The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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A PRAGMATIC THEORY OF 'PENSION FUND CAPITALISM':

IMPLICATIONS FOR MANAGING PENSION ORGANIZATIONS

"What does 'long-term value creation' mean? There is no simple, single right answer to the question. However, with the passage of time, I am increasingly leaning toward Bartley Madden's "The Pragmatic Theory of the Firm" as providing the most useful answer. The best way to describe Bartley is as the non-academic that academics turn to when they really want to know what is going on in the business world. He has worked relentlessly as an intermediary between the theory of economics and finance, and the practical corporate world of actually creating measurable value. That is why I believe his "Pragmatic Theory of the Firm", clearly set out in his new book, is so powerful."

From "Travelling the Road to 'Pension Capitalism'"
The Ambachtsheer Letter, March 2024

"My work career can be categorized as research in finance and in knowledge building. It has logically led to 'The Pragmatic Theory of the Firm' which describes the key components of a corporation's value-creation process."

From the book "My Value Creation Journey" (2024)
Bartley J. Madden

Who Is Bartley Madden?

Bartley Madden's name first surfaced as part of our efforts to understand the investment implications of climate change generally, and of their implications for security analysis and corporate risk modelling in particular. For example, see the **October 2021 *Letter*** "Grappling With An Unknowable Future: Statistics Or Stories?" and the **January 2024 *Letter*** "Improving Investment Models for Pension Funds: How Are We Doing?"

The quote above from our **March 2024 *Letter*** notes that Bartley has long played an important intermediary role between theory and practice in corporate finance and management. His observation that like humans, corporations have life-cycles (e.g., High Innovation, Competitive Fade, Mature, Failing Business Model) is widely used and cited in corporate management literature.[i] This *Letter* takes a closer look at the investment management insights embedded in his "**Pragmatic Theory of the Firm**". Also, it points to organizational insights that come from restructuring his theory into "A Pragmatic Theory of Pension Fund Capitalism".

A Pragmatic Theory of the Firm

Madden starts with the assertion that Milton Friedman's 'maximizing shareholder value' principle is best positioned as a corporate outcome, and not as a purpose. Instead, a useful theory of the firm treats the firm as a holistic system with four key components:

1. A socio-economic firm vision with the power to motivate and even inspire employees.
2. A knowledge-building proficiency that provides operating returns at least equal to its cost of capital through continuous gains in efficiency and innovation.
3. Win-win relationships with all of the firm's stakeholders, both inside and outside the organization.
4. The design and manufacture of goods and services that minimize waste and pollution and thus invest in the well-being of future generations.

In short, successful firms earn at least their cost of capital over the long-term. This requires explicit integration of a firm's purpose and a culture that emphasizes knowledge-building , fostering win-win relationships, and maintaining multi-decade resilience and sustainability.

Knowledge-Building and Value Creation

Arguably, element #2 of the Pragmatic Theory (i.e., knowledge-building proficiency) is the most challenging of the four value drivers to design and implement. Madden suggests approaching it through a Knowledge-Building Loop with six tasks:

1. Foster a Knowledge-Building Culture: it starts with a humble management team that knows and admits it doesn't have all the answers. Learning cultures know that wisdom and truth do not reside in a single place. They are better able to cope with unpredicted events. Get the culture right and it is easier to implement strategies that adapt to changing environments.
2. Apply Strategic Thinking: focus on identifying and understanding the firm's challenges. Focus on the ones with big value-creation upside. Be prepared to build or acquire new skills if necessary.
3. Flatten Organizational Structure: command and control structures are problematic. Flatter structures push down decision-making power and increase employee engagement and creativity.
4. Assess the Efficiency of Existing Businesses: find out how well current processes and practices are working by 'walking around'. How can we create more value with less waste?
5. Improve Existing and Future Businesses: there must be a culture of 'no fear' and a willingness to 'think differently'. The actions of observing, questioning, networking, and experimenting can trigger thinking that leads to new processes, services, products, or even businesses.
6. Build Context-Specific Performance Measurement Protocols: performance metrics must be created that are suitable to specific contexts.

What is the relevance of all this to managing pension organizations? There are two connections. First, the Pragmatic Theory of the Firm is helpful in designing the investment function of pension organizations. Second, it is also helpful in assessing and improving the value-creation potential of the pension organization itself.

Designing the Pension Fund Investment Function

The great economist John Maynard Keynes taught us nine decades ago that active investors fall into one of two possible categories: short-term beauty contest investors or engaged long-term business owners.[ii] Through the Modern Portfolio Theory (MPT) wave of the 1960s/1980s, Harry Markowitz, Bill Sharpe, Jack Bogle and compatriots taught us that passively holding 'the market' is a pretty cost-effective alternative to active 'beauty contest' investing. Multiple studies have confirmed that passive investment strategies generally outperform active 'beauty contest' strategies based on short-term time-horizons.

What about the 'engaged long-term business owner' approach to investing? Keynes praised these investors as "*willing to defeat the dark forces of time and ignorance which envelop our future*". He became one himself as manager of the *Cambridge King's College Endowment Fund* from 1923 until his death in 1946. Subsequent research confirms he handily outperformed the market over these two difficult decades.[iii] In the post-WWII world, Warren Buffet has become a visible personification of this 'engaged long-term business owner' approach to investing.

