pandemic, and the subsequent historical market reactions to it, these concerns have been dramatically heightened.

On top of these issues, the policy responses enacted so far — namely, the record stimulus provided by monetary and fiscal authorities — have caused many in the institutional investment community to contemplate what a sustainable future might look like should these efforts fail to meaningfully lift economic growth prospects.

To address the heightened concerns over the impact that secular low interest rates might have on expected rates of return, actuarial interest rate assumptions, funding levels, etc., Meketa established a Low Interest Rate working group to identify:

- The possible implications of very low secular interest rates;
- Solutions in the marketplace that might already exist, or could potentially be developed; and
- Practices and/or recommendations that Meketa and its clients could implement in a timely manner.

The work

As a first step, we surveyed a limited group of clients and a select group of academics, sell-side firms, and asset management firms with deep expertise in asset allocation, asset / liability management and fixed income. The results of that survey (provided in the summary below) were followed up with a virtual meeting including most of the participants discussing the survey's results and beginning a discussion on "How might we address this?"

Summary of survey findings

The general view is that future economic growth will be slow and gradual over the next several years and that inflation will remain low. While recent policy actions have been helpful in mitigating the immediate risks, they may not be enough to keep growth sustainable beyond recent averages.

Further, some of the same issues and trends that were impacting the economy before the COVID Crisis (CC) remain key factors today, specifically, the continued impact of technology on productivity and employment, as well as continuing long-term demographic trends.

With respect to fixed income expectations, the general view is that while interest rates will likely remain low (and negative in some countries), the expectation is that US yields will remain positive, and the yield curve term structure will remain positively sloped, for the foreseeable future.

While recent policy actions have been helpful in mitigating the immediate risks, they may not be enough to keep growth sustainable beyond recent averages.

With respect to equities, the general view is that, consistent to just prior to the CC, equities remain over-valued. Interestingly, given the amount of fiscal and monetary stimulus during the CC, the general view is that asset price appreciation is likely to continue across not only equities, but other financial assets as well.

Several other factors were considered to have potential impact on the future investment environment. Such factors ranged from de-globalization to the future of Europe to continued political instability, among other issues.

There was some discussion that economic growth could surprise to the upside and that this would likely cause a rise in inflation, which could be thought of as an unlikely scenario at this point. Absent an ability to time the surprise event (a daunting task), constructing a well-diversified portfolio was still seen as best practice.

Additional comments and supportive details

As the survey responses indicate, historic low interest rates, which may be prolonged, present a new and unprecedented challenge to our clients, specifically, and investors more generally.

Institutional investors and all other types of savers, large and small, have been the beneficiary of falling interest rates since August of 1981. At that time, the 30-year Treasury bond had a yield of 14.3%. Now, 39 years later, the yield on a comparable Treasury bond is 1.2%.

That persistent decline in yields generated not only phenomenal nominal and real rates of return (both income and capital gains), but significant diversification and risk mitigation benefits during a handful of economic downturns and recessionary periods. Yields on the constant 30-year Treasury bond are shown in Chart 1.

