# Governance practices:

## Bridging the gap between rhetoric and reality

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Views expressed here are those of the author, who is solely responsible for any errors and omissions.

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## Introduction

Since the 2008 global financial crisis, business models in the pension world have had a big makeover as governance practices, asset allocation and execution capabilities have come under the spotlight.

European pension plans have made some notable improvements in these three areas, which has seen them adopt new approaches to investment and risk management that stand in stark contrast to the old ways.

However, while these changes are a necessary step in the right direction, they do not go far enough.

In many cases, trustees have adhered to the traditional model of managing the easy things that don't matter and avoiding the harder things that do. Many of the changes so far have focused on low-hanging fruit: targeting specific areas that are easy to define and tackle without reinventing operational or governance capabilities.

There have been far fewer improvements in the less tangible aspects of pension business models. To create fundamental and meaningful change, a behavioural and cultural shift is needed for pension funds to navigate the new waters they face today.

Without that behavioural shift we risk merely re-spraying an old car when, in reality, a new model is needed.

## 1. A game-changing decade

Two of the four worst bear markets of the last 100 years rocked the world of investing over a short span of just seven years in the past decade.

During the last decade, three things have become clear: first, the assumptions about risk and return underpinning the traditional asset allocation strategy were not working, as equities were outperformed by bonds over a long period; second, the core/satellite approach did not deliver as actual returns diverged markedly from expected returns for most asset classes; and third, diversification didn't live up to expectations as excessive liquidity ramped up the correlation between asset classes that historically showed only low correlations.

To make matters worse, the quantitative easing programs unleashed by central banks on both sides of the Atlantic since the collapse of Lehman Brothers in 2008 have further served to weaken the link between asset – and liability – prices and their fundamental value drivers.

Investing, as a result, has become a loser's game: one in which the winner is not the one with the best strategy, but the one who makes the least mistakes, much like tennis. Risk mitigation is now the name of the game and diversification is its key tool. In the process, increased reliance on consultants and fund managers has become the shield behind which investors increasingly hide.

Prior to 2000, 80% of portfolio returns came from intelligent asset allocation and 20% from implementation. Since then, the ratios have changed dramatically. In today's world, where effectively implementation has become much more important, intelligent asset allocation accounts for only 50% of returns.[1]

While it remains debatable whether their impacts can be so neatly isolated and quantified, the unavoidable fact is that any investment strategy is increasingly only as good as its execution.

Progressive pension plans are therefore paying as much attention to two other areas of their business models as they are to asset allocation in order to improve their investment performance: namely, plan governance and execution capabilities. The results of the 2014 Amundi Asset Management/CREATE Research Survey evidence this trend.

## 2. Recent progress

Investing in today's world has to account for four key facts of life: risk-on/risk-off cycles; the scarcity of alpha; risk aversion on the part of advisers and outsized macro risks. European pension plans have duly made notable improvements in the three key areas of governance practices, asset allocation and strategy execution.

Pension plans are switching to new areas like absolute return investing, dynamic investing, risk-based diversification and smart beta. This is in marked contrast to the old-style static strategic asset allocation model based on assumptions about risk and return over the longer term.

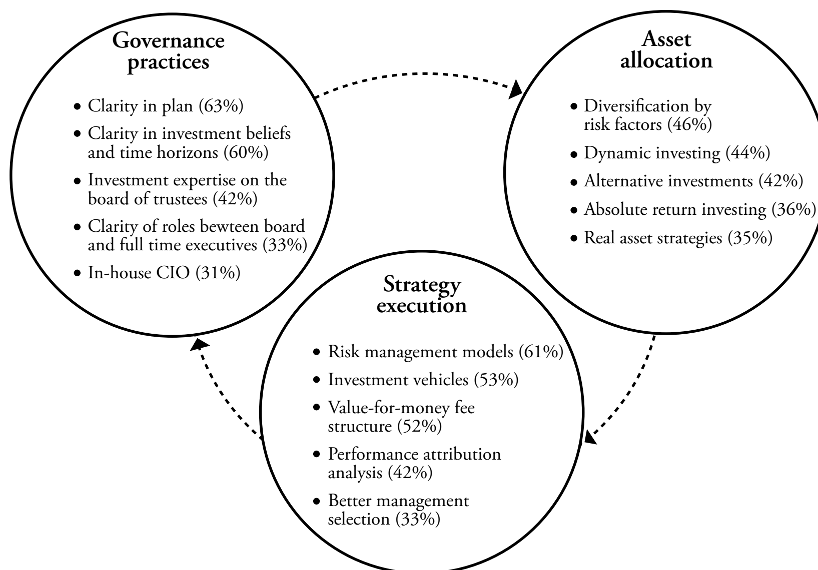
As part of the transition process, governance is acquiring a pivotal role. Greater clarity on "softer" issues like investors' mission, goals and beliefs is regarded as vital in supporting more intelligent, frequent and dynamic asset allocation decision making.

