

Principles, Principals and Agents¹

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Introduction

By delegating the investing of their capital to pension/superannuation funds, members empower trustees to act as their agents in the expectation that decisions will be made strictly in the members' best (retirement) interests. That underlying principle is as clear, explicit and simple in theory as the reality is unclear, implicit and complex in practice.ⁱ

To develop insight into and recommendations about such principal-agency issues we surveyed CEOs of not-for-profit Australian superannuation (*ie*, pension) funds.ⁱⁱ Responses reveal the depth and complexity of the agency eco-system in which the superannuation system is enmeshed; a system that imposes substantial costs on members' retirement benefits.ⁱⁱⁱ

Although largely concerned with the Australian model many of the issues, insights and recommendations below have substantial relevance elsewhere, especially as countries move away from DB retirement systems.

Principal-Agency Costs

The definitive paper on the principal-agency problem was penned by Jensen and Meckling in 1976. An agency relationship is "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent."

Principals delegate to agents because they lack the time and/or the expertise, at least in a comparative sense.^{iv} Having so delegated^v principals face a dilemma: "there is good reason to believe *the agent will not always act in the best interests of the principal*", (Jensen and Meckling 1976), (emphasis added.)^{vi} The resulting challenge "of inducing an agent to act in the principal's welfare" is quite general and exists at every level of "management in firms, in universities, in mutual companies, in cooperatives, in governmental authorities and bureaus, in unions, ... in the performing arts, and real estate." *Agency cost*

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is the difference between the *potential* benefit or welfare the principal would receive were the agent to perform the task completely in the principal's best interests, and the *actual* benefit or welfare the principal receives. Common sources of agency costs include over-servicing, where unnecessary services are charged for, 'shirking' where agents fail to do the best possible job, and rent-extraction where agents capture some of or all of the surplus.

Jensen and Meckling, who emphasise that "agency costs are as real as any other costs", propose market-driven ways of reducing them. In the corporate context they sought to reduce shareholders' agency costs by alignment through share ownership, a tactic that management finessed in favour of more easily gamed equity options, (Jensen and Murphy 2004).^{vii viii} The main tools for reducing agency costs are 'bonding' (including contracting) and 'monitoring', both of which are costly and leave principals facing a trade-off between those costs and agency costs. Because no contract can cover every contingency and no monitoring can cover every action, principals will generally accept some modest remaining 'residual' as the (extra) cost of delegating to an agent. Ideally they will reduce agency costs to the point where any further reduction reduces the net benefits received from the agent's services. Two not un-expected barriers hinder the attainment of this ideal, both of special relevance to pension funds.^{ix} *Hidden actions* occur when the principal cannot observe and hence cannot monitor the agent's efforts because it is either prohibitively expensive to do so or because the efforts are contaminated by noise. *Hidden information* occurs when the agent has superior information, an eternal problem in investment environments where informational asymmetry is ubiquitous and leads to failure of the price-discovery mechanism, (Akerloff 1970)

Agency costs can be expected to be high where these hidden barriers are high, such as in the pension/investment and medical industries. In the latter case a study of the US dental industry, (Naegele 2010), did reveal substantial agency costs.^x Agency costs can be expected to be low where hidden barriers are low, as they should be where open transparency and full disclosure rule, for instance in online retailing. However, for retail investment funds Davis (2011) is probably right in claiming that "funds management is the only area of human endeavour where the internet has introduced an extra layer of intermediation (ie, agents) between the end user and the product." Somewhat earlier, Siggelkow (1999) argued that five characteristics of mutual funds should curb shirking and the surreptitious shifting of expenses onto principals:

- Shareholders (principals) entrust fund providers (agents) with substantial amounts of their wealth.
- Shareholders can redeem their funds at low cost.
- Each type of fund has many competitors.
- The agent's success is in part based on trust.
- Total return and other relevant information including holdings are readily available.

In principle these should so inhibit agents that only minimal residual agency costs remain. Optimistically Siggelkow concluded that "if agency problems (were found in the mutual fund industry) ... it would not bode well for other environments more prone to agency costs." Agency problems *are* found, and as shown by Haslem (2012), are deeply entrenched ... and it doesn't "bode well." Siggelkow (1999) argued

further that if the industry failed to address this “the elemental trust relationship on which (it) is founded (it) is in danger of being undermined.” Fourteen years hence and the problems appear to have worsened, (Bogle 2009), which underlines the strong resilience of agency costs in spite of the law being both clear and narrow on the issue. Perhaps the strongest legal statement was delivered by the UK Court of Appeal in 2009 with its statement that “if you act for a man *you must act 100% body and soul* for him. You must not allow your own interest to get in the way without telling him.” (Emphasis added.)^{xi}

Because we all fail the impractical standard of acting “100% body and soul” for the principals, Diogenes could search for an eternity and fail to find such an agent. We have all supported decisions, activities, products, strategies or comments that were more in our interest (or in those to whom we owe loyalty) than in those of the principals. Diogenes would be better served searching for an agent who merely acts *so consistently and persistently* in the principal’s best interest as to impose only minimal residual costs.

