Putting the Universal Owner Hypothesis into Action:

Why large retirement funds should want to collectively increase overall market returns and what they can do about it

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The Universal Owner Hypothesis, Market Returns and Pension Fund Investment

This paper seeks to offer a perspective from two practitioners about how retirement funds could improve market returns by working together. Both authors have found the Universal Owner (UO) hypothesis a valuable starting point.[3] The UO hypothesis states that a portfolio investor benefiting from a company externalising costs might experience a reduction in overall returns due to these externalities adversely affecting other investments in the portfolio, and hence overall market return. Universal Owners (UOs) therefore have an incentive to reduce negative externalities (e.g. pollution and corruption) and increase positive externalities (e.g. from sound corporate governance and good human capital practices) across their investment portfolios. The UO hypothesis and this focus on extra-financial factors – ie factors which are likely to have at least a long-term effect on business results but which seldom get integrated into investment decisions, irrespective of whether they are part of the research process – is most relevant to large long-term investors, like the world's largest pension funds, which are heavily diversified both, internationally and across public and private markets.

Although in its formally articulated form the UO hypothesis is new, there is much overlap with the common sense understanding that many seasoned pension fund trustees and executives – from all parts of the pension fund community – have of the link between the financial well being of their members in retirement (i.e. their fund's ability to meet its liabilities) and how well the national and global economies are doing and how the indices are moving. In short, pension funds – whether they agree with the UO hypothesis or not – have a legitimate interest in the impact of externalities and other market failures on overall market returns.

The gain from the appropriate management of externalities and other market failures comes from three sources[4]:

- There is a productivity effect that sees return on capital enhanced through more efficient capital allocation.
- There is a growth effect that sees higher productivity feed through to economic growth through the reinvestment of higher corporate profits.
- There is a risk effect[5], which sees a reduction in business risk feed through to a lower cost of capital – which has associated production effects through the mobilisation of capital to productive use that would otherwise be allocated/deposited elsewhere.

[3] The hypothesis was first formulated by Robert Monks and Nell Minow, and has since been elaborated by James Hawley and Andrew Williams

[4] *Enhanced Analytics for a New Generation of Investor: How The Investment Industry Can Use Extra-Financial Factors In Investing*, James O'Loughlin and Raj Thamotheram, USS, 2006

[5] *SRI and Valuation: The Missing Link?*, Société Générale Equity Research, April 2006

These effects can be expected to raise the equilibrium levels of economic growth and return on capital to a higher level – so that the gains from incorporating extra-financial factors like externalities into investing are permanent. And, in a properly functioning financial market, these welfare gains should also be quickly factored into higher asset prices.

The World's Largest Public Pension Funds: A Timely and Unique Role

Whilst recognising the market's ability to create value, there have been several calls for fundamental reform to address welfare-destroying market failures in recent times.[6] As major players at the top of the investment 'food chain,' the world's largest public pension funds (Table 1) have a duty to take an appropriate part in this debate because:

- These funds have a strong business case for doing so (see above)
- These funds have a fiduciary (or equivalent) responsibility for the financial well-being of their members in their retirement years. For the same reasons that trustees think it appropriate to ensure the buying-power of a pension takes into account the effects of wage inflation, there is no reason for not taking into account the impact of the externalised costs of CO_2 emissions on future pensioners' living standards.
- Pension fund decision makers also have responsibility for ensuring inter-generational equity and establishing a contract that continues to attract new members, which means doing what they can to discourage the cannibalisation of the future for the benefit of the present.
- Unlike corporate pension funds, major insurance companies and large fund management firms, public pension funds do not have a conflict of interest vis-à-vis their corporate sponsor or corporate clients when trying to influence corporate behaviour.

Table 1: The Top 20 Pension/Retirement Funds Globally Are Nearly All Public Funds[7]:

Rank	Organisation	Country	Total Assets (US$bn)
1	Government Pension Investment	Japan	1,059
2	ABP	Netherlands	231

[6] Some of the most recent and best argued prescriptions for reform include: *The Battle for the Soul of Capitalism,* John Bogle, Yale University Press (2005); *The Soul of Capitalism: Opening Paths to a Moral Economy,* William Greider, Simon & Schuster (2004); *Capitalism: As If the World Matters,* Jonathon Porritt, Earthscan Publications (2005); *The Fortune at the Bottom of the Pyramid,* C K Prahalad, Wharton School Publishing (2006)

[7] The new Norwegian Government Pension Fund (the continuation of the former Petroleum Fund) will be part of this list in the future. Total assets at 31 December 2005 were NOK 1399.1bn ($207bn). TIAA-CREF ($386 bn), the retirement system for professors and employees of US colleges and universities, is also worth noting although for technical reasons it is often classified as an asset manager by most investment consultants

3	California Public Employees	US	168
4	Local Government Officials	Japan	164
5	Federal Retirement Thrift	US	141
6	National Pension	Korea	135
7	New York State Common	US	117
8	Pension Fund Association	Japan	117
9	California State Teachers	US	117
10	Postal Savings Fund	Taiwan	110
11	*General Motors*	*US*	*107*
12	Florida State Board	US	103
13	National Public Service	Japan	96
14	New York City Retirement	US	96
15	Government Employees	South Africa	87
16	Texas Teachers	US	85
17	PGGM	Netherlands	82
18	New York State Teachers	US	80
19	Public Schools Employees	Japan	76
20	Ontario Teachers	Canada	68

Top 20 Pension Funds Globally (ranked by total assets at 31 December 2004)
Source: Pension & Investments: Watson Wyatt Global 300 Survey (2005)

Opportunities To Increase Overall Market Return Through Collective Systemic Change

Complex market transformation is unlikely to be achieved by pension funds acting alone, even if they are very large. However, working collectively these large funds could have a cost-effective and profound impact, initiating changes that could increase overall market returns by transforming value-destroying parts of the system. At a very fundamental level, pension fund beneficiaries are not in competition with each other (especially if the focus is on overall market returns), nor are the vast majority of the largest pension funds in competition with each other for members. This gives pension fund decision makers an opportunity to take a lead and act together to create more value for pensioners by changing the context within which pension funds, and the investment industry that exists to serve them, work.

