THE BRANDES INSTITUTE

Managing Pension Fund Assets as if the Long Term Really Did Matter

(Excerpt from the submission by the Brandes Institute to the 2003 competition sponsored by Hewitt Bacon & Woodrow and the Universities Superannuation Scheme Limited)

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Background: The Competition

During the summer of 2003, a competition was announced by leading financial organizations in North America and Europe to stimulate discussion of issues of long-term relevance for pension funds. The sponsoring organizations included Hewitt Bacon & Woodrow, and the Universities Superannuation Scheme Limited.

Entrants were asked to submit proposals for a hypothetical asset management mandate from a consortium of institutions. The hypothetical mandate is being awarded on the assumption that existing structures in the asset management industry are not as effective as they could be in meeting the long term goals of pension plans: hence the title "Managing Pension Fund Assets as if the Long Term Really Did Matter."

In particular, contestants were asked to submit proposals that addressed the issues of:

- Managing the business dilemmas related to a time horizon of at least 20 years
- Incentivizing companies that act responsibly and encouraging others to move towards good practice standards

The idea behind the competition was to stimulate intellectual and professional creativity, with a view to improving the way that the pension industry meets its long-term needs.

The following essay is based on the entry submitted by the Brandes Institute to this competition. The Institute's full submission has been edited for ease of reading by omitting the sections dealing with mandatory requirements and manager descriptions required by the hypothetical consortium, so this edited version focuses on the ideas intended to stimulate discussion.

We believe that the intent behind the competition is to raise awareness of important issues, and to provoke thoughtful review of current practices. As such, the Institute's entry should be considered only as a discussion paper. It does not set out the views or recommendations of Brandes Investment Partners®.

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SCOPE OF PROBLEM

In general, institutional investment management firms should have two objectives in working with retirement fund clients. The first goal is to achieve sufficient returns on assets to meet the long-term liability stream. The second goal is to achieve this result while exercising fiduciary responsibilities on behalf of the ultimate beneficiaries, both in the narrower financial perspective and in a broader social context.

This is a business populated with intelligent, experienced, and well-trained professionals. Why then does it appear so difficult to meet these goals?

We believe the core problem is that key retirement plan relationships are based on an adversarial structure and process that rely on focused and limited roles for each money manager (e.g. "do just this, but do it well"). Our proposed solution is to restructure the relationship (plan sponsor/consultant/money manager) on a cooperative basis, with shared objectives at the "big picture" level.

Thus we do *not* think the problem is:

- inadequately trained or inexperienced professionals (plan sponsors, consultants, or money managers)
- a lack of process consistency at plan sponsors or at money managers
- excessive compensation, poor motivation, or personnel turnover (although each of these may impact implementation)

We believe the current structure and process are hampered by *compartmentalization*. By this we mean that the roles of each organization, team, or individual in the process are carefully delineated, and then "compartmentalized," so that each knows exactly what is required within certain prescribed boundaries. Incentives are provided to achieve specific results within the compartment, and input or actions from outside the compartment generally are not solicited (or may be actively discouraged).

The practical impact is that while the client institution is using a large number of well-paid investment professionals in various specialist functions, remarkably few are involved in establishing the long-term financial goals of the client. Likewise, the task of ensuring effective implementation of fiduciary responsibilities is generally confined to a select few. We see no structure in place to involve and empower investment managers to contribute meaningfully in helping the client with either of these responsibilities.

We should note that compartmentalized structures can be very effective in the right context. Good examples are government entities, corporate conglomerates, and the military. In these structures, each unit or individual needs to be very clear on the required role and immediate goals, and do the utmost to achieve those goals while not deviating from an agreed plan. Strategy decisions are made at the top and communicated through the ranks.

Managing Pension Fund Assets *continued*

The structure of the pension fund industry developed as an offshoot of government and corporate organization processes – and appears to have implicitly assumed that compartmentalization is the model to follow.

What are the results?

Compartmentalization of the return goal

Sponsors and consultants take the entire responsibility for allocation of assets in the context of their liability structure. Investment managers are generally not consulted or involved in that decision, and there appears to be little opportunity for them to contribute their ideas "gratuitously."

Investment managers tend to focus primarily on performance targets, as set by the sponsor. While ostensibly these are couched in a long-term context (five years or a full market cycle), practical business implications place an emphasis on a one- to three-year horizon, or even shorter. Thus a significant amount of the managers' energy is focused on retaining or increasing their asset bases given the "rules" set by their contracts.

In turn, a substantial amount of the sponsors' and consultants' effort goes into monitoring/modifying the managers in each compartment, knowing that the managers are motivated only within that context.

In summary, compartmentalization in the quest for returns means that significant intellectual energy is expended internally by sponsors in maintaining, or by managers in "beating," the process, instead of being harnessed cooperatively toward the client's long-term goals.