Pension/Superannuation Funds

Members of superannuation/pension funds delegate almost all decisions to trustee/directors^{xii} (their first tier of agents) who delegate to internal staff (a second tier of (sub-)agents) who delegate to a third tier of asset consultants, who delegate to a fourth tier of fund managers, who delegate to a fifth tier of brokers, In that agency ecosystem the remoteness of (sub-)agents from principals makes bonding and monitoring nigh impossible which creates opportunities to over-service by hiring unnecessary staff or by using more resources than needed, to extract rent, or simply to shirk. Opportunities are magnified by four further aspects, the second unique to the Australian retirement system. First, the underlying commodity is money for which, unlike say ice-cream, agents’ demand will be insatiable. Second, under a system where contributions are compulsory, principals’ engagement, and hence their bonding and monitoring are minimal which creates opportunities for agents. Disengagement is re-enforced by the benefits themselves being remote and abstract, unlike those of a mortgage for example. Third, frequent structural and rule changes require ever more agents for their comprehension and interpretation. Fourth, a plethora of costly product and investment choices re-enforces members’ “poverty of attention”, (Simon 1959), (Salecl 2010), and invites ever more agents. The confluence of these features results in principals who are ill-prepared, ill-informed and disinterested. It would be surprising indeed if that environment did not see large numbers of agents attracted by the possibility of extracting substantial residual agency costs.

The past quarter century has witnessed a dramatic increase in the number, types and costs of agents not just in the pension/superannuation sector but across all sectors of financial services, (Phillipon 2012). The Kay Report on UK equity markets attacked this proliferation, (Kay 2012), “We are concerned by the general trend to additional intermediation, each additional stage adding to costs and creating new possibilities of misalignment... A principal driver of the growth of intermediation has been the decline of trust and confidence in the investment chain. ...Regulation has attempted to compensate ... (and) has enjoyed a degree of success ... but the burden of compliance ... has ... increased.... *Agents should review their practices with a view to establishing more effective working relationships based on trust and respect.*”

(Emphasis added.) The erosion of trust was highlighted in another recent report, (State Street Research 2012), based on surveys of 3,300 institutional and retail investors in 68 countries, which concluded that the industry is over serviced and self-serving. Especially worrying is that only 1/3rd of respondents believe financial institutions, in particular their “primary investment provider” act in their best interests.

The Australian Superannuation System

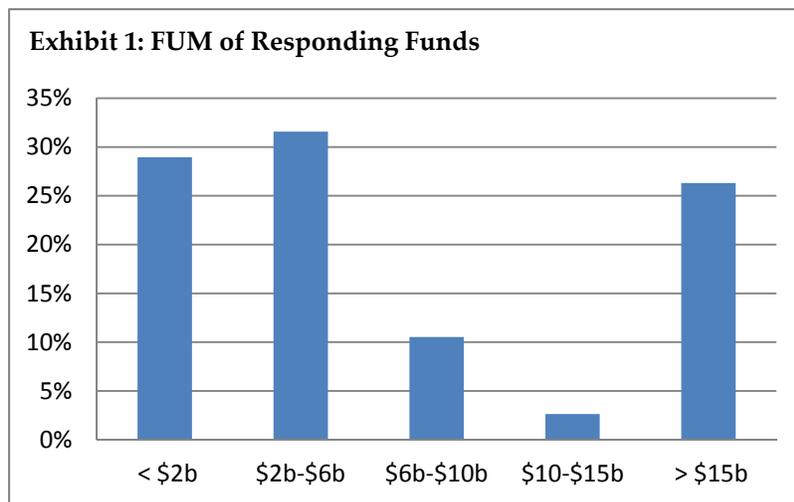
The system bifurcates into the ‘commercial sector’, consisting of banks and financial services companies that manage superannuation funds for profit, and the mutual or ‘not-for-profit sector’ consisting of industry funds, public sector and corporate funds, most of which are ‘public offer’, *ie*, open to everyone. ‘Not-for-profits’ rightly decry the conflict of interest inherent in directors of for-profits simultaneously being directors of the financial services firms that own the funds. The root cause of that clear and evident agency cost was eloquently captured a century ago by Upton Sinclair, “*It is difficult to get a man to understand something when his salary depends on his not understanding it.*” The not-for-profit (industry and public) sector suffers less from that conflict, but equally from other conflicts of interest that lead them too to act at variance with beneficiaries’ interests. For instance, mergers, invariably promoted as “in members’ best interests” through the supposed benefits of economies of scale, have been delayed or cancelled because some trustee/directors risked missing out on board seats. Successful mergers often result in boards bloated to accommodate trustees from both funds. One merged fund now has a board of 19. By weakening effective decision-making and governance^{xiii} excessively large boards impose indirect agency costs. Not surprisingly the same self-interested decisions occur in the corporate sector. Sonnenfeld (2012) reports one CEO shaking his head while recalling how “... we had a merger not go through because of who was going to get what number of board seats.”

Another instance of conflicting interests arises when a trustee found to be unacceptable cannot be removed from the board because the power to do so resides with that trustee’s appointing body, either a union or an employer group. To expand Sinclair’s insight, “*It is difficult to get a man to understand something when his status, position, prestige, future appointments, and loyalty depend on his not understanding it.*” In both the for-profit and the not-for-profit sectors the ancient maxim that *no man can serve two masters* has long been abandoned, (Bogle 2009). Australian public offer funds risk serving the two masters of stewardship and salesmanship, as do US mutual funds. According to Bogle the latter’s focus “turn(s) away from prudent management toward product marketing ... from a focus on long-term investing to short-term speculation. The driving dream is to gather ever increasing assets under management ... at the expense of the principals, whom, under traditional standards of trusteeship and fiduciary duty, they are duty bound to serve.”