The existence of national pension fund trade associations can, in part at least, be thought of as initial efforts to take a leadership role and address overall market return issues collectively. These organisations have played a part, for example, in standard-setting by supporting initiatives like the Combined Code in the UK, the Conference Board’s Commission on Public Trust and Private Enterprise in the US, or the King Commission in South Africa. However, these national organisations have many diverse members and priorities competing for resources. For example, the UK National Association of Pension Funds is heavily influenced by corporate pension funds, investment consultants and fund managers, a situation which has commonality with the Council for Institutional Investors in the late 1990s.[8]

Projects like the International Corporate Governance Network or the Institute of International Finance's Working Group on Corporate Governance & Transparency, and ad-hoc groupings of pension funds coming together to take legal action to send a demonstration effect[9] are examples of similar activity at the international level.

In contrast, the innovative sector and thematic UO projects, like Pharma Futures and the Institutional Investors Group on Climate Change (IIGCC), that have developed over the last 5 years have been created by ad-hoc groupings of pension funds and others.[10] These groups have often worked under the umbrella of, or been actively coordinated by, newer trade associations or non-financial sector organisations.

The focus of the rest of this paper is on the collective opportunities large pension funds have to foster systemic change that would increase overall market returns. Looking forward, the practical goal should be to ensure that projects like Pharma Futures and IIGCC are no longer seen as innovative, but become 'business as usual' and that effective solutions are developed for addressing the predictable challenges inherent in all collaborative initiatives.[11]

Opportunity One: Pension Fund Futures - Exploring 21st Century Fiduciary Duty

Pension Fund Futures is a project in creation which would bring together pension fund trustees, executives and informed commentators.[12] They would work through the complexities of the current situation, understand the dynamics of plausible future scenarios, and build a detailed understanding of the changes required of pension funds and others. As a result the project would:

[8] CII's governance structure was reorganised 2 years ago and this has resulted in a greater focus on collaborative actions of interest to Universal Owners and less energy expended over power struggles regarding control of the agenda
[9] Improving governance by joint shareholder action: Investors await trial to assert rights on News Corp. poison pill, Keith L. Johnson and Andrew Clearfield, *Pensions & Investments,* 6th March 2006
[10] Some of the projects that the authors have direct experience of are summarised in Appendix 1
[11] The corporate sector is significantly ahead of the investment world in this regard. Recognising that left to themselves, the majority of alliances fail, well run corporations have invested in systematically improving their collaborative capacity. See for example: "Managing Alliances for Business Results", Jeff Weiss, Sara Keen, Stuart Kliman (2006) http://www.vantagepartners.com/publications/publication.cfm?id=105
[12] If a group of UO-oriented Charitable Foundations were to fund Pension Fund Futures they would probably be indirectly helping reduce some of the externalities and market failures they were set up to address. Alternatively an investment consultancy firm could take the resourcing lead, perhaps initially through a pilot project undertaken at national level. For further details please contact the authors.

- Identify the major externalities and other market failures that will impact upon the living standards of pensioners beyond 2050
- Outline effective ways in which pension funds (and/or the investment industry that serves them) could effectively address these issues
- Build commitment to change and sustained action amongst participants.

Understanding the complexity of the problem, and moving on to finding potential solutions would involve participants exploring questions like these:

- What is the economic value added from investment in different sectors once the economic consequences of externalised costs are taken into account? According to the New Economics Foundation "the huge profits reported by oil and gas companies would turn into losses if the social costs of their greenhouse gas emissions were taken into account."[13]
- What do innovative assessments of how good companies are at using resources to create 'sustainable value' tell us? The organisation responsible for a 'sustainable value' project which is funded by the EU, believes it has "developed a value-oriented methodology to assess the sustainable performance of companies … in monetary terms".[14]
- What should Universal Owners think about companies who take a proactive stance whilst others adopt a free rider perspective? What criteria should be used to decide if such action is sensible or not from the perspective of Universal Owners?
- What if a pension fund that was based in Europe were to recruit members from emerging market countries in order to manage its demographic profile. How would this impact on the fund's views about the geographic implications of externalities? For example, according to press reports, a recent UK Government study warned that "over 70 million Africans and an even greater number of farmers in the Indian subcontinent will suffer catastrophic floods, disease and famine if the rich countries of the world fail change their habits and radically cut their carbon emissions."[15]
- What would be the consequences of pension funds actively encouraging investee companies to develop strategies for tapping into low-income markets (also known as "bottom of the pyramid"[16] strategies)?