Compartmentalization of the responsibility goal

Sponsors are responsible for defining the fiduciary positioning of their funds. Where this is specific (for example, restrictions on industries such as armaments or tobacco, or on countries due to human rights concerns), the manager's role is to implement within their "compartment." More powerful, however, are the broader statements of preferred fiduciary behavior that influence the managements of portfolio companies to act responsibly. We note that there is still much debate in the industry over the content and scope of such statements.

Compartmentalization, however, means that few sponsors, and even fewer managers, work together to develop and implement fiduciary policies. In the United States, for example, legal and regulatory constraints actively *discourage* such discussions.

In contrast to achieving return goals, where cooperation would be *beneficial,* we believe cooperation is *essential* in developing an effective shareholder responsibility process. The ultimate sanction is the shareholder vote. Much has been written on the passivity of individual and institutional investors and the difficulty and cost of voting against an entrenched management position. Because of compartmentalization, the voices of institutional investors have been "divided," and hence so far, mostly "conquered" by corporate management.

We believe that an important differentiation between commercial and fiduciary issues makes the situation clearer. In commercial issues involving personnel and business decisions by a company, shareholders can (and do) have very different opinions. However, for fiduciary issues, involving the

standards, ethics, and processes by which business is conducted, there may be greater unanimity among institutional shareholders. However, the compartmentalization of the institutional voting process makes it hard to make that collective opinion heard. In the following section, we propose a solution to this problem.

PROPOSED SOLUTION

Compartmentalization of the Return Goal

We noted earlier the analogy with a military force in the way that many retirement plan structures function. To illustrate a solution, we will use another analogy.

We look at the coach of a professional sports team, explaining to the team's management that success is best achieved by strict adherence to the following principles:

- Each player is carefully selected for being the best at his specific skills and position.
- To maintain their focus, players may not communicate with each other during practices or games, or discuss anything with the coach besides their own performance.
- There are no "win bonuses" for the team, but individual players may be awarded bonuses for their own good performance, even if the team loses.
- To provide motivation, any player not performing to the coach's expectations during a game may be substituted – and will only receive salary for the portion of the game actually played.

The team management understands the merits of this approach, but questions why, with such a bunch of talented, focused, and well-paid players, they are losing every game and their best players are looking to be traded away!

Our approach to the "team's" problem is not to fire good players, but to change the entire process so that all participants share an overall goal and are motivated to work together. This appears obvious in our sports analogy, but is exactly the *opposite* of the traditional approach to pension fund management.

Our proposal is to change the consortium's structure and address the limitations of compartmentalization as follows:

- Create an Investment Council for the consortium, with participation by sponsors, consultants, and managers.
- Change the relationship with all managers to emphasize their role in meeting long-term goals of the consortium.
- Create a Research Institute, providing a focus for managers and consultant to work together on common goals and ideas to benefit the consortium.
- Delegate to the consultant the fiduciary role of deciding whether a manager has significantly modified its organization or investment management process.

1. The Investment Council

This body would meet quarterly and provide a forum to discuss the longer-term goals of the consortium, to make sure managers knew how best they could contribute, and to raise/discuss ideas that might improve the consortium's ability to meet those goals. It would *not* review recent market developments, market outlook, or manager performance.

2. Revised Manager Relationships

All manager contracts would be for a minimum of five years, with prior termination possible only on "non-performance" criteria (see #4). A transition period using shorter, staggered mandates would avoid all manager contract reviews occurring simultaneously. Ideally, approximately a quarter of the consortium's mandates would be reviewed/renewed every two years.

3. Research Institute

We propose you fund a research unit, with two to four staff members, to pursue projects of a longer-term nature that may benefit the consortium, or the industry in general. Such projects may relate to the investment markets and asset classes, the relationship between assets and liabilities, the exercise of fiduciary responsibility, corporate governance, or other relevant topics. The Institute would work in conjunction with the consortium's managers and consultants, drawing on their personnel and resources as necessary – and fostering a stronger collaborative atmosphere between managers, and between managers and consultant.

4. Consultant Fiduciary Role

During their mandate, managers would be considered for termination only if they changed their team or approach. The consultant will monitor all managers and request a board review if any of these four criteria occur:

- philosophy or process change
- personnel change affecting process
- organization or ownership change
- compensation modification that may impede a manager's ability to participate in the "team" process

All managers would receive a full review, including performance against their goals, at the conclusion of their mandate. However, performance alone would *not* be a criterion for dismissal during the mandate.

If all these proposals were adopted, we believe you would see immediate benefits. The potential adversarial relationship between sponsor, consultant, and managers would become collegial and more productive – and managers would make a significantly greater contribution toward long-term goals. This would come from improved understanding of those goals as well as incentives to help attain them, through both individual and collaborative manager efforts. In this less pressured environment, managers will continue to perform to the limits of their ability, but without the temptation to stray from their process in difficult times (this would become the most likely way to lose the relationship, as opposed to a desperate attempt to salvage it).