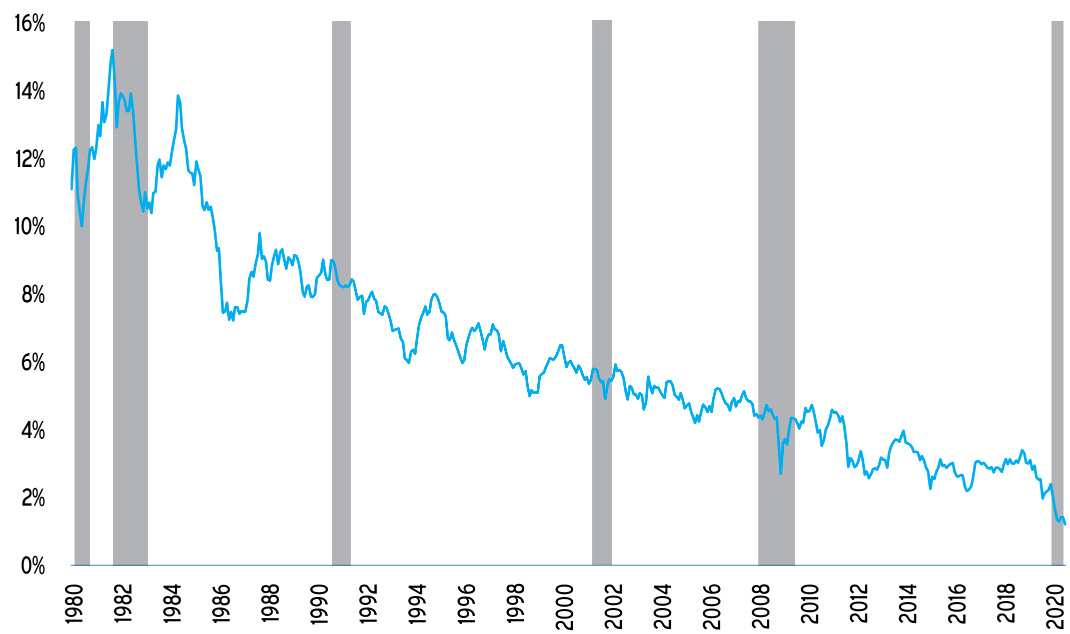

CHART 1
Yield on the Constant 30-year US Treasury Bond[1]
Shading indicates US recessions; most recent is ongoing

[1] Source: FRED

The unbelievably high interest rates, by today's standards, in 1981 reflected the pricing of interest rate risk after CPI increases in 1978, 1979, and 1980 of 9.0%, 13.3% and 12.5%, respectively.

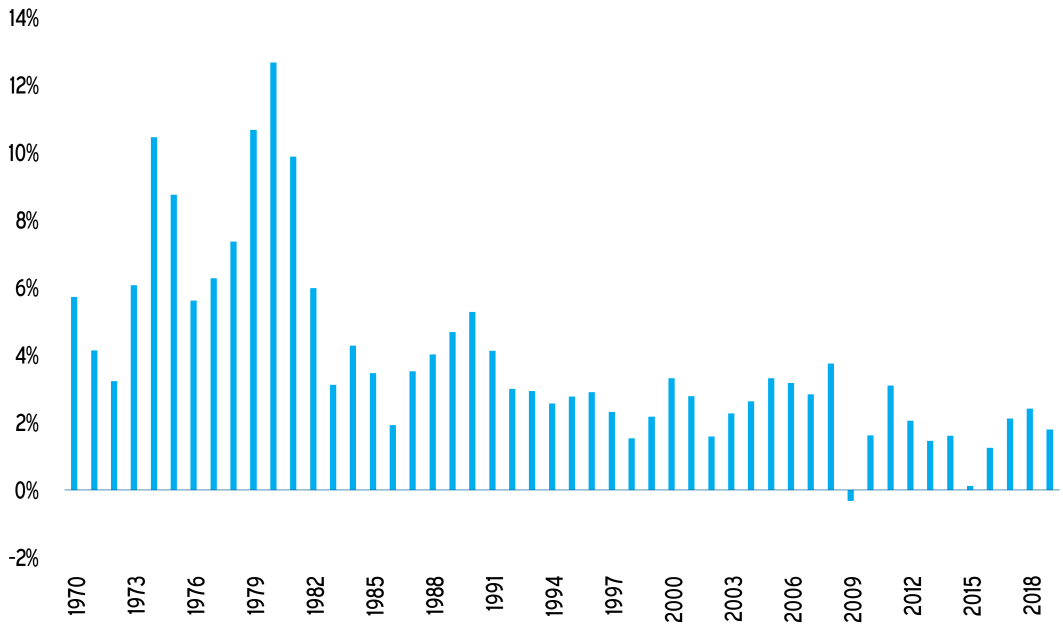

CHART 2
Annual US CPI-U[2]

[2] Source: FRED

In 2020, investors in US Treasury securities (as well as all high grade fixed income) are faced with the lowest nominal and real interest rates in modern history. The US Treasury yield curve, for both nominal and real interest rates, is displayed below:

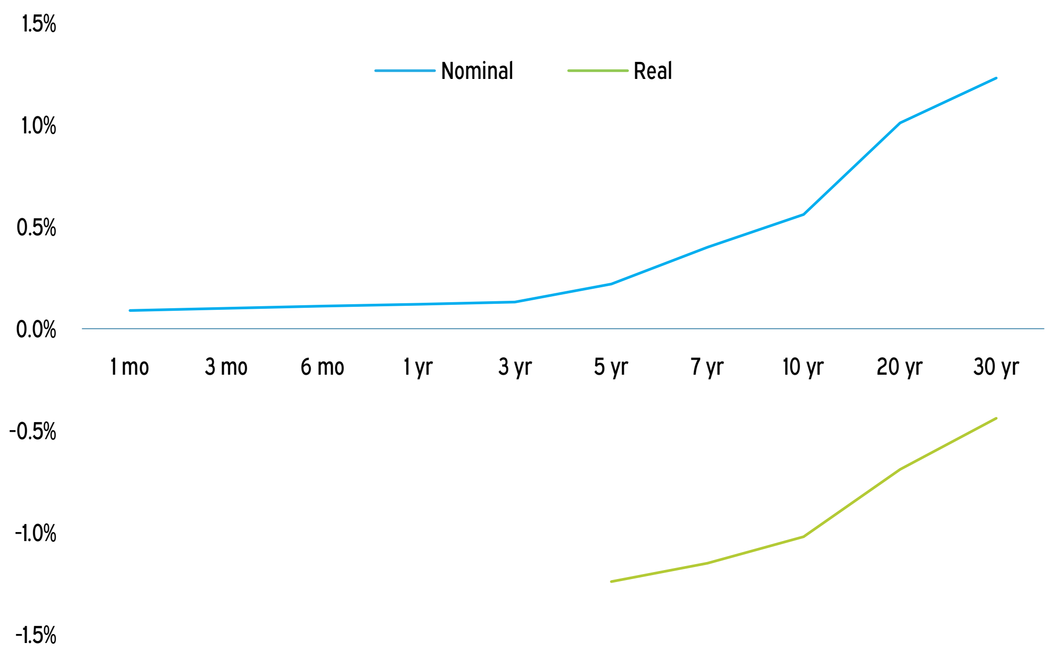

CHART 3
The US Treasury Yield Curve as of August 2020[3]

[3] Source: US Treasury

Investors' portfolios can only grow from two sources. Increased savings and positive rates of return on assets (this is true for the largest sovereign wealth fund and the smallest individual investor). There is NO magic wand, NO silver bullet, and NO getting around it.

Today's investors have a wide array of assets to select from: public and private equity, real estate, infrastructure, natural resources and, of course, fixed income. Since the passage of ERISA in 1974, portfolios have become more and more diversified across asset classes and geographical boundaries.

> With rates having declined to such low levels, it is likely to be more difficult than ever for institutional investors to achieve their target returns.

Further, portfolio structure, asset allocation, and risk management practices, have all become more sophisticated and now allow investors to pursue greater, and more strategic, diversification polices for their portfolios. Fixed income, especially Treasury securities, have played an important role in that process. However, today's low yields call into question how that role may be impacted going forward.

There is a clear relationship between the yield on fixed income securities and their future return. Still, declining interest rates affect the expected return not just of fixed income, but of every asset class. With rates having declined to such low levels, it is likely to be more difficult than ever for institutional investors to achieve their target returns. Investors seeking to achieve the same returns they have in the past, may have to take on greater levels of risk than they have historically.