Survey of CEOs of Australian Superannuation Funds

To better understand the structure, role, influence and costs of agents in superannuation we conducted an online survey followed up in some cases by informal face-to-face discussions^{xiv}. Questions we wanted to answer included: Who are the agents and what do they do? What are their supposed benefits to members? How do agents justify their decisions and actions? What are their direct and indirect costs? Which if any agents leave minimal residual costs and which if any are 'rent extractors'? Do funds employ too many agents? To what extent do/should agents compete, especially on costs? What would the industry look like without them?

The survey, focusing almost exclusively on trustee/directors, asset consultants, internal investment staff and external investment managers, was sent in April 2011 to the CEOs of 63 not-for-profit superfunds with FUM of at least \$500m, representing 76% of all not-for-profits of that size.^{xv} 39 useable completed surveys were returned, a 62% response rate. 69% of the responding funds were industry funds, 17% public sector and 14% corporate, approximately the same distribution as that of the (on average smaller) non-responding funds. 42% of responding funds were Defined Contribution, 58% were Hybrid DC/DB or Defined Benefit. Funds had an average FUM of \$8b, distributed as in Exhibit 1, and an average of 290,000 members with an average age of 40. Responding CEOs were experienced, having spent on average nearly 20 years in the superannuation or investment industries, with 90% having spent at least 8 years in those industries.



Following a context-free definition of principals and agents, CEOs were asked to identify their fund's principals. Only 57% identified *only* the members as their principals. The balance split roughly equally between (a) those who identified trustee/director boards, and bodies that appoint trustees (unions and employer groups for industry funds, governments for public sector funds) as their principals, and (b) those who identified the groups in (a) *and* members as their principals. As discussed in the opening section, from a strictly legal perspective the Trustee *is* the principal of a superannuation trust.

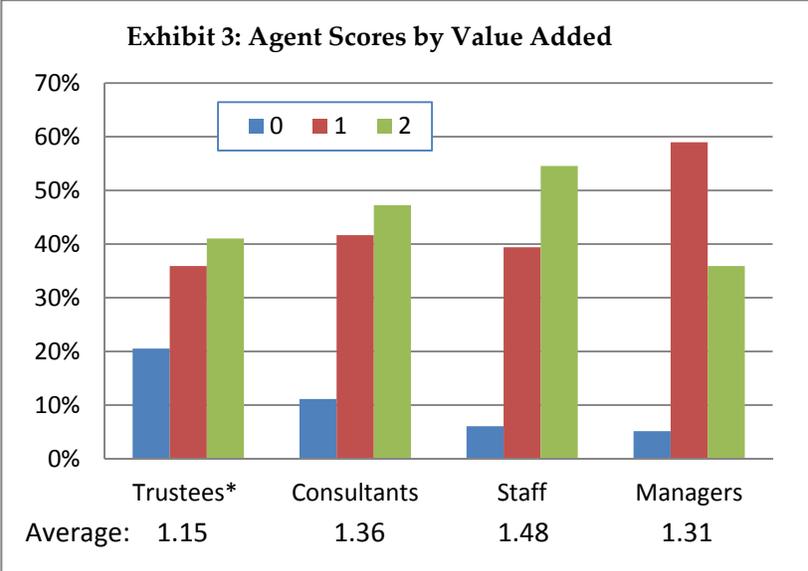
Nonetheless, it is disconcerting that *over one in five CEOs do not consider their members as principals*.^{xvi xvii}

CEOs were asked to assess the effect on members’ benefits in the hypothetical scenario where agents were no longer available. Possible responses were: “A material decrease”, “No material change” and “A material increase”. Exhibit 2 shows a large 51% of CEOs see trustee/directors as having no (or a negative) effect on members’ benefits. Yet in follow-up discussions we were struck by how often CEOs described their trustee boards in glowing terms with nary a critical word. 47% saw consultants as having no (or a negative) effect on benefits, while 39% and 18% respectively felt the same regarding internal investment staff and external investment managers.

Exhibit 2: Effect on Benefits Were Agents No Longer Available (% of Respondents)

	Trustees	Consultants	Inv. Staff	Managers
Material decrease	49%	53%	61%	82%
No material change	46%	44%	26%	13%
Material increase	5%	3%	13%	5%

Less hypothetically CEOs were asked to score agents as +2, +1, 0, -1, or -2, where +2 (+1) = “adds substantial (some) benefits for members net of costs”; 0 = “adds no net benefits” and -2 = “subtracts substantial net benefits”. The scores in Exhibit 3 are broadly consistent with the implied rankings in Exhibit 2.



* One CEO recorded a score of ‘-1’ for trustees.

Interpreting a score of +2 as “acting 100% in members’ best interests” and +1 as “acting half in members’ best interests”, the average scores are: trustee/directors 57%, asset consultants 68%, internal investment staff 74% and external investment managers 65%. Asset-weighted scores were approximately 15% lower suggesting that larger funds might be more aware and more critical of agents.

