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Giving a Voice to Pension Fund Beneficiaries

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Presentation Outline

1. An ageing (developed) world

2. Giving beneficiaries an investment say

3. Implementing a choice-oriented approach
1. The Ongoing Challenge

• Largest pension funds are in developed world
  – > Life expectancy ≈ Longer retirement periods
  – < Birth-rate ≈ Shrinking labor force
  – Funding policy often set by the older generation
    (Brinkman/Coen-Pirani/Sieg 2016)
  → Underfunded (Munnell/Aubry 2015)

• Unrealistic promised benefits/expected returns
  – Diversification benefits in 1994-2010 (Jackwerth/Slavutskaya 2016)
  – But no evidence of active management beating passive benchmarks (Ammann 2008; Hooke/Walters 2015)
  – Performance getting worse in today’s environment (Bams/Schotman/Tyagi 2016)
  – From targeting 8% over 20 years to getting 0% (Faber 2011)?
Explicit and Implicit Promises

• Two payout models
  – Defined contributions (DC): Now dominant in AU (87%)/US (60%)
  – Defined benefits (DB): Still dominant in J/NL/ CDN → 95%

• Defined benefits approach
  – Pension fund bears the risk of underfunding
  – Promised benefits increasingly likely to be unrealistic
  – Pay as you go system → some flexibility but increasingly under pressure → trying to ‘fix’ the system

• Defined contribution approach
  – Beneficiaries bear the risk of underfunding
  – Expected returns increasingly likely to be unrealistic
  – Get what you accumulated → some flexibility but increasingly under pressure → trying to ‘fix’ the system
Short-Term ‘Fixes’

– **Overt** move towards ‘robust’ DC
  
  • Pre-funding to substitute short term accumulation of assets/pay-as-you go systems (Stewart 2014)
  • Putting the funding burden upon individuals
  • Retirement income gap (Rhee/Boivie 2015)

– **Covert** ‘affordable’ pension plan move
  
  • Reducing benefits via adjusted capital payouts
  • Playing with conversion rates
Further Ways to Address the Challenge

• **Gambling for redemption** (Antolin/Schich/Yermo 2011)
  – Risk aversion and liability
  – Backlash effects

• **Exercising voice**
  – Diversification does not equate with passive ownership (Appel, Goremley, Keim JFE 2016)
  – Internalization and private benefits issues

• **Giving beneficiaries a say**
2. Giving Beneficiaries a Say

• Reducing agency issues
  – From a financial/economic perspective
  – From a political/policy perspective

• Individualizing preferences & risk appetite
  – Financial and non-financial
  – Life expectancy and perceptions

• Not unheard of (US 401k; CH Third pillar)
Framing the Approach

• **Having a say within (broad) limits**
  – Continuing to trust professionals
  – Economies of scale

• **Diversity in Preferences and Risk Taking**
  – **Shareholder value**: Proxy for financial preference and risk-taking
  – **Stakeholder value**: Proxy for non-financial preference and time value of money

• **Taking into account existing asset allocation**
  (Towers Watson, 2016 Global Pension Assets Study for P7 countries)
  – **1996**: 52% equity, 36% bonds, 5% cash, 7% others
  – **2015**: 44% equity, 29% bonds, 3% cash, 24% others
Choice Design I

- **Opting-in**
  - Default: 100% fund Mgmt.
  - Opt-in: 20% own choice, 80% fund Mgmt.

- **Preserves fund managers investment discretion**
  - 20% choice
    - Among existing pension fund investments
    - Current portfolios are shareholder & stakeholder value preference compatible (Dyck/Lins/Roth/Wagtner 2015)
  - No need to pick unknown assets/rethink investment strategy
  - Implementation issue: Impact on fund management →
Choice Design II

• No threatening impact on retiree income
  – Takes into account behavioral/financial/political factors
    • Nudges towards status quo
    • Choice limited to 20%
  – Allows for adjustments in beneficiary choices

• Cognitive or educational limitations
  (Chalmers 2013; Fisch/Wilkinson-Ryan/Firth 2016)
  – Limited set of investments
  – Facilitating choice at the implementation level →

• Reduces inter-generational conflicts of interests
  – Constraining managerial focus on short term payouts
  – Reducing the influence of older beneficiaries
3. Implementation

• **Individual asset allocation**
  – Likely to be driven by beneficiary’s age
  – Limiting choice to relative size of given asset class

• **Individual investment picks**
  – Likely to be driven by shareholder/stakeholder preferences
  – Focus on
    • Target governance: Scoreboard approach →
    • Target output: Impact investing →

• **Can beneficiaries do both?**
  – Not operationally challenging in an IT world
  – Impact on fund management →
Facilitating Choice

• **Scorecard approach**  (Kaplan/Norton 1992)
  – Multi-dimensional: strategy ↔ financial, customer, process, learning & growth (human/information/organization capital)
  – No single-valued measure of how performed (Jensen 2002)
  – But adopted by thousands of firms (Kaplan 2010)

• **Impact investing**
  – Social and environmental impact: housing, health care, education, sustainable agriculture, clean technology, etc.
  – Pension funds expect market-rate returns (GIIN 2015 Survey; see also Porter/Kramer 2006)
Impact on Fund Management

• **Assisting beneficiary choice**
  – Providing scoreboard and impact data
  – Within the realm of professional fund management

• **Choice range and frequency**
  – Asset allocation (age) or individual picks (value)
  – Once a year: Own preferences / Dropped investments

• **Post choice portfolio adjustments**
  – Major immediate impact unlikely (offsetting choices)
  – Longer term impact due to feedback loop?