Wealth across Generations:

Can Pension Funds Shape the Future of Capitalism?

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Let me start by thanking *FairPensions* for sponsoring this important event…and all of you for attending…

I propose to split our time together into 5 segments:

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 <u>do</u> this on a large scale
5. An opportunity for you to respond

<u>400 Years of Capitalism</u>

The broadest definition of capitalism I could find is:

"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 that it continues to be today….although 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% in the 7 centuries from 1000 to 1800….compared to a 20-fold (2000%!) increase in GDP per capita for the developed world in the 19th and 20th centuries ….while at the same time significantly reducing the # of hours people worked….and eliminating forced labour for children…and for the aged…

Capitalism's Challenges Today

However, with our entry into the 21st century, most of us are painfully aware that capitalism faces 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 much-diminished 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[1]

The question before us today is what the $30T 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…

Or, repeating the advertised title of this talk….

"Can Pension Funds Shape the Future of Capitalism?"

The short answer is: "Yes we can!"

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 we have 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, 50 years ahead of them…[2]

[1] Jensen and Meckling 'solved' this problem theoretically in 1976 in "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure", Journal of Financial Economics. They predicted that the market system would naturally lead to monitoring and control activities carried out by institutions and individuals "who possess comparative advantages in these activities".
[2] See, for example, "Reclaiming Fiduciary Duty Balance" by Hawley, Johnson, and Waitzer in the Fall 2011 issue of the Rotman International Journal of Pension Management (RIJPM).

Two Challenges

However, this transformation to 'pension fund capitalism' will not be easy[3] …..for two reasons:

1. It requires the redesign of pension systems so these systems themselves become more sustainable and intergenerationally-fair….

and

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….

Let me tell you why I believe these two pre-conditions are essential….and what must be done to bring them about….

Sustainable Pensions

The designs of traditional DC and DB plans are both problematical:

1. Traditional DC plans force contribution rate and investment decisions on participants they cannot, and do not want to make….also, little thought has been 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….raising fundamental questions about the effectiveness and sustainability of this individualistic pension model…

2. 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…. To which 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 proof of the proposition that the # of policy goals must be matched by the # of policy

[3] Peter Drucker titled his prescient 1976 book on the political economy of pensions "The Unseen Revolution: How Pension Fund Socialism Came to America". We think 'pension fund capitalism' may be a more salient descriptor today.

instruments….and this fundamental proposition has direct application in pension system design….

Pension systems have two goals: 1. Pension affordability for workers (and their employers)…and 2. Payment certainty for pensioners…therefore they must offer participants two instruments: 1. A long-horizon (LH) return maximization instrument to support the affordability goal, and 2. An asset-liability matching instrument to support the payment certainty goal….

Logically, young workers should favour using instrument #1 …..and pensioners instrument #2 …..Over the course of their working lives….participants should transition steadily from instrument #1…to #2….[4]

Unfortunately, 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…

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 L-H return-maximization instruments, pension funds <u>cannot</u> the play the wise intergenerational investor role that we have cast them in….

<u>Effective Pension Fund Organizations</u>

Such investment instruments are a <u>necessary</u> condition for a pension fund-led transition to a more functional form of capitalism… ….however….it is not a <u>sufficient</u> one…

Something else is required….specifically, 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-scaled
5. Competitive Compensation

[4] Pillar 1 public pensions should be taken into account in calculating the pension payment certainty needs for retirees. In many cases, it will not be necessary to shift the entire Pillar 2 retirement savings pool from investment instrument #1 to #2. These design challenges have become very real in the UK with advent of NEST.

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 <u>and</u> understand the purpose of the governance function as distinct from the executive function in the complex business of pension management….while most <u>actual</u> pension boards pass the first test…they do far less well on the second….
3. Actual investment behavior suggests many pension funds do <u>not</u> have sensible investment beliefs….John Maynard Keynes pointed out the distinction between short-horizon 'beauty contest' investing and genuine L-H wealth-creating investing way back in 1936…yet even today…the former dysfunctional investment style continues to dominate the latter…[5]
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 L-H wealth-creating investment strategies successfully requires a special breed of investment managers <u>working inside pension organizations</u> ….yet, because these people are not cheap….this requirement is usually discarded in favour 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 L-H wealth-creating investment mandates, they <u>cannot</u> play the wise intergenerational investor role we have cast them in….

<u>Opening Up a Second Front</u>

This is an appropriate time to acknowledge the many people and organizations working hard on the 'pension fund transformation' project around the world…..and as sponsor of this event, it is further appropriate to single out *FairPensions* for special mention….

Over the course of its six-year life, *FairPensions'* research publications, advocacy campaigns, and engagement strategies have had a measurable impact on UK decision-makers…..elected officials, regulators, pension trustees, business executives, investment managers…in their understanding that retirement savings should not be invested based on

[5] Chapter 12 of Keynes' "The General Theory of Employment, Interest, and Money" (1936) may still be the best ever essay on sensible investment beliefs, their implications, and their consequences. We quote liberally from it at the end of this document, imagining how <u>he</u> might have crafted this speech.

short term profit considerations….but on the longer-term, sustainable wealth-creation potential of prospective investments…..