Interpretations need to be moderated by power relativities that shade assessments: CEOs are appointed and assessed by trustees who in turn effectively appoint and assess the consultants, managers and internal staff. The endowment effect is likely to bias CEOs to see those they appoint through rose-tinted glasses and those who appoint them through dust-encrusted glasses. Nonetheless, their views do and should carry weight. As Sonnenfeld *et al* (2013) observe in the corporate context, “Not only do CEOs have enormous experience to draw on but their views are the ones boards are most likely to heed.” On that basis alone the high levels of relatively negative views in Exhibits 2 and 3, especially those for the trustees who are responsible for governance, questions whether *the superannuation system is optimally structured for the benefit of members*, and whether agents are unacceptably far from acting “100% body and soul” for members.

Sources of and Barriers to Agents’ Added Value

CEOs were asked to assess the “improvements in members’ net benefits” that derive from agents. Exhibit 4 records the percentages of responses to possible sources of benefit improvements that were suggested in the survey. In the opposite direction Exhibit 5 records percentages of responses to “material barriers to getting the ‘best’ from agents”. ‘N/A’ indicates questions that were not asked (some of which in retrospect should have been.)

Exhibit 4: How Agents Improve Member Benefits

	Trustees	Consultants	Inv. Staff	Managers
Higher risk-adjusted returns from				
... improved decision-making	51%	67%	64%	92%
... deeper understanding	N/A	54%	N/A	46%
... selection & monitoring	N/A	80%	N/A	N/A
... new invest. opportunities	10%	44%	59%	N/A
Improved efficiency	21%	33%	54%	46%
Better communication	41%	28%	49%	13%
No improvements	21%	0%	3%	0%

Exhibit 5: Material Barriers to Agents Adding Value

	Trustees	Consultants	Inv. Staff	Managers
Conflicts of interest	23%	18%	3%	36%
Short time horizons	15%	15%	5%	46%
Focus on competition/career	18%	23%	15%	46%
Inadequate skills/temperament	62%	28%	21%	21%
High costs	0%	0%	0%	53%
Lack of time	56%	N/A	N/A	N/A
Off-the-shelf	N/A	38%	N/A	31%
No material barriers	26%	23%	38%	15%

Trustee/Directors as Agents

Exhibit 4 suggests that relative to the three other agents CEOs see trustees as at best marginal in improving members' benefits. Only in the area of 'better communication' is their rank comparable to that of others. In partial mitigation our survey did not explicitly address their governance role in setting the fund's vision and developing its broad strategy. However, governance is surely irrelevant if not reflected in improved member benefits, something which, according to Exhibit 4, CEOs do not believe to be the case. The data does bifurcate with 21% declaring that trustees add no value (consistent with the hypothetical Exhibit 2) while 26% see no barriers to their adding more value, as if they are operating at maximum effectiveness. The larger the fund the more CEOs reported trustee/directors as adding value. Curiously public sector funds value their trustees the least, perhaps due to a preponderance of enforced political appointments.

'Lack of time' and 'inadequate skills/temperament' are seen as major barriers to trustees adding material value, both of which can be overcome through improved selection, training and enforced commitment of time.

Very few funds attempt to align trustees' compensation to outcomes. 80% pay a flat fee which a small number of funds augment by a bonus. One fund pays an asset-based fee presumably as an incentive to increase FUM likely justified by a belief in the member-benefits of scale.^{xviii} 97% of funds pay trustee boards 5bps or less so in aggregate trustee compensation is a small component of total *direct* agency costs.

Asset Consultants as Agents^{xix}

All but one fund regularly use asset consultants, 77% of whom formally report to the governing board and/or investment committee while 21% report to the CIO. Consultants are seen to add most value through selection and monitoring of external managers and in improving investment decision-making. Other sources of added value mentioned include “raised level of debate about investments”, and “risk allocation”.

The modal reported barrier to consultants adding value is ‘off-the-shelf advice’ which points to the indirect cost of consultants focusing on the profitability of their business. Other barriers mentioned include “lack of fund staff to extract ideas”, “emphasis on managers not assets” and “under-remuneration”, the latter supporting consultants’ oft-heard complaint of being underpaid. When asked, no respondents saw different fee structures as making a material difference to outcomes consistent with very few funds trying to align consultants’ compensation to outcomes through either an asset-based fee (17%) or a performance fee (14%). The majority (58%) pay only a flat fee sometimes (17%) augmented by project fees. Based on CEO’s estimates the average cost of 10bps makes consultant compensation a relatively small component of total *direct* agency costs.

Internal Investment Staff as Agents

The 79% of funds (mainly the larger ones) that do have internal investment staff have an average of 8, while 10% have more than 20. Staff are reported to add value mainly through improved investment decision-making and efficiency. Other sources of added value include two that should lower agency costs, “focus solely on the fund, no business development responsibilities” and “staff engage with members”. One respondent however did see “conflicts of interest as just as common (if not more so) with in-house staff.”

With the notable exception of manager selection and monitoring CEOs see investment staff as adding more value and with fewer barriers, than consultants, who to some extent they probably replace. Noticeable in Exhibit 5 are the 38% of CEOs who see ‘no material barriers to getting the best’ from staff, a possible but untested symptom of an endowment effect.

Just under half of internal investment staff are compensated via a flat fee, the balance having an additional performance-based bonus. The average internal investment staff compensation as estimated by CEOs is 9bps, comparable to that of consultants.

External Investment Managers as Agents

CEOs reported employing an (estimated) average of 32 external investment managers, a figure that hides a wide variation. A surprisingly modest correlation of 0.3 between FUM and number of managers hints at smaller funds employing an excessive number of managers, possible evidence of over-servicing.