The emphasis on governance is also backed by organisational improvements – like enhanced investment expertise on the board, delegated authority to full-time executives and an in-house CIO – to secure agility in today's real-time markets driven by 24-hour news cycles.

To complete the circle, improvements are also evident in execution capabilities1, including value-for-money fee structures, improved risk management, better manager selection, the right choice of investment vehicles, and judicious use of derivatives, shorting and leverage.

[1] Amundi Asset Management/CREATE-Research Survey 2014

**The emerging business model in the pension landscape**
**(% of respondents implementing changes)**




Source: Amundi Asset Management / CREATE-Research Survey 2014

The biggest change in the emerging pension business model centres on risk management. Its causes are being separated from its consequences; its management from its measurement; its time dependency from its randomness. Crucially, volatility is no longer the key measure of risk; instead, risk is often defined by the maximum drawdown trustees are willing to tolerate in a given year.

Additionally, operational risk is being prioritised, consistent with the emphasis on efficient execution.

To put it into context, according to the 2014 Amundi Asset Management/CREATE Research Survey, just under 90% of pension plans have refined their asset allocation approaches to a 'large' or 'medium' extent (mainly the former). Just under 85% have upgraded their governance to a 'large' or 'medium' extent (again, mainly the former), and just under 80% have refined their execution capabilities to a 'large' or 'medium' xtent (once again, mainly the former).

On the surface, therefore, the scorecard looks impressive. However, as the case study below shows, the battle is far from over.

# 3. Closing the gap between rhetoric and reality

There is a yawning gap between the rhetoric of the governance improvements of recent years and their reality on the ground.

As the funding ratios have been hit by falling discount rates, a culture of micro management has been evident. In that context, the recent changes in governance practices can best be described as work in progress.

Creating effective change in business practices requires the kind of mindset shifts that usually take time to nurture. They require new personnel, skills and attitudes as much as learning from past regrets.

For trustees, the challenge is how to delegate authority to investment professionals without losing control. They have to walk a fine line between their fiduciary role and executive empowerment. In particular, control needs to move to the strategic level - which requires a different mindset.

Full-time executives, meanwhile, have an equally fine line to walk between personal accountability and career risk. Blame culture accentuates principal–agency risk where executives put their own interests above those of their plan.

These balancing acts require behavioural changes that are not yet evident in the European pension landscape.

## Case study: a UK pension plan

*"Externally, the financial crisis exposed the weaknesses in our asset allocation. Internally, it exposed the deep fault lines in our governance practices, which had long been a taboo subject.*

*"Hitherto, our trustees were a group of well-meaning people with little experience of investing. Largely relying on external advice, they were prone to herd instinct and overly conscious of their career risk.*

*"Few knew how to manage the principal–agency risk that proliferates through the pension food chain. Micro management was the norm. Our solvency ratio plunged by 26 percentage points during 2008-11. Our sponsor would only make an additional recovery contribution if we had a root-and-branch look at all our operations.*

*"To gain insights into best practices, we visited some of the Canadian plans and also some sovereign wealth funds that weathered the crisis better than most. The biggest lesson we learnt was that, contrary to conventional wisdom, asset allocation is not the biggest driver of returns. A world-class strategy requires world-class execution.*

*"In the raging bull market of 1982-2000, asset allocation had more weight. This is no longer the case, thanks to today's risk-on/risk-off cycles, the scarcity of alpha, persistent valuation anomalies and super-sized macro risks.*

*"We have started a change programme that has turned the spotlight on to governance. We have had special learning programmes for trustees to bring them up to speed about our plan's long-term mission, our investment beliefs, our time horizons and our liabilities. There is a lot more clarity on these issues.*