At the same time, management philosopher Peter Drucker, in his 1976 book "The Unseen Revolution", made the critical observation that through their pension funds, workers would increasingly become the owners of the means of production. He noted this would raise important questions about how, and by whom these growing pools of retirement savings would be managed. He advocated that it should be done through well-governed, arms-length, unconflicted pension institutions. Logically, these new institutions would see themselves as Keynes' engaged long-term business owners rather than as unengaged short-term beauty contest traders.

Starting in the 1990s, this kind of pension institution has been emerging, first in Canada, but now increasingly throughout the world. Thus how 'engaged long-term business owners' should conduct themselves is becoming an increasingly important question. A good place to start is with the conception of a practical theory of the firm, which is what Bartley Madden has brought to the table with his 4-component model. The model poses four questions for long-term investors to address:

1. Can the firm articulate a vision of where it is going in a clear, compelling manner?
2. Does it have the knowledge-building proficiency required to at least earn and continue to earn its cost of capital? Does it use a Knowledge Building Loop to ensure that proficiency continues to be effective?
3. Does it convey a 'win-win' mindset in dealing with its internal and external stakeholders?
4. Does it convey a 'win-win' mindset in considering the welfare of future generations?

Seriously addressing these questions raises important organizational issues for 'engaged long-term business owners'. Where does this kind of work fit into our investment organization? What kind of skill/ experience sets are needed to do this work effectively? What should be insourced and what could be outsourced? How do we best collaborate with other like-minded investors? How do we measure the impact of this work on our organization's investment returns?[iv]

That final question above prompts yet another question: Can 'The Pragmatic Theory of the Firm' be used as a component of measuring investment performance? If we can develop metrics for each of the four components of the Theory (vision clarity, knowledge-building proficiency, win-win behavior, future generation welfare), we would end up with a 'value-creation score' for each portfolio company, aggregating up to a total 'value-creation score' at the portfolio level. Such a score, compared to the scores of other investment organizations, would provide important information about any organization's ability to select and foster value-creating investments in its portfolio.

Designing the Pension Organization Itself

What about the pension organization itself? Should it not also be able to answer these four strategic questions in the context of its own purpose and how to best achieve it?

1. <u>Can the pensions organization itself articulate a vision of where it is going in a clear, compelling manner?</u> For example, could/should the organization achieve scale economies by expanding its membership base? How could this vision best be accomplished?

2. Does the pension organization have the knowledge-building proficiencies required to improve its pension design and to earn a higher rate of return on its accumulated retirement savings? Does it use a Knowledge Building Loop to ensure that these proficiencies continue to be effective? On the pension design side, for example, should it consider moving to separate accumulation and decumulation pools? On the investment side, should it repurpose and reposition its investment function to more effectively utilize Madden's 'Pragmatic Theory of the Firm'? What would be the organizational implications such moves?
3. Does the pension organization convey a 'win-win' mindset in dealing with its internal and external stakeholders? There are multiple contexts. Internally for example, young and old plan members need to both be treated fairly. Externally, employers and taxpayers also need to be treated fairly in a cost-benefit sense. Also externally, is the organization making efforts to collaborate with like-minded other pension organizations to achieve collective goals benefitting all?
4. Does the pension organization convey a 'win-win' mindset in considering the welfare of future generations? An obvious example here is for pension organizations to make 'net zero' GHG commitments. Future generations are losers if we continue to 'win' by permitting the net emission of green house gasses into the atmosphere as part of today's good and services production processes. More generally, we must not unduly burden younger generations to financially support older generations as the latter enter the post-work phase of their lives.

Future *Letters* will address each of these four questions a greater detail.

The Power of Good Theory

Here, we close by reflecting on the power of good theory. Good theory is logically consistent, and simplifies complex socio-economic realities to their essence by using only a few key explanatory variables. Madden's 'Pragmatic Theory of the Firm' surely passes that test, and we commend it to you to guide both the design of your investment function and the strategic direction of your organization itself.

Keith Ambachtsheer

Endnotes:

i. *Madden is involved with the* ***Madden Center for Value Creation*** *at the Florida Atlantic University's business school. He has a series of work-in-progress* ***papers co-authored with Prof. Doug Stevens*** *that lay out a practical plan to incorporate intangible assets for the needed New Economy Accounting and that extend the pragmatic theory of the firm by incorporating social norms.*

ii. *See Keynes' book "****The General Theory of Employment, Interest, and Money****", Chapter 12 (1936). There he explains beauty contest investing this way: "Most investors are not concerned with what an investment is really worth, but with what the market will value it at three months or a year hence. .....the object is to outwit the crowd by guessing which stocks average opinion will judge most attractive, and to pass the bad, or depreciating stocks to the other fellow".*

iii. *See Chambers and Dimson, "****The British Origins of the US Endowment Model****", Financial Analysts Journal, Mar/Apr 2015.*

iv. *These questions are equally relevant for commercial investment managers who choose to adopt the 'engaged long-term business owner' philosophy as the basis of their investment model. Amsterdam's Ownership Capital, Boston's MFS Investment Management, and Paris's BNP Paribas Asset Management are examples.*

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