The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

August 2021

MAKING YOUR NEXT *ANNUAL REPORT* 'CLEAR, CONCISE, AND COMPELLING':

A PRACTICAL 'TO DO' LIST

"You have stolen my dreams and my childhood with your empty words…..
Entire ecosystems are collapsing…..we are in the middle of a mass extinction…..
…..and all you can talk about is money and fairytales of eternal economic growth…..
We will not let you get away with this…..right here, right now is where we draw the line….."

Greta Thunberg
Speech to the UN Climate Summit, 2019

Clear, Concise, and Compelling

Greta Thunberg's climate-change speech to the United Nations raised the bar for communicating in a clear, concise, and compelling manner. Her 2019 message continues to reverberate and spur action around the world to this day. The message of this *Letter* is that pension organizations should resolve now to design and produce their next Annual Report in ways that your readerships too will praise as 'clear, concise, and compelling'.

This is not a random thought on a hot day in August. Just in the last three days I had three separate conversations with senior pension organization leaders about rethinking the shape, style, and purpose of their organization's Annual Report. They agreed that historically, these documents have been too long, too cluttered, and uninspiring. At the same time, the stakes for clearly reporting how the organization is investing its accumulated retirement savings continue to rise. For example, the new emerging term 'Net-Zero' may only have seven letters, but brings with it demanding new reporting responsibilities. What does 'Net-Zero' mean, and is your organization 'on track' to meet 'Net-Zero' targets?

Global thought-leader, and just-retired *CBUS Super* CEO, David Atkin praised the *Integrated Reporting Framework* for providing not only an effective reporting structure, but also for facilitating stronger organization design and communication. In his words: "The *Framework* is not only a great stakeholder communications tool, but also fosters strong business improvement processes for the organization itself." The main goal of this *Letter* is to show why that is the case, using the *Framework*'s five topics (organization purpose, governance/organization design, business model, performance, risks/opportunities/strategy) as its guide. At the same time, the *Letter* also shows there is plenty of opportunity within the *Framework* to be clear, concise, compelling……and creative. Note that this *Framework* is similar to that recommended by the *TCFD* for climate-related reporting. The message of this *Letter* is that it should be applied to the organization's entire Annual Report.

Organization Purpose

Not that long ago, it would suffice to say that the purpose of a pension organization is to deliver adequate pensions at an affordable cost, which in turn requires maximizing financial returns subject to the risk bearing willingness/ability of plan's risk underwriters. In a world which is shifting to systems thinking about sustainability, such a simple purpose statement is no longer adequate.

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For example, a new **Report** by the legal firm Freshfields, Bruckhaus, Deringer argues that investor purpose statements must address the 'Investing for Sustainability Impact' (or IFSI) question. The study divides *IFSI* actions or investments into two categories: *Instrumental IFSI*s and *Ultimate Ends IFSI*s. *Instrumental IFSIs* are expected to improve the risk-adjusted return prospects of the fund and therefore are required from a fiduciary perspective. *Ultimate Ends IFSIs* are expected not hurt those prospects while at the same time achieving a well-defined positive social outcome. The question here is: is such an action permissible? There may not be a clear answer to that question. The Report notes it would be helpful in this case if the organization could demonstrate that fund participants are sympathetic to the action or investment undertaken.

What does this mean in practice? The movement to 'Net-Zero' noted above offers a good example. Does an organizational decision to go "Net-Zero' fall in the *Instrumental IFSI* or *Ultimate End IFSI* category? Arguably in the former, as a 'Net-Zero' investment regime helps guard pension assets against overexposure to both the physical risks of climate change, as well as the transition risks related to decarbonizing the global economy. In contrast, actions related to addressing *UN Sustainable Development Goals* related to poverty, hunger, health, education, and equality arguably fall in the *Ultimate Ends* category.

A new **Study** by *CEM Benchmarking* published by *TOP1000FUNDS* adds an interesting new dimension to the *IFSI* discussion. Out of a sample of 340 asset owner funds in their database, 68 are PRI Signatories, indicating that they adhere to the PRI's six principles of responsible investing. *CEM* reports that for the five-year period ending in 2018, the 68 Signatory funds out-performed the 272 non-Signatory funds by an average of 0.4%/yr. after adjusting for differences in asset mix policy, fund size, and percentage of assets managed internally. This result suggests that, on balance, paying attention to *IFSI* considerations has a positive payoff for asset owner beneficiaries.

Governance and Organization Design

As with purpose, the governance and organization design sections of Annual Reports of pension organizations have historically been simple, providing Board member bios, their Committee memberships, and their attendance records. This too is becoming inadequate in a world shifting to systems thinking about sustainability. Increasingly, the Boards of pension organizations must possess the collective skills, experience, and strategic thinking capabilities to provide effective oversight of its investment, administration, and stakeholder communication functions in this new, more complex world.

What does this mean in practice? It starts with the owners of the pension organization ensuring that its purpose is updated to reflect 21st Century realities and then asking what the implications are for Board size, skills/experience composition, and Board member selection processes. With the right people in place, the Board must satisfy itself that the organization's business model is fit for purpose, and that it has the right people, technologies, organization design, incentives, and culture to generate outcomes consistent with organizational purpose. This publication has cited multiple studies over time confirming the reality that good governance matters, and that it improves organization performance over time.