[13] http://news.bbc.co.uk/1/hi/sci/tech/4696924.stm
[14] According to their recently released study, BP – the worst UK performer of the study – costs the EU15 economy the equivalent of about £90 billion (about 10% of the UK's GDP). They also claim to have identified car manufacturers that contribute positively to Europe's sustainable performance. For further details see: http://www.advance-project.org/survey/download/index.html
[15] http://news.independent.co.uk/environment/article353476.ece
[16] *The Fortune at the Bottom of the Pyramid*, C K Prahalad, Wharton School Publishing (2006) and *Investing in the Base of the Pyramid: A Focus on Microfinance*, Dr. Ivo Knoepfel, onValues Investment Strategies & Research, An unpublished briefing paper for the Principles for Responsible Investment process

- How should a pension fund deal with a risk issue which is severe, difficult to time but highly likely to occur some time in the coming decades (e.g. pandemic influenza)? And related, what will be the environmental or social equivalent of the WorldCom, Enron, Tyco etc saga?
- Should pension funds be seen as "an insurance against risk to quality of retirement life"?[17] And what are the implications of this? For example, might this mean being concerned about the impact of externalities not only on the fund per se but on the economic interests of the beneficiaries and if so, what should fiduciary responsibility mean if this impacts differentially on older and younger beneficiaries?
- If, as some influential advocates propose,[18] there is a shift within the sector to consciously adjusting investment returns for risk, how can this be done to take into account extra-financial risk?
- What would be the impact on corporate and analyst behaviour, the allocation of capital and market returns if the major pension funds collectively decided to incentivise CEOs to aim for fair stock market value, to develop strategies to achieve robust and sustainable return on invested capital (ROIC) and to do away with earnings guidance?
- Would UO type pension funds be better off in an environment of high market volatility, significant M&A activity, bubbles and busts (ie a context which suits active managers)? Or in an environment of less volatility (where the gap between market price and fair value was reduced) and lower nominal returns? And what can pension funds do to encourage the likelihood of each environment?
- If Universal Owners took a proactive approach to supply chain management and wanted partners who really met their needs, what would their supply chain look like if they were starting from scratch? What balance would be struck between 'exit' and 'voice' in asset management? [19] Should pension funds implement some elements of this UO-friendly investment industry themselves, either in-house or collectively?[20] What would an appropriate external mandate look like?[21]
- Under what circumstances would other asset owners and managers (e.g. foundations, churches, insurance companies, passive and active mutual funds) adopt some aspects of the UO approach and which aspects will they be most attracted to?

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[17] Personal communication, Rob Bauer, Head of Research, ABP Investments
[18] *Adjusting Investment Returns for Risk: What's the Best Way?* The Ambachtsheer Letter, March 2006
[19] *Exit, Voice and Loyalty: Responses to Decline in Firms, Organisations, and States,* A O Hirschman, Harvard University Press (1970)
[20] *Peter Drucker's Pension Legacy: A Vision of What Could Be,* The Ambachtsheer Letter, November 2005
[21] *Long-Term, Long-Only Investing: A Consultation Paper* (responses by 2nd June), Marathon Club: http://www.marathonclub.co.uk/

- The governance structures that pension funds use were designed for an earlier time and very different context. What governance structure would be "fit for purpose" for a UO pension fund?

Opportunity Two: The Principles for Responsible Investment

The Principles for Responsible Investment (PRI) project provides a timely and relatively easy way for concerned pension funds to start working together in a more systematic and comprehensive manner on extra-financial factors. The potential is significant.

The PRI project was convened by the UN Secretary-General and is facilitated jointly by the UN Environment Programme and the UN Global Compact who operate as PRI's secretariat. Its big picture goal is to identify and act on the common ground between the long-term objectives of institutional investors and the sustainable development objectives of the UN by creating an investment network that is squarely focused on improving the integration of extra-financial issues into investment processes.

The project has now developed a set of Principles for Responsible Investment which can be adopted by asset owners, investment managers and other professional service providers (e.g. investment consultants and sell side research organisations). As an initiative led by asset owners, this focus on professional partners – who have very considerable influence in their own right – could be a highly significant factor in defining how the investment supply chain chooses to relate to this debate. For example, investment consultants play a key gate-keeper function in many markets (the US and UK in particular). Generalising about the past, they have tended to see these issues as ones which are either of interest to a minority of clients (ie those with strong or 'atypical' values) and or about the investment styles of niche (ie SRI or Corporate Governance) fund managers. By signing the PRI – which asks for CEO level sign off and a commitment on behalf of the whole organisation, not just an environmental, social and governance (ESG) or socially responsible investment (SRI) product or practice – all signatories would be embarking on a path to mainstream their commitment to this agenda. Sell side brokers are similarly powerful actors and potential future signatories.

The Principles, which were launched in late April by the UN Secretary General, are the result of investor and expert working group meetings held in the US and Europe over the last year or so.[22] The investors who announced their membership in the first week of the project collectively account for approximately $4 trillion (with some double counting since this includes both asset owners and

[22] For further details see www.unpri.org on or after 27th April 2006

investment managers) and there will be an immediate active recruitment phase to gain additional signatories.

The Principles represent a commitment to a voluntary process for integrating an important subset of extra-financial issues – namely ESG issues – into investment and governance decisions, and an on-going commitment to evaluate their implementation of the Principles.

PRI has enormous potential to interact positively with the other opportunities listed in this paper. For example, some of the large pension fund signatories to PRI could be an ideal core group for the Pension Fund Futures project (above). This, in turn, could lead to further development of the Principles over time.

