Wiley Finance Series

The Future of Pension Management

Integrating Design, Governance, and Investing

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The reasonable man adapts himself to the world.
The unreasonable one persists in trying to adapt the world to himself.
Thus all progress depends on the unreasonable man.

George Bernard Shaw
Man and Superman, 1903

Preface

I thought my third book on pension management, *Pension Revolution*, published in 2007, would be my last. To their credit, Bill Falloon and his Wiley colleagues changed my mind. How? By featuring that 2007 book at the CFA Institute's 2015 Annual Conference in Frankfurt. To my surprise, attendees were lining up to buy an eight-year-old book on a revolution in pension design, management, and investing!

THE EVOLVING PENSION REVOLUTION

A lot of things have happened in the pensions world in the past eight years, many foreseen in the 2007 book, some not. On the pension design side, the traditional defined benefit (DB) and defined contribution (DC) formulas are converging into hybrids with names such as "defined ambition" (DA) and "target benefit" (TB). The Netherlands and Australia offer good examples of these shifts. The former is transforming its traditional DB plans into DA plans, while the latter is transforming its traditional DC plans into TB plans. At the same time, pension coverage is expanding in some countries through government initiatives. The United Kingdom is leading the way with its National Employment Savings Trust (NEST) initiative, while the United States and Canada are designing their own strategies to expand workplace pension coverage.

On the pension-governance front, the process of reconciling the opposable needs for boards of trustees to be both representative and strategic continues to slowly move in the right direction. There is a growing understanding that it is not a question of "either-or," but rather how to get *both* ingredients into board composition. Why both? Because pension boards need legitimacy to be trusted, and at the same time, need to be strategic to produce value-for-money outcomes for their stakeholders. This strategic mindset addresses tough issues such as organization design and culture, investment beliefs, incentives, and stakeholder communication and relations. Behind these governance imperatives lies the broader question of organizational autonomy. Unnecessary legal constraints are increasingly seen as value-for-money destroyers in pension organizations.

Pension investing has been changing for the better, too, starting with serious re-examinations of investment beliefs. There is growing evidence the leadership of the global pensions sector is beginning to see its job as transforming retirement savings into wealth-producing capital. There are a number of factors at play here. One is the simple reality that good investment returns are increasingly difficult to come by. Another is a growing understanding of the zero-sum nature of short-horizon active management. Yet another is that both logic and empirical evidence support the idea that long-horizon active management should, and actually does, produce higher long-term returns than either passive or short-horizon active management. However, saying is one thing, doing another. For many pension organizations, there is still a sizable aspiration–implementation gap to be closed.

THREE "UNREASONABLE" MEN

In that moment at the Frankfurt conference, I recognized that the significant pension revolution developments of the last eight years in pension design, governance, and investing should be chronicled in a coherent, integrated manner, and that I was well placed to do that job. However, I would not be doing it alone. A good deal of the necessary insight and inspiration would come from three "unreasonable" men, as defined by George Bernard Shaw ("... all progress depends on the unreasonable man ... ").

Dutch Nobel Prize winner Jan Tinbergen's Two Goals/Two Instruments principle offers a way out of the long-standing affordability-versus-safety dilemma in pension design. Achieving both goals effectively will require two instruments, not one. Father of modern management principles and practices Peter Drucker asserts that pension organizations are not exempt from governance effectiveness dictates. Ineffective governance will produce poor outcomes for the pension organization's stakeholders. The 20th century's most influential economist John Maynard Keynes makes a clear distinction between dysfunctional short-term "beauty contest" investing and wealth-producing long-term investment processes. Yet, ironically, many boards continue to choose the former over the latter. Readers will encounter these three "unreasonable" men and their ideas many times through this book's 27 chapters.

There are other "unreasonable" people who deserve mention as contributors to the ideas and their implementation set out in this book. Nobel Prize winner George Akerlof's "asymmetric information" insight figures prominently in my thinking about the design of pensions systems and organizations, as does the life-cycle theory of personal finance set out by Nobel Prize winners Robert Merton and Paul Samuelson. Former Dean of University of

Toronto's Rotman School of Management Roger Martin's work on integrative thinking and the creative resolution of opposable ideas has also played an integral role in the structure and tone of this book.