*"On the structural side, there is more delegated authority to full-time executives to reflect the real-time nature of today's investing. We have recruited two new trustees onto the board with significant investing experience.*

*"However, change has been easier on paper than in practice. First, the UK law enjoins trustees to exercise the highest level of diligence in all aspects of plan operation.*

*"This stringent fiduciary role sits uncomfortably alongside the notion of delegated authority. Second, the mindset changes essential for minimising our culture of micro management are proving slow to develop. The level of trust needed to make delegation work is also proving hard to achieve.*

*"Third, peer and career risks create conflicts of interest in the value chain and slow down progress. New ways of investing require new skills and new mindsets. These are hard to develop, as the requisite behavioural change requires a high-trust environment. We don't have that – yet."*

Source: Amundi Asset Management / CREATE-Research Survey 2014

# 4. Decisions are scarier

That said, it is important to note that the context for trustees' decisions is also changing.

Funding deficits and the increasing sense that defined benefit (DB) pension schemes are a legacy problem rather than a valuable incentive in employee remuneration, creates a less supportive backdrop. Every decision that trustees make faces greater scrutiny from an increasingly critical sponsoring employer.

It's not going to get easier. In the past, the 'risk of not being able to pay pensions' was a dim and distant issue somewhere over the horizon. Now, scheme closures and tax changes mean the cost of future benefits still building up is modest and dwarfed by outgoing benefit payments to current pensioners. Underlying cash flows are negative: perhaps masked temporarily by deficit contributions.

Within their own working lifetimes trustees may discover that they should have done something else with the money. As pension plans move into their run-off phase, it is not hard to see how negative cash flow diminishes the capital base that could previously have been used to right a sinking ship. Compound interest becomes an ogre, not a friend.

So decisions are scarier.

Against that backdrop, loss and risk aversion take over. The risks are increasingly emphasised and the problem becomes framed in terms of avoiding failure. As the fight or flight instinct kicks in, the brain is screaming "run way" (from the difficult decision).

The simple fact is that trustees can never get the answer completely right because they can't know the future. They know they will be wrong. Consequently, they can be tempted to focus on compliance and governance processes to avoid bad decisions by relying on qualified advisors or executives. While they challenge those advisors' advice, when it comes to making decisions, they tend to err on the side of deferring to their advisers, or simply deferring decisions (i.e putting them off).

It seems safer not to make a decision or put it off, rather than act – a status quo bias familiar in behavioural finance.

The fact that it's a group decision makes it likely the outcome will be even more conservative. A group is more easily influenced by the doubts of the pessimist, who can see the risks vividly, than by the enthusiast, however well informed.

And yet, as any trustee group knows, their job is to make decisions. Advisers, meanwhile, are hardly going to deny trustees the opportunity to make decisions as the profitability of their business models thrives from from such decisions, advice and change.

However, there is a shared desire for the decisions not to be too scary - nothing that will cause too much regret or cause the scheme to be too much of an outlier.

# 5. Easy decisions: path of least resistance

So the tendency is to stick to decisions that won't cause trustees and their advisers too much pain.

It is this tendency, however, that reinforces the gap between governance rhetoric and reality, and holds schemes back from implementing genuine change to ensure their business model is able to cope with the new reality – in other words, they are re-spraying an old car, when what is needed is a completely new model.

Taking the path of least resistance, or simply avoiding decisions, is not only ineffective, it can also have unintended consequences.

For example, beating a fund manager up about poor performance, even though it is often due to bad luck rather than ineptness, might help trustees feel better, but rarely has a significant impact, other than encouraging a fund manager to retrench to a peer-group benchmark or risk-controlled process. Both of these behaviours, which remain prevalent today, ultimately work against the end client.

The pension business model has evolved to some degree to improve decision making capabilities.

Employing an executive team 'in-house' and having a financial and emotional alignment that is stronger than that with an external adviser is a common solution because it provides the ability to make decisions, additional accountability and a feeling of control.

However, it can also bake in a degree of inflexibility that leads to an inability to change radically - unless everyone is also aligned in their understanding about how a governance model and team might need to change over the next 5-10 years. This is hard – *status quo* bias again.