With a high profile launch in the USA and Europe, the project has got off to a strong start. The long-term success of the PRI initiative will be defined by how effectively it performs in some key areas including:

- Expanding the focus beyond traditionally defined ESG issues to include other extra-financial factors which are often mis-priced by the market, such as innovation and mergers & acquisitions. Innovation is increasingly accepted to be a critical factor in defining how quickly the corporate sector will adapt to the sustainability challenge.[23] And many M&As would seem to be value destroying[24] and are also well known to have serious consequences for employee well-being.[25]
- Moving beyond process commitments to undertake joint action and in this, developing a process for prioritisation that has high credibility for intellectual rigour and absence of political or other influence.
- Supporting existing projects that have some track record in being part of the solution – eg giving mandates which encourage long-termism (eg the Marathon Club) or creating a business case for sell side research to address extra-financial factors (eg the Enhanced Analytics Initiative).
- Developing a governance structure and culture which clearly reflects institutional investors' interests whilst also retaining the valuable connection with the UN and through it, the vast range of stakeholders who have an understandable interest in PRI.

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[23] Natural Capitalism: Creating the Next Industrial Revolution, Paul Hawken, Amory B. Lovins and L. Hunter Lovins, Back Bay Books (2000)

[24] For a review of the UK experience, see: *Do Takeovers Create Value? A Residual Income Approach on UK Data*, Magnus Bild, Andy Cosh, Paul Guest and Mikael Runsten, ESRC Centre for Business Research, University of Cambridge Working Paper No 252. For a review of US experience, see: Robert Bruner, Does M&A Pay? A Survey of Evidence for the Decision-Maker, Journal of Applied Finance, Spring/Summer 2002, 48-68

[25] Responsible Restructuring: Creative and Profitable Alternatives to Layoffs, Wayne F. Cascio, Berrett-Koehler (2002)

- Motivating members to adopt a "continuous improvement" approach, learning from and benchmarking against peers whilst being able, if needed, to deal with the few members who may sign up but then – for whatever reason and despite all good efforts – fall well behind their peers.

Opportunity Three: Amplifying Signals to Investee Companies Through Collective Action

Well informed commentators have wondered if it is actually possible to change the way the investment supply chain works and re-orientate it towards the long term needs of its clients.[26] It is symbolic that at a time when there are near record levels of pension fund deficits, the profits from proprietary trading – transactions made by a securities firm that affect the firm's account but not the accounts of its clients – have never been higher. Whether as some critics argue, investment banks are using the huge information advantage they have as market makers to profit at the expense of their customers is a debate that is only just starting.[27] The good news is that there has been more high level attention focused on the problem of weak alignment of interests over the last five years than at any other time since the 1980s. Some of the projects and organisations which have had or which can be expected to have a significant impact include: the Myners Review;[28] a competition (sponsored by USS and Hewitt Associate) which was, somewhat provocatively, entitled "managing pension funds as if the long term really did matter"; the Marathon Club;[29] the Conference Board;[30] the Trades Union Congress;[31] McKinsey & Co;[32] and the International Centre for Pensions Management.[33]

Success should, however, not be assumed given the influence of the supply chain.[34] Asset owners who want to create an investment supply chain that is more aligned with the long-term interests of their end beneficiaries will need to face up to some challenging decisions. Making the interventions in the investment system that will have the maximum positive impact over the next decade calls for asset owners and their investment advisers to undertake a steep learning curve and above all, to collaborate far more effectively than they have to-date. Fortunately they are able to draw on relevant lessons from projects described in this paper and also from the corporate sector, where considerable effort has gone into understanding the principles and practices which make for good supply chain management. We suggest a triple focus to amplify signals to investee companies: firstly, in direct engagement with

[26] *Eradicating 'Beauty Contest' Investing: What Will It Take?,* The Ambachtsheer Letter, October 2005
[27] Goldman's Lustrous Quarter, Mathew Goldstein, TheStreet.com, 14 March 2006
[28] http://www.hm-treasury.gov.uk/documents/financial_services/securities_and_investments/fin_sec_mynfinal.cfm
[29] www.marathonclub.co.uk
[30] *Revisiting Stock Market Short-Termism,* Matteo Tonello, The Conference Board, 2006
[31] http://www.tuc.org.uk/pensions/tuc-11565-f0.cfm
[32] Building the Healthy Corporation, Richard Dobbs, Keith Leslie & Lenny Mendonca, The McKinsey Quarterly 2005 Number 3
[33] http://www.rotman.utoronto.ca/icpm/
[34] *Alpha, Beta, Bafflegab: Investment Theory as Marketing Strategy*, The Ambachtsheer Letter, April 2006

corporates with regard to their reporting of extra-financials; secondly, through the sell side research process, and thirdly, from that part of the fund management industry where long-term holdings and overall market returns is the basis of the investment product (i.e. passive fund management). The Pensions Futures project may also suggest other areas for intervention, not least for how fund managers who want to better align with the interests of UO asset owners.[35]

A) Encouraging Better Corporate Monitoring, Management and Reporting of Extra-Financials

Investors have more than reasonable grounds to be concerned about the general capacity of corporate management with regards to material extra-financial drivers of risk and reward. According to Deloitte, more than 90% of corporate managers confirm that extra-financial factors are either critical or important drivers of success.[36] Nevertheless, 40% of these managers rate themselves as being average at measuring and monitoring these factors, with 23% describing their ability to do this as being only fair or poor. In a parallel study, McKinsey & Co found that more than 50% of directors admitted to having a limited sense of their company's prospects over the next 5-10 years and only 4% said they fully understood their company's long-term prospects.[37]

Institutional investors could play an important role in addressing this challenge by encouraging national and international regulators and standard setting bodies (eg International Accounting Standards Board) to push forward the reporting agenda on extra-financials. Encouragingly, several asset owners and even some investment managers have risen to this challenge[38] but a much larger and more influential investor alliance is needed. Fortunately, there seems little reason for well-diversified and long-term institutional investors *not* to want to support such work, not least given the support that has been expressed by several corporates and many accounting bodies.[39] In parallel, some investors could also set useful precedents by making reporting reform a requirement in companies where shareholder value has been destroyed and weak corporate governance is implicated. Use of class action suits – or similarly 'muscular' engagement strategies where class actions are not possible – to achieve corporate governance changes at such companies is now well established. Adding better reporting to the list of required changes would simply mean extending this established principle.