Many more people have contributed to this book in one way or another, including colleagues, clients, family, and friends. I thank you all, but mention only two by name. My wife and partner, Virginia Atkin, once again provided the inspiration and encouragement to write this book, while also ensuring I was not consumed by it. My editor Christina Verigan skillfully guided my original manuscript of the book into this much improved final version.

Keith Ambachtsheer
Toronto, Canada
January 2016

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PART One

Touchstones

Literally: Stones used to test the quality of precious metals.
Metaphorically: Tests to assess the value or merits of a claim or idea.

—Adapted from the *Oxford English Dictionary*.

CHAPTER 1

Improved Pension Designs and Organizations

Gateways to a More Functional Capitalism

"... with the separation between ownership and management which prevails today ... and with the development of organized investment markets ... a new factor of great importance has entered in ... which sometimes facilitates investment ... but sometimes adds greatly to the instability of the system ..."

"... it might have been supposed that competition between expert professionals ... would correct the vagaries of ignorant individuals left to themselves ... it happens however that their energies and skill are mainly occupied otherwise ... largely concerned with foreseeing changes in conventional valuations a short time ahead ..."

"... the measure of success attained by Wall Street ... regarded as the institution of which the proper social purpose is to direct new investments into the most profitable channels in terms of future yield ... cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism ... if I am right in thinking that its best brains have in fact been directed towards a different object ..."

—Excerpts from John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (1936), Chapter 12.

A "GATEWAYS" LECTURE IN LONDON

Some time ago, I was invited by the UK's ShareAction organization to give a lecture in the Houses of Parliament. It provided an opportunity to place Keynes' insights on faux vs. functional capitalism, Peter Drucker's on the special role of retirement savings in shaping capitalism, and Jan Tinbergen's on aligning pension goals and instruments in a 21st-century setting. These insights lead to the critical conclusion that the over-$30 trillion pension fund sector is by far the largest investor class with a fiduciary duty to invest across generations. Thus it is the leading institutional investor class with a clear motivation to, in Keynes' words, "direct new investments into the most profitable channels in terms of future yield."

The lecture, which I called the "Gateways" lecture, acknowledged that capitalism faces strong headwinds today as reflected in issues such as aging populations, physical limits to growth, bubbles and financial crises, a growing rich–poor divide, and continuing alignment of interest challenges between corporate managers and owners. Also, the traditional defined-benefit (DB) and defined-contribution (DC) pension designs both mitigate against pension funds playing the wise intergenerational investor role we would like them to play. Their ability to play this role is further hampered by the generally weak governance and organizational structures of these funds.

The good news is that there is no need to invent either better pension designs or stronger organizational structures. Logic and research have already identified them. Further, here and there, they already exist in practice. Our collective challenge is to vastly accelerate the process of moving these better ways into widespread practice around the globe. In the end, it is a question of what Peter Drucker would call effective leadership.

SETTING THE STAGE

The Gateways lecture had four parts:

1. A quick sweep through 400 years of capitalism
2. An equally quick assessment of the challenges facing capitalism in the 21st century
3. The special role pension funds should and could play to address these challenges
4. Getting pension funds to actually *do* this on a large scale

Capitalism is an economic system in which the means of production are privately owned and operated for profit, usually in competitive markets. Many consider the Dutch East Indies Company, founded in 1602, as the prototype of the first modern corporation, complete with key features such as limited liability for shareowners and the ability for them to buy or sell their shares on the stock exchange. However, it was the 19th-century industrial revolution that transformed capitalism into the dominant economic system it continues to be today.

At first, its major owners were not institutions, but powerful individuals with names such as Carnegie, Rockefeller, Getty, Vanderbilt, Ford, and JP Morgan. With their passing, and after the deeply traumatic experiences of WWI, the Great Depression, WWII, and the drawing of the Iron Curtain across Europe, we witnessed the birth of "institutional capitalism" with insurance companies, mutual funds, and pension funds becoming the dominant owners of the means of production.