Business Model

What does it take to produce adequate pensions at an affordable cost? For starters, it requires defining 'adequate' and 'affordable'. Adequacy requires studying post-work retirement and spending patterns, longevity, and integration with a country's universal Pillar 1 pension plan. For example, if an 'adequate' pension is $60K/yr. and the Pillar 1 pension provides half of that, the target Pillar 2 pension is $30K/yr. for life.[i] A key driver of the affordability of that $30K Pillar 2 pension is the investment return on accumulating pension contributions. The higher the projected investment return, the lower the projected contribution rate required to produce the target pension.

So where does this critically-important projected investment return come from? Often, it seems out of thin air. In fact, it usually comes out of a complicated dance between academics, actuaries, consultants, and the investment professionals and Boards of pension organizations. A far simpler, more honest, and more defensible approach would be to use a simple return projection model such as the Gordon Model where R=Y+G. In real terms, for risk-free bonds, G is always zero and Y is also zero today. For a well-diversified portfolio of equity-oriented investments, I am comfortable starting with Y=3% and G=1.5% today, adding up to an R=4.5%.[ii]

Now comes the hard part. That simple R=4.5% projection for equities came from a macro 'top down' approach. The new 'Net-Zero' world reminds investment organizations that they should be making those R projections micro 'bottom up' as well, one investment at the time. Why? Because the 'bottom up' approach is required for investment organizations to monitor their own progress towards 'Net-Zero' through time. Specifically, investee corporations report their emissions annually.[iii] If they are truly on 'Net-Zero' paths, then the investment organizations holding their shares can show they too are on 'Net-Zero' paths.

But there is more. These new massive micro data generation processes logically lead to performing Gordon Model-type analytics at the individual corporation level. Each corporation has its own 'base case' Y/G combination. A logical question becomes: 'how much will a carbon tax of $50/CO2ton impact the Y and G (and hence R) of Corporation X? How about $100/CO2ton or $150/CO2ton? If the R of Corporation X becomes increasingly negative in these scenarios, the investment question becomes: can Corporation X successfully transition to profitability in a 'Net-Zero' world? If not, why is it in our portfolio?[iv]

All this makes David Atkin's point: a requirement to explain a pension organization's business model in its Annual Report forces careful thinking about what that model actually is, and how it works in practice.

Performance

The need for careful thinking extends to organizational performance and its measurement. Which dimensions of the organization should be subjected to performance measurement? Selecting the right benchmarks against which to evaluate actual outcomes is also critical. Such benchmarks could be absolute, market-relative, or peer-relative, and should cover both short-term and longer-term timeframes.

Here is a list of organizational outcomes that are candidates for performance measurement in pension organizations:

- Income replacement rates for retirees
- Member satisfaction levels
- Board composition and effectiveness
- Organizational structure and culture
- Gross and net investment returns
- Investment-related costs
- Progress towards investment-related goals (e.g., the return generation model, the trajectory to 'Net-Zero', other ESG goals in the S and G areas, in/outsourcing targets)
- Benefit delivery and administration-related costs
- Progress towards benefit delivery and administration-related goals (e.g., call centers, financial planning tools, education, advice, IT upgrades)

Important feedback loops here are the connections between performance targets, outcomes and incentive compensation structures in the organization.

Risks, Opportunities, and Strategy

In the context of a pension organization's purpose, business model, and performance, the logical final Annual Report topic is: where do we go from here? That requires a brave leap into the unknown, and there is no single best way to do that. However, the John Kay-Mervyn King book "Radical Uncertainty" (reviewed in our August 2019 *Letter*) is helpful. First, they reject 'volatility', the MPT definition of risk, as the key investment risk metric for pension organizations with long horizons. Instead, these organizations should create a forward-looking 'reference narrative' based on their best answer to the question 'what is going on here?' from politico/socio/economic/climate/health perspectives. The logical follow-on question is: 'what could derail our reference narrative?' On one hand, the answer could posit net positive surprises, on the other, the surprises could have net negative connotations.

This narrative framing sets the table for the concluding strategy discussion in a pension organization's Annual Report. What risks and opportunities do the three scenarios suggest for pension adequacy? For risk bearing? For investing retirement savings and their stewardship? For governance structure, business model, and organization design? For interactions with plan members? For collective action with peer organizations? For setting performance targets in all these areas? All possible topics for the Report's closing strategy discussion.

In Conclusion

Returning to *CBUS Super* for a moment, have a look at how the organization brings all these dimensions together as it continues working on improving its Annual Report. Appropriately, the title of the short presentation is "**Integrating Organizational Thinking, Strategy, and Reporting**". Do you want your organization's next Annual Report to pass the 'clear, concise, and compelling' test? If 'yes', now is the time to start planning how to make it happen. The intent of this *Letter* has been to provide guideposts for that planning process.

Keith Ambachtsheer

Endnotes:

i. *Setting income replacement targets is of course far more complicated in the real world, but these complications are outside the scope of this Letter.*
ii. *The Y of the 'real world' KPA Advisory pension fund is actually 5% today....with a real G of 1.5% still a reasonable expectation.*
iii. *Not all corporations provide this information yet. Requiring them to do so is an obvious next step in corporate disclosure requirements.*
iv. *See the new paper by Mark Van Clieaf and Tamara Close "**Climate Change and NetZero Transformation**" for an exposition of the analytical implications of long-term investing and the need for fiduciary investors to be able to demonstrate that they not only understand these implications, but are actually using the requisite analytics in their investment decision processes.*

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