To be effective when advocating this change, asset owners will need to accept that – as currently incentivised at least – passive fund managers have no major business interest in the general quality of

[35] It is noteworthy that some of the projects outlined in Appendix 1 have not been as widely supported by specialist SRI and corporate governance fund managers as one might expect.
[36] *In the Dark: What boards and executives don't know about the health of their business*, Deloitte LLP and the Economist Intelligence Unit, 2004.
[37] *The view from the boardroom: a McKinsey survey of directors shows that they're tired of playing defense*, Robert F. Felton and Pamela Keenan Fritz, 2005 special edition: Value and performance, McKinsey Quarterly
[38] http://www.tomorrowscompany.com/news.aspx#newsitem9
[39] www.iasb.org/current/comment_letters.asp?showPageContent=no&xml=16_230_79_24022006.htm

reporting on extra-financials and *all* active managers (including in-house managers) believe weak corporate transparency and market inefficiency favours them, which is clearly impossible. But even if there was a fund manager was more capable and had a competitive advantage with less disclosure, the beneficiaries and the plan sponsors – who are universal owners – are likely to be disadvantaged across their entire fund portfolio by a few managers who seek a regime that favours their own business plans over the interests of the Universal Owner who is likely to benefit, in overall terms, from better disclosure. This is one of many examples where the trustees and senior executives, as Universal Owners, must be careful to distinguish their beneficiaries' interests from those of their investment managers and be assertive in their response.

B) Sell Side Research and its Knock-On Impact on Buy Side and Corporate Behaviour

The Enhanced Analytics Initiative (EAI) is designed to amplify the market signals that long-term investors send to the sell-side researchers at investment banks and independent houses about the kind of research that is wanted. This in turn changes the conversations sell-side analysts have with the companies they cover.[40] Moving beyond those who simply complain about the backward looking, narrowly focused and 'me-too' characteristics of much sell side research – research which is effectively paid for by the asset owner client and which investment managers therefore do not really have to assess in terms of 'value for money' – EAI members agree to allocate a minimum of 5% of their commissions to those sell-side firms that are providing the buy-side with information that genuinely meets their long-term investing needs by effectively covering extra-financial factors and influencing corporate behaviour in these areas. As explained above, extra-financial factors are those fundamentals that have the potential to impact companies' financial performance in a material way and which are not generally captured in investment decisions. These factors tend to be of a medium- to long-term nature, the timing of their impact is often difficult to predict, and they are frequently difficult to quantify, at least at the start of efforts to do so. The term includes ESG issues but also covers other issues such as M&A, innovation and quality of auditing/accounting.

The co-ordinated "pull" signal from 16 members (both asset owners and fund managers) who, between them, manage nearly $1 trillion, has already had a significant impact on the sell side community. The number of research providers producing relevant extra-financial analysis increased from 17 to 31 in the 12 months following the December 2004 Baseline Evaluation. In the same period there has been an increase of 500% in the number of reports qualifying for evaluation.[41]

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[40] *Is the sell-side going soft?*, Philip Coggan, Real IR, 12 Nov 2004
[41] http://www.enhanced-analytics.com/

The project is also reinforcing the early awareness amongst mainstream buy-side analysts that there is value in understanding these extra-financial dimensions of corporate performance.[42] The main benefit of this process is not that such information gives buy side analysts a simple informational edge, although this can happen. Rather it helps an active fund manager secure a more sustainable advantage that comes from his or her ability to put marginal pieces of information into context with other information to reach novel conclusions and so operate as a genuine active manager. Coming from credible and trusted sources, such research helps portfolio managers make defensible decisions, develop mental models that allow them to think differently from the market and avoid the fixation with earning information and other behavioural characteristic that feature so prominently in active management as widely practised today.[43]

According to some well-informed critics, the sell side displays a “dedicated blindness to capital's collateral consequences, an indifference to the future of society even as they search for the future's returns.”[44] To the extent that this assessment is true, EAI is also evidence that the sell side can be influenced by simple market mechanisms to change the nature of the conversations mainstream analysts have with companies. EAI has been effective because some investment managers have overcome the inertia that blocks changes to the way commission is paid. In that sense, EAI is also a proxy indicator of good management within the investment manager – without appropriate leadership and a management culture that is attuned to the interests of the end beneficiaries, a fund manager may well choose not to join the initiative until client pressure makes joining a necessity.[45]

C) Collectively Addressing the Long Term Risks of Passive Fund Management

Many pension funds now have an index-tracking core, and low margins and economies of scale mean that this market is served by only a few large fund management firms. For example, Barclays Global Investors and State Street Global are now the third and fourth largest fund managers in the world with a total of over $1.7tn assets under management.[46]

This global, and similar national, concentration creates an important opportunity for the largest pension funds to require these firms to *jointly* fund permanent national or regional teams that focus on enhancing long-term market returns through carefully targeted shareholder activism undertaken on behalf of all their clients. The largest pension funds would play a key role in the governance of these

[42] O’Loughlin and Thamotheram
[43] Seven Sins of Fund Management: A Behavioural Critique, James Montier, DrKW, November 2005
[44] Greider
[45] *Diluted SRI*, John Plender, Financial Times, 24 October 2005; *Raising the Performance Bar: Challenges facing Global Investment Management in the 2000s*, Amin Rajan, Barbara Martin, David Ledster & Neil Fatharly, KPMG & Create, 2004
[46] Pensions & Investments / Watson Wyatt: World 500 (ranked by assets at 31 Dec 2004)

teams, which would probably be staffed by those people who are already engaging on behalf of long-term investors in their national markets.