72% of managers *formally* report to the board and/or the IC, 10% report to the CEO, 33% to the CIO, and 13% to ‘other’, but typically managers report *informally* to more than one master, perhaps a sign of funds attempting to better monitor these most expensive of all agents.

An interpretation of the 92% figure in Exhibit 4 as a belief that managers operate at near peak effectiveness is weakened by the relatively large barriers in Exhibit 5. Not surprisingly costs are perceived as the major barrier to getting the best from managers, but only slightly ahead of short-termism and careerism, probably the most common of all indirect agency costs.

15% of funds remunerate managers *only* by an asset-based fee, all others augment that with performance-based or bonus fees, presumably as an attempt to reduce agency costs through improved alignment. The average annual cost of management as estimated by CEOs is 106 bps, again a figure that hides a wide variation.

International Data

A slightly truncated version of the survey was repeated at the International Centre for Pension Management Conference in Washington DC, October 2011. Respondents were 70 senior executives of large mainly DB pension funds from over 10 countries, consisting of CEOs, CIOs and trustee/directors, with a smattering of consultants, regulators and academics. The different composition of the Australian and international samples and the likely strong selection bias in the latter sample due to their membership in ICPM makes the drawing of comparative inferences extremely problematic.

Comparing Exhibit 6 to Exhibit 5 - the same exhibit for Australian respondents - reveals some sharp differences highlighted in bold.

Exhibit 6: Barriers to Agents Adding Material Value (International)

	Trustees	Consultants	Inv. Staff	Managers
Conflicts of interest	48%	50%	20%	58%
Short time horizons	41%	48%	40%	61%
Focus on competition/career	20%	41%	75%	58%
Inadequate skills/temperament	78%	35%	43%	30%
Lack of time	54%	N/A	N/A	N/A
Off-the-shelf	N/A	66%	N/A	28%
No material barriers	0%	0%	3%	0%

Relative to this *special* international sample Australian funds appear to be less critical and less aware of agency costs. They *appear* to be:

- Less likely to see or admit to *any* barriers to agents adding material value.
- Far less likely to be critical of trustee/directors.
- Less likely to see or admit to conflicts of interest or short-termism as barriers.

- Less likely to see or admit to consultants providing off-the-shelf advice as a barrier.
- Less likely to be critical of internal investment staff. Different structures and responsibilities probably have substantial explanatory power here. Australian funds tend to have fewer staff involved in actual investment decisions beyond manager selection and monitoring, whereas staff at many international funds have hands-on investment decision-making responsibilities.
- More likely to see or admit to managers' fees as excessive.

Whether any of these conclusions hold *in general* would require a comparable international survey.

Other Agents

Funds and their agents delegate to a plethora of other agents beyond the four main ones. Exhibit 7 lists some other (sub-)agents funds have used. Regulators, industry bodies, media, and superannuation rating agencies are not agents in the usual sense because funds don't delegate decisions to them, though they do pay the first two. Nonetheless these 'indirect' agents do influence funds and so can impose indirect agency costs. The Exhibit also shows the extent of sharing of agents.^{xx} Although sharing can reduce agency costs, on average only 17% of funds have shared agents. Larger funds tend to share more though some claim their size makes co-operation less valuable.

Based on the scale in Exhibit 3 in which +(-)2 means "adds(subtracts) substantial net benefits", Exhibit 7 shows the average score of all agents and the percentage of respondents who rated agents as having no (or a negative) effect on member benefits. 'Indirect' agents ranked particularly poorly, especially those that rate superannuation funds.

Exhibit 7: (Direct) Use, Sharing and Scoring of Agents

Agent	Used	No (or negative) Effect	Average Score	Shared
Internal non-inv. staff	92%	9%	1.47	17%
Financial planner	76%	12%	1.24	24%
Transition manager	87%	9%	1.15	11%
Accountant, Auditor	97%	21%	1.06	35%
Custodian	92%	33%	0.89	17%
Lawyer	100%	32%	0.87	54%
Recruitment agent	92%	53%	0.50	3%
Broker	51%	56%	0.50	9%
Industry body	84%	60%	0.37	14%
Investment bank	47%	63%	0.31	20%
Media	83%	6%	0.17	52%
Regulator	72%	6%	0.07	81%
Rating agency (Super)	81%	11%	- 0.12	65%

Internal non-investment staff (1.47) score equal first with internal investment staff (1.48) in terms of adding most value to member benefits, scores that are likely inflated by an endowment effect. Lawyers are ubiquitous and scored poorly yet appear to be insufficiently shared. The bottom five agents were the only ones reported as *subtracting* value from members. Responses to other survey questions show that 31% (respectively 28%) of CEOs see regulators as subtracting (respectively adding) value, a state of affairs that should be of concern to the industry.