Before we diagnose the ills of today's version of capitalism and discuss possible remedies, we should reflect for a moment on its central role in the remarkable transformation of the still-largely agrarian societies of the 18th century into the post-industrial societies of the developed world today. As just one indication of this remarkable transformation, global GDP per capita grew roughly 50 percent in the seven centuries from 1000 to 1800, compared to a 20-fold (2,000 percent!) increase in GDP per capita for the developed world in the 19th and 20th centuries, while at the same time significantly reducing the number of hours people worked, as well as eliminating forced labor for children and for the aged.[1]

ADDRESSING CAPITALISM'S 21ST-CENTURY CHALLENGES

However, with our entry into the 21st century, most of us are painfully aware that capitalism is facing strong headwinds today. For example:

- Physical limits to continued economic growth in such forms as carbon emissions, pollution, water usage, and food production
- Aging populations and very modest economic growth prospects in the developed world
- Preferences by collective electorates and individual family units to maintain or enhance public services and private living standards through borrowing rather than through current taxes and earnings
- Increased frequency of bubbles and crises in financial markets
- A growing societal have–have not divide in both perception and reality
- Continued alignment-of-interests challenges between corporate managers and corporate owners[2]

The question before us is what the over-$30 trillion global pension fund sector can do to ameliorate some of these headwinds, while at the same time fulfilling its mission to provide retirement income security to hundreds of millions of beneficiaries.

I believe it is within our reach to move capitalism in a direction that is more wealth-creating, more sustainable, less crisis-prone, and more legitimate than the "headwinds" capitalism of today. And why specifically pension funds? Because they are the only global investor class which has a fiduciary duty to invest across generations. In determining their investment strategies, pension funds are duty-bound to be even-handed between the financial needs of today's pensioners and those of young workers, whose retirement years lie 30, 40, even 50 years ahead of them.

However, this transformation to pension fund capitalism will not be easy for two reasons:

1. It requires the redesign of pension systems so these systems *themselves* become more sustainable and intergenerationally fair.
2. It requires the redesign of pension fund organizations so that they *themselves* become more effective and hence more productive stewards of the retirement savings of young workers and pensioners alike.

These two pre-conditions are essential and will take hard work to bring about.

SUSTAINABLE PENSION DESIGNS

The designs of traditional DC and DB plans are both problematical:

- **Traditional DC plans** force contribution rate and investment decisions on participants that they cannot and do not want to make. Also, little thought is given to the design of the post-work asset decumulation phase. As a result, DC plan investing has been unfocused, and post-work financial outcomes have been and continue to be highly uncertain. This raises fundamental questions about the effectiveness and sustainability of this individualistic pension model.
- **Traditional DB plans** lump the young and the old on the same balance sheet, and unrealistically assume they have the same risk tolerance, and that property rights between the two groups are clear. These unrealistic assumptions have had serious consequences. Over the course of the last decade, aggressive return assumptions and risk-taking, together with falling asset prices, falling interest rates, and deteriorating demographics, have punched gaping holes in many DB plan balance sheets. Unfocused responses have ranged the full spectrum, from complete de-risking at one end, to piling on more risk at the other.

Fortunately, there is a growing understanding of these traditional DC and DB design faults, and of the problems they have caused and will continue to cause plan participants in the years ahead. There is also the beginning of an understanding of what must be done to address these design faults.

The Dutch economist Jan Tinbergen won the first Nobel Prize in Economics for his proposition that the number of policy goals must be matched by the number of policy instruments. This proposition has direct application to pension system design. Pension systems have two goals:

1. Affordability for workers (and their employers)
2. Payment security for pensioners

Thus it follows plan participants need two instruments: first, a long-horizon (LH) return compounding instrument to support the affordability goal; and second, an asset-liability matching instrument to support the payment security goal.

Logically, younger workers should favor using the first instrument, and pensioners the second. Over the course of their working lives, plan participants should transition steadily from the first to the second. There continues to be considerable resistance to adopting this more transparent, robust "two goals–two instruments" pension model. Some continue to defend traditional DB models for emotional rather than rational reasons; others continue to defend the *caveat emptor* philosophy of traditional DC plans because they profit from it.

In concluding these comments about pension design, let me be clear about why the two goals–two instruments design feature is critically important to pension funds' ability to reshape capitalism. Without the existence and legitimacy of highly focused, well-managed, long-horizon return-compounding instruments, pension funds *cannot* the play the wise intergenerational investor role that we have cast them in.

EFFECTIVE PENSION FUND ORGANIZATIONS

Such investment instruments are a necessary condition for a pension sector-led transition to a more functional form of capitalism. However, they are not enough. Something else is required. We must also have pension organizations that can effectively construct and manage the two needed implementation instruments. Fortunately once again, we know what such pension organizations look like. They have five success drivers:

1. Aligned interests with pension plan participants
2. Strong governance
3. Sensible investment beliefs