The permanent teams would focus on a combination of key issues and/or key sectors where value-destroying market failure is evident today or likely in the future. Pharma Futures is a good example of the kind of work that could be undertaken. Similarly, the work initiated by the Extractive Industry Transparency Initiative (EITI) could be rolled out to cover other "at risk" sectors (eg construction). Or owners may choose to engage with some car manufacturers to explore why they are feel justified to use lobbying and legal strategies to block regulations for "cleaner cars" when other car manufacturers are able to meet these standards.[47]

The permanent nature of the teams would mean that the ongoing or intermittent interventions that are so often required during long-term sector transformations would be possible. The staff would be significantly freed from the marketing and reporting pressures and also the conflicts of interest inherent in their current corporate reporting lines. This would create the context for both healthier, but also more assertive (when needed), relationships with corporations. It is also likely to be a more cost effective solution.

The teams' analysis would be widely available and would provide important indicators of which extra-financial issues should have been integrated into company valuations by mainstream analysts. This information could then be used by the largest pension funds to send signals through the active fund management market. It would also be useful to the investment consultants who assess and the research teams who serve these managers and as identified earlier, both are major players in their own rights.

One option would be to combine these teams with an existing national or regional body and there are good possibilities here in several countries (e.g. Australian Council of Super Investors[48], Canadian Coalition for Good Governance[49], Council for Institutional Investors in the USA[50] or Eumedion[51]). In any case, the basic principle would be that a critical mass of pension funds investing passively in a given market would jointly agree that they wanted this shared function and would approach their passive managers to discuss and assess various options. The Swiss fund Ethos, whilst not linked to passive fund managers, is a promising example of how pension funds can combine to create a

[47] http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2004/dec/greenhouse.xml
[48] http://www.acsi.org.au/
[49] http://www.ccgg.ca/web/ccgg.nsf/web/ccgghome
[50] http://www.cii.org/
[51] http://www.eumedion.nl/English

dedicated unit that is now highly influential in that market. It is noteworthy that although small in size, Ethos has also been actively involved in many joint engagement projects outside Switzerland.[52]

Of course, passive fund managers would be free to choose not to participate. Similarly, pension funds would be free to choose not to use such a fund manager in the future and this loss of market share would soon send signals that would be hard to ignore.

PRI signatories could, either formally or informally, take a lead in incentivising their favoured passive firms to help underwrite this means of addressing the long-term collective risks of passive investment. The teams would add a 'voice' strategy to passive fund management, that is complementary to the 'exit' strategy inherent in active fund management.

Opportunity Four: Legitimacy through Consultation And Organisational Learning

John Bogle refers to pension funds as ineffective 800lb gorillas, because they often lack – or feel they lack – the legitimacy needed to use their influence with confidence.[53] Some of the opportunities above are designed to enhance legitimacy, but this could be further strengthened by involving pension fund members in an appropriate manner in strategic decision making, and embedding organisational learning.

The typical pension fund member is far removed from the investment and governance decision-making that happens on his or her behalf. Many of them are unaware of the potential influence the largest funds could have on the way the global economy develops, and how this could influence both their quality of life in retirement and the future their grandchildren inherit. Members who are aware of this are understandably daunted about how best to encourage their fund to act.

On the other hand, pension funds have understandable concerns about being co-opted by vocal minorities and campaigners who typically encourage members to focus on issues which often have more to do with NGO and political campaigns than priorities for institutional investors.[54] Whilst these concerns are real, if pension funds are going to play a more systematic and inevitably higher profile role in improving overall market returns, it will be important for them to address member-based

[52] http://www.ethosfund.ch/e/ethos-foundation/ethos-foundation.asp
[53] *The Battle for the Soul of Capitalism,* John Bogle, Yale University Press (2005)
[54] Whilst this has often been the preserve of the green and political left, there are several recent cases where right wing groups have also sought to advance their political agendas by influencing institutional investors to engage with particular companies or countries. Concerns about union and corporate capture of public sector funds, through appointment of union or business-friendly trustees, is also relevant here.

legitimacy issues in a way that avoids political capture, safeguards professional judgement and ensures that fiduciary oversight is retained.

There are many ways that these sensitive issues can be addressed in a balanced manner. And as experience and confidence grows, one could expect an evolution to progressively higher levels of member involvement. One option that might be suited in the near term would be for pension fund members, along with other stakeholders (see below), to be encouraged to suggest – or to respond to suggestions of – potential priority issues for shareholder activism. Qualitative market research would have a role to play – to ensure the voice of the silent majority was heard – as would questionnaires. After analysis by the permanent teams above, the governance structures that had oversight responsibility for these teams could choose between a short-list of priority areas that focus on long-term wealth creation. The reasons why the issues were on the short-list would be made public, as well as the reasons why any ideas were rejected and, of course, the reasons for the final choice. Over the longer term mechanisms like decision markets could be used to test priorities.[55]

A potential additional benefit of the above process might be more members holding their pension funds to account against their published priorities and commitments. It is noteworthy that many pension funds believe there to be a premium for corporations who have active owners and there is no reason why the same could not apply for pension funds themselves. This would have the added benefit of addressing the widespread concern that governance improvements are needed in the pension fund sector.[56] As noted above, a pragmatic and evolutionary approach to greater transparency (about the drivers of risk and reward for the pension fund itself) and similarly to greater member involvement will be important.