Change in Agent Costs and Influence

CEOs reported an average 25% increase over the past decade in total direct costs of all agents as measured in bps^{xxi}, an increase slightly less than overall price inflation. Even allowing for a bias to understate costs, this modest increase sounds surprising given the global explosion of agents in financial services (Philippon 2012), the rise of manager fees (Malkiel 2013), and in the Australian context the substantial increase in exposures to more expensive alternatives investments and the consequent rise of new specialist alternative asset consulting firms. However the bps cost increase is swamped by the 154% increase in superannuation fund assets over the same period^{xxii}. Thus in dollar terms *reported* agency costs have increased by 218%, or 6.6 times inflation.^{xxiii}

CEOs also reported an 11% average increase in agents' "influence on decisions and outcomes" over the past decade.^{xxiv} This raises questions beyond the scope of a simple online survey. For instance, does the modest beneficial effect of agents evident in Exhibits 2 and 3 justify a doubling of their costs relative to

that influence? Alternatively it might be that funds have learnt to use agents more effectively and so are extracting proportionally more value from the increased costs.

Conclusions & Recommendations

Our survey confirms and re-enforces the view that agency costs in superannuation are as substantial as they are ignored. Respondents estimated total *direct* cost of all agents in superannuation to be in the range 1-2% of FUM while our survey reveals substantial *indirect* agency costs due *inter alia* to inadequate skills, insufficient criticism, lack of time spent on issues, and poorly aligned structures. Based in part on the costs of active management (Bird, Gray and Scotti 2013, Malkiel 2013), and on more general considerations (Bird and Gray 2009), (Gray and Watson 2011) we estimate total indirect costs to be around 2-3% of FUM, definitely a material figure.

Explicit concerns raised by the survey include:

- Over one in five CEOs do *not* consider their members as principals.
- A majority of CEOs see trustees as having no (or a negative) effect on members' benefits. Major barriers to trustees adding value are 'lack of time' and 'inadequate skills/temperament'.
- A large 26% of CEOs see no barriers to getting the best from trustees, and an even larger 38% see no barriers to getting the best from internal investment staff, a possible but untested symptom of an uncritical culture, in itself a source of indirect agency costs.^{xxv}
- Over the past decade *reported* agents' costs have increased much more than FUM and have doubled relative to agents' reported influence.
- The high levels of relatively negative views about agents suggests that the superannuation system is far from optimally structured in members' best interests.

Policy attempts to reduce agency costs fall under three broad headings.

Financial Literacy

The hope is that by raising members' financial literacy to levels comparable to those of agents, well-informed members will lower agency costs. This is unlikely to succeed because the cognitive and affective commitment required to become and *remain* financially literate is excessive for most reasonable people with lives to live, (Willis 2008). With few exceptions members will *always* be disengaged, though less so near and post retirement, making it relatively easy for agents to preserve and protect their advantages in information, comprehension and power.^{xxvi}

Alignment

Attempts to reduce agency costs through better aligned compensation have largely failed in both the corporate and pension worlds, as recognised even by Jensen. As Kay (2012) reports, “Misalignment of incentives has been addressed by ... bonus and incentive schemes of increasing complexity. ... this attempt to create identity of interests between agents and principals has in practice become a principal source of friction between them.” Some are brazen about it. One argument for improving the alignment of manager fees was greeted by a manager with the snort, “However you structure performance-based fees managers will always be able to game them.” Much agent talk of aligning incentives is self-serving interest masquerading as high principle in which ‘aligning’ often means ‘a-lining’ pockets.^{xxvii}

Competition

In principle in a market with informational symmetry competition forces the cost of goods and services down toward the marginal cost of production, a mere handful of basis points in the case of a broad equity mandate. In practice agents compete on brand and image not on price, (Malkiel 2013). Investment managers, in whose world quality can never be determined, don’t compete on price lest it is interpreted as a lowering of quality, as it is with women’s *haute* fashion. Six years ago competition was introduced to the Australian retirement system whereby (almost) all members have a choice of superannuation funds. Since then *all* fund’s costs have risen while only 1½% of members have voluntarily exercised choice, (Fear & Pace 2010). In areas such as insurance, competition probably has lowered costs to members, but in the dominant area of investment returns, competition *reduces* aggregate returns and hence benefits through an increased reliance on short-term momentum, a decrease in fundamental investing, and a consequent sub-optimal allocation of capital, (Bird & Gray 2009). The ideological platitude that competition is intrinsically beneficial must be challenged, as Kay does, “... there is little reason to believe that the outcome of a competitive fund management industry would necessarily be best for savers ... however much information the consumer may have (it is very difficult) to assess quality. In such a market price competition is not an effective weapon; margins and charges will tend to be set at conventional levels and, if market entry is easy, products and producers will proliferate. ... this pattern of misdirected competition, focusing on marketing and product proliferation but not on price, seems to describe the UK [and Australian] fund management industry.” This view resonates with our respondents as only 38% see competition as materially improving member benefits. Most (59%) see it as having a neutral effect while 3% see it as damaging benefits. Even in the context of US College Endowments, Goetzmann and Oster (2012) is inconclusive as to whether competition is beneficial.

Agents not members benefit most from competition. Members *could* benefit more were super funds to assert *collective* power on their behalf, yet, as some respondents complained, since fund competition began there has been a noticeable fall in sharing and co-operating. Hybrids of co-operation and competition can also increase member welfare, (Brandenburger and Nalebuff 1986). By pooling non-variable inputs, such “co-opetitive” arrangements can lower costs while parties still compete on output, price and marketing strategies. Co-opetition requires strong bonding and monitoring lest agency costs undermine co-operation, but if successful it can free-up human and capital resources, as banks do by sharing credit card facilities, ATMs and clearing houses. Almost all fixed costs of superannuation,

including administrative staff, legal and custodian services, consulting and much investment management could be shared for the benefit of members. Exhibit 7 shows the notion does have *some* hold in superannuation.