Managing Pension Fund Assets *continued*

In essence, modifying the consortium dynamics will have transformed its decision structure from compartmentalized to cooperative. Effectively, the whole team – sponsors, consultant, and managers – will be organized and incentivized to use the same approach (on a larger scale) espoused for the investment managers hired: a disciplined yet intellectual, collegial approach, where each unit is encouraged not just to fill its specific role, but to contribute to the total success of the "team."

Compartmentalization of the Responsibility Goal

As noted earlier, there may be significant unanimity among institutional shareholders regarding fiduciary issues involving the standards, ethics, and processes by which business is conducted. However, the exercise of this opinion is effectively blocked by the compartmentalization of the institutional voting process.

What isn't working

Independent directors are not enough. These directors may find it socially and psychologically hard to stand up to a board united against them. Further, independent directors receive their compensation from the company, which in itself provides an incentive not to rock the boat.

Non-management shareholders generally are not well suited to bring forward qualified director nominees for several reasons:

- Individual shareholders rarely have the means or influence to implement change.
- Pension plans do not typically have sufficient interest in any one company to justify the expense of activism.
- organization or ownership change
- Institutional investment management firms are typically not good vehicles for nominating board members. This is due to a shorter time horizon, the high expense relative to the perceived benefit to their holding, and the conflict inherent in an employee of the manager becoming a director (responsibility to manager's clients vs. responsibility to company shareholders).

What would work?

We believe that the key to fiduciary responsibility is having an *effective* voice on the board of portfolio companies. Accordingly, our proposed solution is Independent Director Services (IDS), an organization that would provide qualified director candidates. In our proposal, the consortium would establish a non-profit, self-funding institution providing and supporting high quality, independent board candidates. While IDS initially would be an initiative supported by the consortium, its consultant, and its managers, our expectation is that IDS would be opened as a vehicle for other like-minded plan sponsors, consultants, and investment managers to exercise more effectively their fiduciary responsibilities.

As we noted, a key problem has been not only the lack of independent directors, but their difficulties in taking effective adversarial action when needed. These difficulties can be social, financial, or due to the lack of effective support from shareholders. The IDS solution addresses each challenge.

Directors proposed and appointed through the backing of IDS would have strong support backing their position for the establishment of appropriate governance standards at the companies on whose

boards they serve. As they are not introduced by incumbent management and are not financially dependent on board compensation, they avoid financial and social pressures to toe the line.

The primary function of IDS would be to identify, screen, and qualify an outstanding group of director nominees, to promote their election, and to support their needs as representatives of the fiduciary duties of shareholders. With other governance entities, IDS would develop and maintain guidelines for good practice as a director. IDS would collect its directors' compensation and would pay those directors, but not for the specific company board on which they sit.

Initially, we would expect IDS to be active primarily in the United Kingdom and North America. Once established, IDS may assist in developing parallel organizations worldwide, in conjunction with local institutions.

CONCLUSION

In this proposal we have identified the structural problem as compartmentalization, of both the return and responsibility goals.

We propose that you restructure the decision process away from a "compartmentalized" structure to a collegial process. Sponsors, consultant, and investment managers would work together through an Investment Council, supported by a Research Institute. All would have incentives based on the collective attainment of the consortium's long-term goals. This would replace the current short-term imperative on managers to "perform" and on sponsors and consultant to "act to prevent" future underperformance.

The proposed solution to carrying out the consortium's fiduciary responsibilities is to establish an entity ("IDS" or Independent Directors' Services) that would create a truly effective independent voice on corporate boards. This would be achieved through sponsoring an organization that identifies, promotes, and supports independent directors.

These two entities, the Investor Council and IDS, and their means of functioning, represent the most innovative aspects of this proposal. While the two are independent of each other, they both address the central problem: compartmentalization.

Strengths

The proposals are:

- Simple. They are behavioral solutions to a behavioral problem.
- Understandable. Both financial professionals and the beneficiaries/general public can understand the approach: "working together is better than working separately."
- Easy to implement. Both the Investment Council and IDS can be created by the consortium.
- Global in context, but easy to implement regionally. Your actions could serve as a platform for a global restructuring of the industry.

Managing Pension Fund Assets *continued*

Weaknesses

The proposals are:

- Time-consuming to implement fully and effectively. Significant "up front" and ongoing management resources are needed from all parties to make the structures work.
- Susceptible to resistance by those unwilling or unable to change. By requiring all parties to behave differently, the natural human instinct to resist changes will need to be overcome.

Challenges

We see the biggest challenge as overcoming the perception that financial professionals cannot work cooperatively, as opposed to working competitively and limited to their own self-interest.

Based on our own experiences and collegial process, we believe that this is achievable in a broad context. The existing structure of the investment management industry emphasizes competition, or a "win/lose" model. Your request expresses concern that this model could be drifting toward "lose/lose" – and our proposal suggests a way to shift to a cooperative "win/win" framework. We believe this is achievable through the leadership of progressive retirement plans that are willing to establish and participate in a better "business model."

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