A key factor in defining whether 'reasonable' members[57] of pension funds show trust in the professionals who act on their behalf will be how well these funds manage the reality that the interventions outlined above are designed to deliver long-term benefit. Even if it were possible to measure the effectiveness of an intervention with certainty, this could only be done years, possibly decades after the intervention had been made and even then, it is unlikely that a pure causal connection could be made. What is possible is to actively reflect on current practice in this new area

[55] *The Wisdom of Crowds: Why the many are smarter than the few*, James Surowiecki, Abacus (2005)

[56] "Ambachtsheer slams pension fund governance", IPE.com 25 May 2004. And as noted by a spokesman for the World Economic Forum in their report *Mainstream Responsible Investment*, "A particular problem is that most pension funds fail to meet the bedrock governance standards they increasingly demand of companies, and trustees are often poorly equipped for their duties."
http://www.weforum.org/site/homepublic.nsf/Content/New+report+investigates+why+socially+responsible+investment+has+yet+to+be+embraced+by+the+mainstream+financial+community

[57] As with "investors", not all "members" are the same. Particular attention should therefore be paid to *man on the Clapham omnibus* - a descriptive formulation coined by a British judge in 1903 to describe a reasonably educated and intelligent but non-specialist person.

of promoting market returns and keeping abreast of new theoretical or practical developments, and, when necessary, alter future practice – ie a learning by doing approach.

For example, the permanent shareholder activism teams mentioned above could work with external facilitators to embed a 'plan, do, review' cycle into their work. As both priority setting and implementation will be important to the teams' success, both these aspects will need to be reviewed regularly. To avoid co-option the facilitators would need to be changed periodically. An alternative to using external facilitators would be rotating peer review, involving other teams with similar roles in related fields or other regions.

As some priority areas will require significant effort over a lengthy period, it will be important to ensure that the priority setting process itself is particularly robust and the work of academic specialists could be particularly important.[58] Poor prioritisation processes could lead to the wrong priorities being chosen or insufficient commitment to long-term projects amongst key stakeholders. For example, the role of the pension funds in the governance of the shareholder activism teams will be important, and a link between governance and implementation could be achieved through secondments of pension staff to particular projects. Priority setting would also be enhanced by seeking the views of enlightened leaders from the corporate sector and those who can bring the legitimate expectations of other stakeholders to the table[59], and again over the longer term decision markets could be used.

During project implementation balancing the tensions of short term accountability and associated performance measurement with long-term objectives will be important. Short-term objectives will need to be derived from the long-term goals, rather than being based on what is easy to monitor and measure today. Above all, the retirement funds involved will need to take a proactive and robust approach to communication. Their focus should be on the majority of members who can be assumed to be 'reasonable' whilst remembering that some members, by definition, will not be.

[58] The Swedish Foundation Mistra is providing an early example of what such engagement with academics might achieve. For further details see: http://www.mistra.org/mistra/english/researchresults/researchprogrammes/activeprogrammes/sustainableinvestment.4.58b55df710900f8463c800020966.html

[59] Export credit agencies in the UK and Canada have some experience of how such multi-stakeholder committees can interface with senior civil servants. This in turn builds on considerable experience within the corporate sector of the value of such committees and what constitutes "good practice".

The Way Forward

Despite much human progress in the twentieth century there is growing evidence of environmental risk[60] and societal polarisation[61] that could jeopardise the quality of life of future, perhaps even current pensioners. Political leaders around the world seem united in advocating the same solution, which is 'more of the same', based on technological innovation, GDP growth through greater consumer activity in free markets, and electoral democracy. Each of these has brought much benefit but there are growing questions about the long-term prospects from globalisation, at least as currently configured. To quote from the Tällberg Forum, "Is *Globalisation* sustainable? Can *sustainability* be globalised? Is *Democracy* sustainable? Can *Prosperity* be globalised? Can our intensely interconnected globe remain worlds apart?"[62]

These questions – and most importantly, their practical implications – are not yet explicit board level agenda items for many asset owners. Yet the case for more rigorous leadership attention is a strong one, given the time frame of liabilities and the evidence that large asset owners can, when acting together, be an important part of the solution. Through seizing the opportunities described above, the world's largest public pension funds can expect to encourage greater market efficiency (in particular allocative efficiency) and also greater alignment between how economies operate and the broader interests of society. Whilst each opportunity offers good scope for progress, it is when they are combined over time that end beneficiaries will see greatest value added.

The projects described are individually doable. They have either started, are in the process of being launched, or important prototypes exist. Decision makers looking for one initial action to sign-off at their next board meeting could either focus on joining PRI (not least in order to help crystallise the leadership group needed for Pension Fund Futures) or sign-up to EAI (to catalyse a change in sell-side analysis and active fund management). Those asset owners who have already made a commitment to being active owners and who make use of passive investing strategies could, in addition, start to explore options within their region for how they can act together to significantly reduce the costs of risks associated with passive fund management.

