Briefing Note

on

Pension Fund Governance

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Introduction

Pension fund governance is at the root of delivery of adequate pensions at an affordable price, with a reasonable degree of payment security. Good governance is aimed at managing risk in the widest sense: not only investment risks, but also risk of fraud, and operational risk such as the risk of information systems malfunction.

In the following section, we will list the five success drivers in pension fund governance. Subsequently we will treat each one of them in more detail.

This briefing does not provide a “recipe” to be followed in setting up pension fund governance. We list some issues to be considered. The combination of choices to be made, differs from case to case. As this briefing is not a scientific treatise, we will not back up all our claims and statements with references from literature.

The five success drivers in pension fund governance

The five success drivers in pension fund governance are as follows:

- Aligned interests with pension plan participants
- A proper Board composition
- Sensible investment beliefs
- The right scale
- Competitive staff compensation

Many of these issues are interconnected, and therefore this briefing note should be read as a whole.

Aligned interests with pension plan participants

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[1]. The first step to deal with these problems is to be aware of them and to address them openly. These problems can be minimized by keeping the structure of investment mandates as simple as possible, and by investing in instruments that the Board understands. The cost structure of mandates and investment should be completely transparent to the Board.

The Board should at all times be in the driver’s seat. The Board should set out allocation policies in broad lines. Then it should decide which type of investments are based

[1] We paid elaborate attention to Principal-Agent problems in the briefing note “On asset management issues in relation to the National Pension Fund (NPF)”, dated 17 July 2017.

implemented in-house, and for which outside agents (such as investment banks and asset managers) are contracted.

In this process, the Board can engage outside experts, paying these experts an appropriate fee for their services. Unfortunately, what is very common, is that commercial asset managers, notionally "for free," "at no cost" , "advise" Boards on asset allocation and implementation issues. <u>This should be avoided at all times</u>. The tail should not wag the dog. The only thing free in this world is cheese in a mousetrap. It amounts to creation of a major conflict of interest. Especially government agencies are prone to this mistake, as usually they have limited budgets to pay staff or advisors. However, I should be noted that taking advice from future service providers will result in much larger cost charges and potentially skewed investment decisions.

A proper Board composition

The effectiveness of a Board is determined by its composition. Therefore, the process through which Board members are selected is key. Historically, the main characteristic of the Board member was his/her representativeness of a certain group of stakeholders, for example employer-, employee-, retiree- or government representatives. While it is true that representativeness creates an important sense of legitimacy, it is not enough. Boards must also embody the collective skills and experience sets required to be an effective oversight body. They must understand the process of value creation and be able to oversee its implementation.

On the one hand, this can be accomplished by additional training of traditional stakeholder's representatives. On the other hand, there will be a need to hire independent experts as part of the Board. These experts could be from academia or industry. They can be actuaries, economists, lawyers or investment experts. It will be very important to ascertain their independence of outside commercial and political interests. We understand that the law on the National Pension Fund (NPF), indeed foresees four independent experts to be members of the Board.

It is important that Board members understand the purpose of the governance function as distinct from the executive function in the complex business of pension fund management. That is: Board members should not attempt to meddle in individual investment decisions. If they feel an investment to be inappropriate or sub-optimal, they should inestigate the appropriateness of the framework of mandates that gave rise to this investment rather than try to overturn any particular decisions on the micro-level.

Sensible investment beliefs

Sensible investment beliefs include:

- An understanding of the merits of diversification. Markets do not reward the additional risk caused by concentration of investments in one particular security, industry, country or region.
- Distinguishing long-term value-added investment decisions from short-term "beauty contest" type of stock picking. The latter ultimately only benefit the commercial agents engaged in this "zero sum game"-type of activity[2].

Other investment beliefs are not universal, but the Board should have some view on issues such as:

- The merits or otherwise of "momentum" investing (= investing in securities that have recently increased in value, speculating that due to inertia such increases persist).
- The merits or otherwise of "growth" investing (= investing in securities that pay no or small dividends, speculating that the price of this security will increase in future)
- The merits or otherwise of "contrarian" investing (= investing in securities that have sold off recently, where the downward correction can have overshot)
- The merits or otherwise of "private equity" or "hedge funds".
- The merits of "passive" versus "active" investing.
- The need to hedge currency risk[3]

The views of the author of this note are quite clear: any strategy dependent on frequent trading and short-termism, will ultimately be defeated by high cost levels and by the fact that others (with ultra-high-speed connections to the main trading floors and complex computer algorithms) will be better at this game.

The right scale

Effective pension organizations need sufficient scale to be able to afford the human and financial resources to be successful, while enjoying low costs per unit of capital invested. Happily, NPF as a nation-wide provider, is likely to attain this scale within a few years. It will be required to earmark a certain percentage of contributions and/or a certain percentage of assets to cover costs. Potentially, there will be an initial government grant to cover start-up costs.

[2] We paid elaborate attention to these issues in the briefing note "On asset management issues in relation to the National Pension Fund (NPF)", dated 17 July 2017.
[3] We also paid attention to currency risks in the briefing note "On asset management issues in relation to the National Pension Fund (NPF)", dated 17 July 2017.

In our view, administration and asset management costs should, after a limited initial period, be below 0.5% of assets[4]. This can be accomplished by "keeping it simple". Depending on the exact portfolio allocation (to be decided by the Board), the fund can relatively cheaply invest in:

- Domestic government bonds
- A representative basket of domestic equity
- International stocks and bonds through low-cost passive funds
- Potentially an allocation to commodities like gold and silver, physically stored in a safe location

Competitive staff compensation[5]

Successfully executing long-horizon wealth-creating investment strategies requires high quality investment managers (as opposed to "traders") working inside the fund. However, such people need to be appropriately rewarded, and their market value is usually high. Because of this, in many cases far more expensive people are hired outside the organization. The reason is that their cost is not visible, as only net investment returns are reported to the participants.

How should overall compensation be structured? On the hand, there should be a base salary, on the other hand there should be a performance bonus. The distribution over these two categories may differ by type of employee. International practice suggests that a split of 60% / 40% is quite common.

Within the performance bonus, part is driven by certain organizational goals (Key Performance Indicators – KPIs) having been accomplished, and some is driven by investment performance, as compared with an appropriate benchmark portfolio.

For the ratio of the performance bonus related to organizational goals (people trained, procedures in place ad functioning well etc.) versus the bonus for investment performance, there is a difference depending on the level in the organization. International practice suggests that for a CEO a split of 50% / 50% is quite common, while for a front-line investment manager this would be 20% / 80%.

Finally, the bonus for investment performance should ideally be assessed on a very long-term basis, for example on a 20-year horizon. However, of course this is impractical. Therefore, a 4-5-year vesting period would be a practical compromise between immediate reward and reward for truly long-term sustainable results. This could be implemented by allocating

[4] This may seem an ambitious goal, given that the two largest pension funds in the Netherlands, with hundreds of billions of dollars in assets, spend approximately 0.5%-0.8% of assets under management, yet we feel it can be achieved

[5] We also paid attention to compensation / remuneration of asset managers in the briefing note "On asset management issues in relation to the National Pension Fund (NPF)", dated 17 July 2017.

annual bonuses, where part of the amount is deferred, or a claw-back provision is put in place, so amounts paid can be partially retroactively reclaimed from the employee, should the investment performance disappoint in future years.