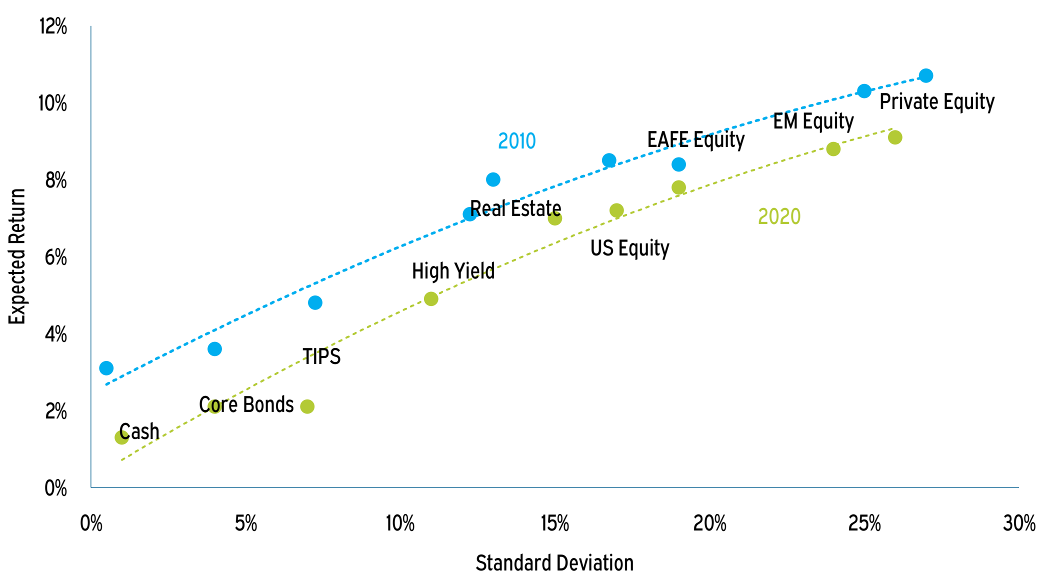

CHART 4

Less Return for the Same Risk[4]

[4] Expected return and standard deviation are based upon Meketa Investment Group's January 2010 and July 2020 long-term (20 year) Capital Markets Expectations.

A word on risk vs. uncertainty

"Risk" and "uncertainty" are words that have garnered heightened attention in the past few months. Although, in common usage, both terms refer to a similar situation, in economics, the definitions of risk and uncertainty are quite different.

In Frank H. Knight's landmark book, *Risk, Uncertainty, and Profit* (1921), the distinction between the two is clearer:

→ ***Risk*** *is present when future events occur with measurable probability. Risk can be quantified, either on a priori grounds or on the basis of empirical observation; and*

→ ***Uncertainty*** *is present when the likelihood of future events is indefinite or incalculable. Uncertainty is not measurable, and so cannot be quantified and handled through insurance or other arrangements. Uncertainty occurs in circumstances that cannot be analyzed either on a priori grounds, because they are too irregular, or through empirical observation, because they are too unique. The Covid Crisis falls squarely in this category.*

While the COVID pandemic's impact on the economy has arguably increased risk in the capital markets, it has undoubtedly also increased uncertainty about future returns. The number of unprecedented conditions in the capital markets (e.g., historically low interest rates globally, unprecedented fiscal and monetary stimulus globally, and growing debt loads on governments and corporations) reduces one's confidence in relying on past relationships and behaviors of asset classes to guide forward-looking investment strategy. We acknowledge this increase in uncertainty, and, as a consequence, approach planning for the future with the appropriate amount of humility regarding the range of returns that are possible.

Potential options and considerations

Based upon the survey and the virtual meeting, along with additional input from clients, a broader group of consultants, and follow up discussions with the investment management community, we have started the process of answering the question of "How might we address this?"

First, investors should determine how much risk they are willing to take. If they can live with lower returns, there is no need to take on more risk. If not, they should decide how much additional risk and what level of modifications are acceptable.

Second, if investors, after reviewing the attributes of a range of strategies and approaches, believe a change is appropriate, they should evaluate the following options (and possibly others) to determine what, if any, changes make sense for them:

- → A barbell approach to asset allocation
- → Continue to accept, and potentially increase, risk exposure
- → Use low rates to your advantage; consider leverage
- → Be opportunistic...and patient in specific strategies (e.g., real estate, natural resources and infrastructure)

The barbell approach: mixing low and high risk assets

Target returns for institutional investors have been declining, but not nearly as quickly as interest rates. These lower interest rates flow through to many asset classes, thus lowering their expected return and arguing for owning higher-risk assets such as equities, along with hedges such as long Treasuries and other Risk Mitigating Strategies (RMS).