The relative failure of financial literacy, alignment and competition highlights the need for different policy approaches.

Specific Recommendations

1. Funds should regularly report to members and to regulators on actions taken to identify, assess and reduce direct and indirect costs across the entire agency ecosystem. Specifically, funds should report on the effectiveness of:
 - (i) Bonding, monitoring and other relevant 'local' actions.
 - (ii) Actions taken to reduce "agency creep" where each new agent's cost is immaterial while the aggregate cost can be substantial.
 - (iii) Mergers, sharing, co-operation, co-opetition and other relevant 'global' actions.

2. To ensure these actions have maximum impact on member benefits
 - (i) Selection and monitoring of trustees, the *primary agents* in the retirement system, should be based *solely* on whether their skills, motivation, temperament, training, experience and time are appropriate for *inter alia* selecting and assessing (often highly technical) agents.
 - (ii) Trustee boards rather than appointing bodies should be directly responsible for hiring, disciplining and firing trustee/directors. In particular, failure to spend sufficient time on board issues should be grounds for firing.
 - (iii) A *majority* of trustees should be independent of employer/employee appointing bodies.^{xxviii} There are three grounds for this. First, in the 25 years since superannuation began the workplace has changed significantly. Employers are no longer expected to have any responsibility to employees beyond compensation and health and safety demands, while unions now represent a mere 13% of private sector workers.^{xxix} For those groups to still control retirement savings is at the very least an anachronism that imposes indirect agency costs. Second, it is widely recognized that diversity of backgrounds, experience and mental models significantly improves decision-making, (Erhard *et al* 2003). The current trustee appointing process runs counter to that insight. Third, the sheer size and complexity of funds and global markets demands higher levels of skills and commitment.^{xxx xxxi}

In a nutshell, the industry should respond firmly to Johnson and de Graf's (2009) warning, "given the prevalence of misaligned interests throughout the investment chain, the importance of identifying, realigning and managing the interests of pension beneficiaries and their agents *should be a priority.*" (Emphasis added.)

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Endnotes

ⁱ Under typical structures the legal principal (and legal owner of the assets) of a 'superannuation trust' is the trustee while CEOs, Consultants, .. are the legal agents of the trustee. The trustee does have substantial duties towards members, the beneficial owners, but legally members are not the principals, nor therefore are trustees their agents. Nonetheless, in commonly accepted parlance the industry refers to members as principals and trustees as their agents. Recently passed Australian legislation formalises this and contains a covenant requiring individual trustees to perform their duties and exercise their powers in the best interests of the beneficiaries.

ⁱⁱ For the purpose and structure of the Australian superannuation industry, see Bird and Gray 2012.

ⁱⁱⁱ Both authors have been and continue to be agents - consultants, investment managers and advisors.

^{iv} Even if the principal has the time, the expertise and a comparative advantage she still might delegate to agents because their use might be compulsory, as it is for companies' use of external auditors, or highly desirable, as per the wisdom that a lawyer who defends himself has a fool for a client. Experimental economics suggests yet another reason - to avoid making morally difficult decisions, (Hamman, Lowenstein & Weber 2009), or more broadly to transfer blame, at least psychologically, when results don't pan out.

^v In a perfect frictionless market with total transparency and symmetric information, where the pricing mechanism co-ordinates the economic system and generates outcomes that are optimal for each expected utility maximiser, there is no need for agents as players will transact directly in the market. (Coase 1937).

^{vi} In his folksy but biting way Buffett crafts the parable of the Gotrocks family who, being advised by a plethora of agents as to what to do with their money, ignominiously slide into becoming the Hadrocks family. (Buffett 2005, 2006).

^{vii} That corruption has been placed at the heart of the financial crises, (Dobbin and Jung 2010).

^{viii} Jensen now recognises the weakness in expecting agency costs to be 'minimised' solely through alignment of compensation, (Erhard and Jensen 2012). Not only can such alignment be gamed but too great an emphasis on pecuniary alignment can "crowd out" non-financial reasons for working, (Sandel 2012), such as a sense of public service commonly cited in the context of pension funds. Ghoshal (2004) goes further and sees the attempt to align agents to principals' interests through compensation structures, as amoral in that it "actively frees managers from any sense of moral responsibility."

^{ix} In *The Theory of Moral Sentiments* Adam Smith mentions a curious further barrier. Monitoring may lead to agents being reprimanded when they over-reach their mandate. But uncertainty can arise regarding the agent's mandate and hence also regarding fault. Smith warns that being reprimanded for something we didn't cause can lead to disillusionment and a loss of trust, which may increase residual cost.

^x Agency costs depended critically on whether dentists were salaried or paid by fee-for-treatment. The latter structure provided a financial incentive to over-service and hence imposed greater costs. Patients (*aka* principals) with complex treatment requirements were *not* over-serviced. Rather, those requiring simpler procedures were over-serviced through unnecessary routine check-ups and fillings. A similar result was observed by Clemens and Gottlieb (2012) who estimated that a 2% increase in reimbursement rates from US Medicare led to a 5% increase in the amount of physician treatment received by a fee-for-service patient.