Whether all the opportunities above are brought into creative and productive synergy over the coming years cannot be predicted. "All" that is required to start the process is for the decision-makers of the largest retirement funds around the world to start to embrace the opportunities that exist today to increase overall market returns, safeguard or improve the quality of life of pensioners, and so maintain

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[60] *Collapse: How Societies Choose to Fail or Succeed*, Jared Diamond, Viking Adult (2004)
[61] *World on Fire: How Exporting Free Market Democracy Breeds Ethnic Hatred and Global Instability,* Amy Chua, Anchor (2004)
[62] How on earth can we live together: Getting Serious, Tällberg Forum, 2006

the inter-generational contract which is at the heart of the pension fund system. In the words of the noted American anthropologist, Margaret Mead: "Never doubt that a small group of thoughtful, committed people can change the world. Indeed, it is the only thing that ever has".

Appendix 1

Name of Project	*Theme and/or Sector*	*Key Collaborating Organisations*	*Host / Co-ordinating Group*	*Successes / Strengths*	*Challenges / Weaknesses*
OFR type reporting by UK corporations *(after Finance Minister, Gordon Brown, abolished the UK government's OFR initiative)* www.tomorrowscompany.com/	Transparency	Sustainability, Tomorrow's Company & USS plus key individuals	Same	• Provided leadership and demonstrated the possibility of an effective option which was neither mandatory over-prescriptiveness nor laissez faire voluntarism • Several major financial sector players in the UK (incl. Aberdeen, EIRIS, Henderson, Insight, Investec, Jupiter, Morley, RailPen, UKSIF) chose to support the approach • Engaged major non-UK players (incl. British Columbia, Calvert, KLD, Eurosif, UniSuper), indicating that there could be international investor support for a 'race to the top' in reporting • Follow on project with regards the IASB's Management Commentary gained significant international support including CalPERS, Australian Super Funds	• Several fund managers who had previously supported OFR failed to support this initiative • Mainstream UK investor trade associations failed to support this initiative
Carbon Disclosure Project (CDP) www.cdproject.net/	Climate change and carbon exposure	210+ institutional investors, inc. pension funds and asset managers	CDP Secretariat (7 people) with foundation support, government grants and investor finance	• Largest ever collaborative project with AUM of $31 trillion (approximately 10% double counting) • Raised profile of climate change as an investor issue • Encouraged better and more disclosure of carbon and climate change by FT500 corporates and as a result, more active corporate management of risks	• Focus is limited to corporate disclosure (eg engagement with non disclosers is low key) • Scope of activities limited by mandate from investor to encouraging disclosure • Uncertain whether/how analysts are actually using the information in absence of material taxation / regulation of GHG emissions.

Enhanced Analytics Initiative (EAI) www.enhanced-analytics.com	Integrated financial and extra-financial analysis by sell side	BNP Paribas Generation, Mistra, PGGM, RCM/dit/dbi & USS (these founder members have since been joined by 10 others (incl ABP, Hermes, SNS Reaal, Sogeposte)	Consultants (onValues & Capital MS&L) with support in year 1 from USS	• Raised awareness about the lack of sell side commentary on 'extra-financials' and the consequences on both companies and buy-side • Significant positive impact on brokers (x4 increase in relevant output and x3 increase in number of brokers within first year of project) Do these numbers agree with those in the text? • Helped to create a climate in favour of unbundling • Asset owners and fund managers both gain from working together • Some investment thought leaders have backed the project	• Many fund managers who have an SRI profile have not yet joined • Leadership is needed to change commission allocation and overcome the 'political' obstacles to membership • EAI members face the same challenge to engage the mainstream buy-side as do other fund managers • North American membership got off to a slow start but this was addressed in March 2006 when Calvert & CPP
Extractive Industries Transparency Initiative (EITI) www.eitransparency.org/	Transparency in allocations of financial resources generated by the extractives sectors	Institutional investors (initiated & led by F&C), companies and countries	EITI Secretariat, based at DFID	• Encouraged corporates to begin to disclose fees paid in licensing, taxes etc • Encouraged governments, many of which were not known for their openness, to begin the path to greater transparency in extractives income.	• Actual transparency improvements are slow • Weak involvement of companies from some countries (eg USA, many emerging market countries) • Level of ownership by & active involvement of investors other than F&C is unclear
Institutional Investors Group on Climate Change (IIGCC) www.iigcc.org	Climate Change Inc. workstreams focusing on specific sectors, e.g. Aviation, Construction & stakeholders (eg trustee training, public policy)	Now >25 asset owners and fund managers from the UK, France, Switzerland.	Now part of the Climate Group (previously support from USS and secretariat support provided by UKSIF in exchange for a quarterly fee)	• Large and enduring membership base established, leading to permanent staffing • Delivery through multiple workstreams focusing on public policy, corporate engagement and trustee education etc • Effective collaboration with some investment consultants and others	• Difficulties encountered in setting priorities across a diverse membership base with different geographical foci and missions • Some concern about the profile of the IIGCC entity vs. the profile of the members • Difficulties in maintaining leadership/cohesive drive and mobilising resources
Pharma Futures www.pharmafutures.org	Pharma	ABP, OPERs & USS	UKSIF's Just Pensions Programme	• Demonstrated that without a business model shift, substantial improvements in corporate responsibility were unlikely • Demonstrated that a business model change was likely • Involved key players not normally engaged in these discussions (e.g. board execs, mainstream buy & sell-side analysts) in a constructive and innovative dialogue	• Phase 2 of project (the implementation phase) has been delayed in part due to dilemma of finding individual organisations to support a project which has a strong public good dimension • Engaging the support of other pension funds & fund managers has proven difficult