And *FairPensions* is not alone in this quest….as just two further examples, the *UN 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 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. A serious, collective search is on for a middle way between these two designs ….and I am betting they will find it…

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….

Three 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. [6]
2. *FairPensions* founding executive director Alex van der Velden and his colleagues at the Dutch pension organization *PGGM* have for the last 3 years managed a 3B euro equity portfolio in a manner that would have received John Maynard Keynes' hearty stamp of approval…The portfolio has an explicit L-H focus, considers both macro and micro economic, financial, as well as environmental, social, and governance (ESG) factors… with *PGGM* consciously acting as an active owner of the dozen corporations the portfolio is currently invested in… ….Not surprising to me…the portfolio has performed well by both return and risk criteria in its (admittedly short) 3-year life…something I (and Keynes!) would expect to continue in the years ahead….[7]
3. *Ontario Teachers' Pension Plan* was designed in 1990 as a high-performance pension organization, explicitly endowed with the 5 success drivers set out in this speech….. Today, over 20 years later, it has verified investment and pension

[6] Full disclosure: I am a CEM co-founder and co-owner.

[7] Active owners are interested in the quality of the board of directors of investee corporations, as well as in their policies regarding such strategic issues as managerial incentives (e.g., executive compensation), allocation of retained earnings between re-investment, share buy-backs, and dividend payments, long-horizon enterprise risk management, etc. Often the most effective and efficient way to deal with these types of issues is through collaborative strategies with other active owners. Look for Alex van den Velden's approach to L-H investing in the Spring 2012 issue of RIJPM.

> 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…[8].

<u>In closing: a vision</u>

In closing, I leave you with a vision….imagine thousands of investment managers with the kind of mandate Alex van der Velden is fortunate to have had for the last 3 years….working for hundreds of '5 success drivers' pension organizations like *OTPP* has been for the last 20 years ….The result would be $Trillions of retirement savings managed with a truly L-H focus, carefully considering both macro and micro economic, financial, and ESG factors….all consciously acting as active owners of the thousands of corporations they have invested in….

I put it to you that if we could achieve that vision, we would not just create more wealth for current and future pensioners….we would in the process 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 skeptical eyes of today's occupiers of Wall Street….and of other financial centers around the world….

…and now over to you….

I look forward to your responses and our conversation.

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[8] See "Effective Pension Governance: the Ontario Teachers' Story" by Lamoureux in the Fall 2008 issue of RIJPM. There may be a dozen or so '5 success drivers' pension organizations in the world today. Another dozen or so have publicly declared they intend to join this elite club. New York City did so very publicly with its $120B in pension assets just two weeks ago. We stress that while all of these organizations have (or aspire to have) significant internal investment capabilities….focused, cost-effective outsourcing strategies will likely continue to be part of their overall investment programs.

John Maynard Keynes' Version of this Speech:

Excerpts from Chapter 12 of "The General Theory of Employment, Interest, and Money" (1936)

On forming return expectations and making investment decisions:

"…expectations of prospective returns are based partly on existing facts…and partly on future events which can be forecasted only with more or less confidence…we may sum up the latter as the 'state of long-term expectations'…"

"…the 'state of long-term expectations', upon which our decisions are based, does not solely depend on the most probable forecast we can make…it also depends on the <u>confidence</u> with which we make it…"

"…our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, and Atlantic liner, a building in the City of London amounts to little…those who seriously attempt to make any such estimate are often so much in the minority that their behavior does not govern the market…"

"…in former times, when enterprises were mainly owned by individuals who undertook… investment decisions…they did not really rely on precise calculations of prospective profit…if human nature felt no temptation to take a chance…there might not be much investment as a result of cold calculation…"

"…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…"

"…the daily revaluations of the Stock Exchange, though primarily made to transfer old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment…"

"…in point of fact, all sorts of considerations enter into market valuations which are in no way relevant to the prospective yield…as the proportion of stock owned by persons who do not manage and have no knowledge of the special circumstances of the business in question increases…the element of real knowledge in the valuation of investments …has seriously declined…"

"…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 social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future…the actual object of most skilled investors is 'to beat the gun'…to outwit the crowd…to pass on the bad half-crown to the other fellow…"

"…professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs…the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole…"

On the societal implications of this behavior:

"…it is the long-term investor who most promotes the public interest, who will in practice come in for the most criticism, wherever investment funds are managed by committees or boards or banks…for it is the essence of his behavior that he should be eccentric, unconventional, and rash in the eyes of average opinion…if he is successful, that will only confirm the general belief in his rashness…and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy…"

"…worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally…"

"…speculators may do no harm as bubbles on a steady stream of enterprise…but the situation changes when enterprise becomes the bubble on a whirlpool of speculation…"

"…when the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done…"

"…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…"

Ideas as fresh, relevant, and powerful today…as when Keynes wrote them over 75 years ago…there is nothing new under the sun….except, possibly, our understanding of what needs to change…and how to go about it.