This strategy effectively marginalizes assets with expected returns in the middle of the opportunity set that tend to be correlated with higher risk assets. Moreover, the barbell approach takes on risk more efficiently as it provides better downside protection than a typical portfolio that theoretically consists of the same level of risks.

Continue to accept, and potentially increase, risk exposures

Given lower interest rates, achieving the same target return will likely require continuing to invest in higher-risk assets. While higher-risk assets are less attractive in absolute terms, they may be more attractive in relative terms.

One approach is to continue to take advantage of illiquidity via private markets. Specifically, private equity, infrastructure, and real estate all offer higher relative returns while offering some diversification benefits. They also have the added benefit of providing greater potential alpha than many public markets.

However, ramping up in private markets can take a considerable amount of time, especially given the amount of capital overhang and recent pause in transactions. That means public equities will have to continue to be the mainstay of many portfolios. And while we continue to expect equities to produce higher returns than lower risk assets, we expect those returns will be lower and riskier than they have been over the past decade. More "buy and hold" patience may be required.

At this time, the level of uncertainty is extreme by many standards. Indeed, there is no financial text book that sheds light on what to expect when expansive global fiscal and monetary policy, strained geopolitics, and a pandemic, occur simultaneously.

How to turn low rates to your advantage: leverage

If the Fed is determined to maintain policy rates at considerably accommodative levels for a prolonged period of time, this warrants consideration of leverage as a means to enhance returns.

Specifically, leverage works so long as the return on the purchased assets exceeds the cost of borrowing (i.e., the interest rate) to buy those assets. And in this current environment, with borrowing costs at record low levels, this may be a particularly attractive opportunity.

However, it is important to note that while leverage provides the potential benefit of magnifying gains and making a portfolio more efficient (i.e., producing a better risk-return profile), it also magnifies losses.

Be opportunistic…and patient

The market has historically rewarded investors who were willing and able to act opportunistically during past periods of market stress.

> We do not yet know what the best opportunities are going to be, or if they will be the same as in past economic downturns, so an opportunistic approach requires patience and a contrarian nature.

However, we do not yet know what the best opportunities are going to be, or if they will be the same as in past economic downturns (e.g., distressed credit), so an opportunistic approach requires patience (i.e., waiting for the "fat pitch") and a contrarian nature (i.e., having the courage to stand against a dominant view). We further believe that major opportunities occur infrequently and are very hard to time.

Still, we consider it prudent to have the ability to invest opportunistically. This includes having a stated policy, governance structure, and investment process in place that allows you to do so when appropriate.

At Meketa, our preference is to have a dedicated opportunistic class with ranges from 0% to an upper threshold rather than an ongoing static allocation, as the latter method is not fully consistent with an "opportunistic" approach. To be clear, this approach is not for everyone, and a willingness to accept higher tracking error and increased complexity are necessary requirements. Meketa Investment Group can assist in this work.

Summary and next steps

The coronavirus pandemic has had a greater impact on peoples' daily lives, the economy, and markets, than any event since World War II.

What the total effect will be, both in the near-term and long-term, may not be known for quite some time. Uncertainty is high. In such an environment where it is challenging to assess where the market might be heading, it is prudent to have a little humility and a strategically diversified portfolio.

What is clear is that the world has changed from ten years ago, and what has worked for the past decade is not necessarily going to prove as effective going forward. It will likely be more difficult than ever to achieve target returns. While doing so may prove challenging, it is not impossible. Through a combination of options, you can improve your odds of success.

Finally, as this is an evolving and dynamic process, we will continue analyzing the survey results and expand on the recommendations briefly outlined above, as well as explore additional ideas and opportunities that may prove beneficial to our clients and the broader institutional investment community.

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