Will fiduciary managers or implemented consulting help? The advantages of agility and dynamic manager selection and out-of-the-box asset allocation seem attractive. But what are the unintended consequences? Will there be enough players and independent decisions to create an efficient market or will it just create pools of assets that become easier to predict by those daring to be an outlier?

As always, tackling the difficult decisions, playing to organisational strengths and daring to be different (i.e. taking risks) are the way to win.

Have today's trustees simply given up? Who can blame them given the sharp focus they are under from the sponsoring employer, regulator and their members?

# 6. Breaking free: a way forward

Creating the willingness to tackle the big, difficult decisions requires a behavioural shift on behalf of today's trustees. It also requires an environment and culture in which trustees feel comfortable making decisions about which risks the pension fund should take and, most importantly, how it should take them.

When it comes to building decision-making confidence, one step that can be achieved within the existing governance model, is to take greater risk with a defined part of the assets, where the part depends not only on the risk appetite but also the skills that the organisation has to take those risks. Crucially, the decisions to be made within this part can play either to the organisation's existing capabilities or preferences, or take it where it wants to be in five years' time.

The aim might be to have an incubator or controlled experiment that could then be used as a model for the rest of the assets over time.

The box on the following page outlines six steps that form a broader and more resilient process schemes could follow.

It is critical, however, that the model goes beyond mathematics and assumptions, and looks at the resources and relationships necessary to deliver the strategy and mission. Only by doing so can the pension fund strategy be brought back in to the world of business decisions - an approach that governance consultants Avida strongly advocates.

And although these are more significant decisions, they are perhaps closer to the comfort zone of 'lay' trustees, especially those who have run businesses, divisions or teams and been responsible for strategy, resourcing and external contracting. It is these issues that will come to the fore in delivering success for pension funds as they mature.

Ultimately, there is no right answer, but reducing discomfort and building appropriate confidence at an appropriate cost can be done through the right governance. If that is achieved, then difficult decisions can be made with confidence and pension business models stand a far greater chance of being able to implement effective change to adapt to today's new investment reality.

## Six steps along the way forward

1. Open a different kind of dialogue with the sponsoring employer. Deliberately back away from the conflict which is encouraged by the regulatory environment about funding negotiations. Try to understand how the operating model of the pension fund (in-house/strategic partnerships/cultural trends) can be aligned with the sponsor's thinking. This moves the dialogue towards a partnership approach looking for a viable solution that might draw on resources from the employer in a different and more flexible way. What risks do we want to have, the skills to manage in-house and which should we outsource?
2. Develop a strategy for how the pension fund will succeed and deliver its financial mission of paying everyone the right pension. Agreeing the financial objectives and timescales will clearly need input from the sponsor, but so will the operational ones. The aim is to create a stronger sense not only about where we want to go but how we get there: to agree about what the fund wants to be good at and how it will operate over its remaining lifetime. Although the process of developing a strategy takes some time, it provides a better context for future discussions and priorities that might otherwise be dominated by technical discussions about assumptions, models and the latest regulatory changes or ideas. It creates a business model and business strategy that the sponsor, the trustees and their executive (if any) can own. Critical in-house expertise and associated alignment in rewards will be clearer, too.
3. Carry out some scenario planning about different financial outcomes to test how resilient the pension fund's business strategy might be. What are the risks to its success? How might these be mitigated? What operational and financial contingency plans are needed? Again, business thinking about resilience – how to stop a crisis becoming a disaster – will leave the fund better placed for the future.
4. Identify the right external partners/providers for delivering success, whether fund managers, consultants, fiduciary managers, administrators or systems providers. Having the right skills and services is one aspect, but, with more clarity about the business strategy, other qualities will be important in making sure the relationship has staying power. Cultural fit, consistent business models into the future, systems and services that might help in a crisis are all important and things that can now be defined and included in the procurement process and buying decision. Think of it as a 'joint venture for mutual advantage' rather than a 'hire and fire' world. Fees can be quite different too, to reflect the partnership.
5. Take control of meeting agendas and priorities. With a clear business strategy it should be easier to identify which things are noise, which things can be delegated and which things matter. Raise your eyes and raise your game.
6. Get the management information right. Prompt information, transparency and visibility is the key to building confidence and avoiding expensive knee jerk reactions, micro management and change for the sake of it.

## The 300 Club

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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