^{xi} Even "telling him" is likely to be insufficient. Asymmetry of information and power, intrinsic to highly technical and specialised areas such as investing means "telling him" will likely be contorted into "persuading him" that agent actions and costs are in his interests, (Mullainathan and Schleifer 2005). In the US where sales commissions on houses hover around 6%, online selling at less than 2% failed for that reason. In spite of increased transparency and

ease of price discovery real estate agents persuade buyers and sellers of their ability to “tailor” services, (Lowenstein, Moore and Cain 2012.)

^{xii} Trustees of Australian superannuation funds are responsible for offering members a choice of investment and insurance options (including defaults).

^{xiii} A 2011 study by Bain Capital claims that 7 is the optimal board size, “every person added after that decreases decision-making ability by 10%”, www.thenonproffitimes.com/news-articles/smaller-boards-flexible-engage-all-members/. Beyond 10 loss of coordination and a fall in individual member’s interests sets in. The average US corporate board size is 9.2, www.investopedia.com/articles/professionals/032913/wall-street%E2%80%99s-glass-ceiling.asp. A 2009 Foundation Centre study found an average of 5.5 trustees for US Foundations.

^{xiv} Construction of the survey (available on request) was informed by the Centre for the Study of Choice, www.censoc.uts.edu.au, and was first tested on a small sample of CEOs. Follow-up discussions were informal and designed to give CEOs an opportunity to provide colour to their responses.

^{xv} All but three of which are regulated by the Australian Prudential Regulatory Agency.

^{xvi} The legal documents in some DB funds do specify certain non-members as principals.

^{xvii} Smaller funds were more likely to see only members as principals. Perhaps they are closer to their members.

^{xviii} Although disclosure of compensation is information members need to monitor their trustee agents, few funds report it.

^{xix} For a substantial analysis of the agency problem in institutional investment consulting see Youngdahl (2013).

^{xx} Respondents wrote-in a further six: administrator, marketing adviser, insolvency firm, risk/compliance adviser, auditor, and communications provider.

^{xxi} 22% reported an increase of over 50% while 10% reported a *decrease* in agency costs.

^{xxii} <http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/kpmg-acfs-monograph-superannuation-trends-and-implications.pdf>

^{xxiii} On the positive side, funds lowered some components of agency costs by bringing more management and advisory services in house.

^{xxiv} 6% reported a decrease in influence.

^{xxv} Our survey and follow-up discussions revealed an especially difficult to ‘treat’ barrier to reducing agency costs – our capacity for self-delusion. In one experiment, (Ariely 2012), subjects were asked to rate pictures that each bore a logo of one of two galleries one of which was known to be sponsoring them. Subjects consistently rated the pictures from their sponsoring gallery higher than those from the other. When asked, they confidently rejected the proposition that sponsorship affected their judgment, and brain scans showed the subjects weren’t lying; rather, knowledge of payment had stimulated pleasure areas of their brains. Anecdotal evidence, re-enforced by our follow-up discussions, suggests that agents’ belief in their own purity of purpose is matched by cynicism about that of other agents; each agent has a proclivity to see the agent immediately ‘above’ as the principal while dismissing those ‘below’ as mere rent-seekers. Our prior is that such a socially complex interlocking agency ecosystem is likely to be resilient, difficult to penetrate, and mutually supportive in resisting reforms, an alternative hypothesis being that the mix of purity and cynicism results in an effective self-regulating system.

^{xxvi} One way agents achieve this is through organisations that provide a veneer of ‘professional independence’. Meaningful discussions of agency frictions are unheard of in such organisations, except in reference to other agents. Following one talk mildly critical of agents, a well-known industry figure was warned by an equally well-known board chair to cease and desist lest he “undermine confidence in the system.”

^{xxvii} To a very modest extent asset-based fees can better align managers and clients, but that alignment is too often destroyed by diseconomies of scale. Paul Myners awarded the title of greatest innovation in financial services (at least for agents) not to the ATM, as suggested by Paul Volcker, but to the *ad valorem* fee, though the title is seriously challenged by the commitment fee. The few attempts to introduce a flat fee in combination with a well-constructed performance-based fee have failed to gain serious attention. For decades institutional investors have screamed for performance fee structures that don’t give managers a free option, structures in which managers lose money when clients do. One hedge fund aligns its portfolio managers by holding performance fees in escrow to be clawed back in the event of loss, but refuses to offer the same structure to its clients.

^{xxviii} The Cooper Inquiry, (Cooper 2010), called for a third of trustee/directors to be independent of both the union and the employer groups that appoint them, a recommendation instantly rejected by the government for agency reasons – its union base was explicit about rejecting that recommendation, as always “in members’ best interests”. Surveyed funds have on average a mere 1.1 independents. Conditional on having any independents the average is still only 1.9. The data is too small to assess whether independence makes a material difference to members’ benefits, though evidence from the women’s movement suggests that until minorities form a cohort of around a third their influence remains muted.

^{xxix} Membership in the private sector is 13%; in the public sector 43% for an average 18%. See www.abs.gov.au/ausstats/abs@.nsf/mediareleasesbytitle/9F48D6BD3EAF15FACA25742A007C0E8F?OpenDocument

^{xxx} Over the past 25 years trustees of not-for-profits deserve recognition for steering funds out of capital guaranteed and into the market, away from a huge domestic bias and into international markets, and into alternative assets such as infrastructure,

^{xxxi} Central banks and the judiciary might be used as role models for independence.