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

4. Right scale
5. Competitive compensation

Unfortunately, there are only a handful of pension organizations on the planet today that score well on all five counts. Instead:

1. Most pension organizations employ many layers of agents in the execution of their mission. The greater the number of layers of agents employed, the greater the likelihood that principal–agent problems will arise with their attendant costs.
2. Ideal boards of trustees are passionate about the cause, and also understand the purpose of the governance function as distinct from the executive function in the complex business of pension management. While most actual pension boards pass the first test, they do far less well on the second.
3. Actual investment behavior suggests many pension funds do not have sensible investment beliefs. John Maynard Keynes pointed out the distinction between short-horizon "beauty contest" investing and genuine long-horizon wealth-creating investing way back in 1936. Yet even today, the former dysfunctional investment style continues to dominate the wealth-creating latter.[3]
4. Effective pension organizations need scale to afford the requisite resources to be successful and to drive down unit costs. Yet, far too many funds continue to be too small to attain either of these two critical success drivers.
5. Executing long-horizon wealth-creating investment strategies successfully requires a special breed of investment managers working inside pension organizations. Yet, because these people are not cheap, this requirement is usually discarded in favor of hiring far more expensive people outside the organization. Why? Because their cost can be buried by only reporting net returns to plan stakeholders.

Again, let me be clear about the bottom line of all this. Without the existence and legitimacy of pension organizations willing and able to create and execute long-horizon wealth-creating investment mandates, they cannot play the wise intergenerational investor role we have cast them in.

OPENING UP A SECOND FRONT

Many people around the world are working hard on the pension fund transformation project I describe here, including the ShareAction organization. Its research publications, advocacy campaigns, and engagement strategies have had a measurable impact on UK decision makers, elected officials, regulators, pension trustees, business executives, and investment managers in their understanding that retirement savings should not be invested based on short-term profit considerations. Instead, they should be based on the longer-term, sustainable wealth-creation potential of prospective investments.

And ShareAction is not alone in this quest. As just two further examples, the Principles for Responsible Investing (PRI) project is rapidly globalizing the responsible investing movement around the world. The Rotman International Centre for Pension Management (ICPM) project is documenting the drivers of sustainable pension systems and of effective pension organizations, and translating them into actionable implementation strategies—and this list could go on.

Having said that, I do believe the time has come to accelerate the implementation of the pension fund transformation project by opening up a second front. We must develop explicit strategies to move from saying to doing at a faster pace. To that end, in pension design space, the Dutch have publicly acknowledged that the traditional DB plan is dead, but that does not mean moving to traditional DC plans. Similarly, the Australians have publicly acknowledged that their traditional DC plans need "income-for-life" back-ends. Serious searches for middle ways between traditional DB and DC designs are underway, and I am betting better ways will be found and implemented.

In pension delivery space, my colleague David Beatty at the Rotman School of Management advocates a "measure, disseminate, and celebrate" strategy: Measure what should be managed, disseminate results widely, and celebrate successes publicly. Two quick examples of the "M-D-C" strategy:

1. **CEM Benchmarking Inc.** has been measuring the cost-effectiveness of pension organizations since 1991. Research using the resulting databases is validating the "5 success drivers" model.[4]
2. **Ontario Teachers' Pension Plan** was explicitly designed with the five Drucker success drivers in mind in the late 1980s. It, too, began operations in 1991. Over 20 years later, OTPP has accumulated investment and pension administration track records unequalled anywhere in the world. It is most encouraging that the growth in other large pension institutions, both in Canada and elsewhere, adopting OTPP's "5 success driver" formula is beginning to accelerate.[5]

In closing, I leave you with a vision.

A VISION

Imagine workers around the world covered by pension arrangements that secure retirement income at affordable contribution rates. Imagine tens of trillions of dollars managed under truly long-horizon, wealth-creation investment mandates by hundreds of “5 success drivers” pension organizations like OTPP. I put it to you that if we could achieve that vision, we would not just create sustainable income streams for millions of current and future pensioners. We would also transform today’s “headwinds” capitalism into a more sustainable, wealth-creating version, less prone to generate the financial bubbles and crises of the last decade, and more legitimate in the eyes of a skeptical public.