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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'

– <u>Overt</u> 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)

– <u>Covert</u> '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 <u>payouts</u>
  - Reducing the influence of <u>older</u> 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.
  - Increasingly complementing public investments (ILO World Social Protection Report 2014-2015)
  - 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) <u>or</u> 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?