The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

February 2024

THOUGHTS ON BUILDING AN EFFECTIVE PENSION GOVERNANCE FUNCTION:

TWO DIFFERING POINTS OF VIEW

"The purpose of this book is to assist pension boards in improving their decision-making."

From the new book "Decision-Making for Pension Boards"
By Alfred Slager and Martijn Vos

"Pension boards are responsible for the governance of the fund, but do not conduct its day-to-day activities themselves. Rather, they enunciate the mission, establish the goals and policies, design a fiduciary structure with appropriate decision rights, and monitor the 'what' and 'why' of the fund's achievements."

From the 1998 book "Pension Fund Excellence"
By Keith Ambachtsheer and Don Ezra

What Do Pension Boards Do?

Reading their book, it quickly became clear to me that authors Slager and Vos and I have different perceptions of what pension boards are, and what they do. The pension boards in my books and articles are groups of outside fiduciaries with the primary task to ensure that the pension organization they are overseeing has a clear purpose and that the organization has the requisite plans and resources to achieve it.[i] In contrast, the pension boards in the Slager-Vos book seem to be primarily decision-making bodies that not only ensure the organization has a clear purpose, but also create the plans and acquire the resources to achieve it.

For example, the Slager-Vos book offers this quote from a 2006 HBR article titled "**The Seasoned Executive's Decision-Making Style**": "*At any moment on any day, most executives are engaged in some aspect of decision-making: exchanging information, reviewing data, coming up with ideas, evaluating alternatives, implementing directives, following up.*" Slager and Vos seem to imply that board members are executives with decision-making responsibilities like coming up with ideas and then evaluating and possibly implementing them.

In contrast, my 1998 book with Don Ezra (cited above) and my 2016 book "The Future of Pension Management" make a very clear distinction between the governance function which provides oversight, and the executive function which manages the organization. In fact, the book chapter titled "How Effective Is Pension Fund Governance Today?" opens with the results of three large pension fund surveys (conducted in 1997, 2005, 2014) where CEOs were asked to rank the effectiveness of the boards they report to. The most recent of these surveys garnered 81 responses evenly split between Asia/AUS/NZ, Europe, USA, Canada. Interestingly, out of the identical 23 survey statements the CEOs were asked to rank in terms of their satisfaction with board performance in 1997, in 2005, and in 2014, the same 5 statements ranked dead-last each time:

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- The compensation levels in our organization are competitive (i.e., they are not).
- Our board examines and improves its own effectiveness on a regular basis (i.e., it does not).
- The executive function has the authority to retain and terminate investment managers (i.e., the board feels it needs to be involved).
- Our fund has an effective process for selecting, developing, and terminating board members (i.e., it does not).
- Performance-based compensation is an important component of our organization design (i.e., it is not).

The CEOs were also given the opportunity to include a few personal observations about their Boards with the survey. They were consistent with the survey findings:

- "Too much Board turnover and too little in the way of requisite skills and experience."
- "Too much emphasis on administrative issues and too little on the strategic direction of the organization."
- "Our Board flies just above the treetops instead of at a high fiduciary altitude."
- "No appetite to discuss competitive compensation models."

Leaving their book's blurring of the governance and executive functions behind at this point, Slager and Vos make an interesting observation about the link between good governance and good organizational performance.

Does Good Governance Produce Good Organization Performance?

They write: "*The importance of good decision-making by Boards cannot be understated, especially when it comes to matters that directly impact the pensions and financial well-being of participants long-term. Industry insiders consider Canada Pension Plan Investments a well-run fund, because its governance and decision-making has led to persistently good returns for participants. The Board of California-based CALPERS showed inconsistent decision-making when they postponed rebalancing in 2008 and missed out on the recovery of financial markets. It prompted the pension fund to evaluate and re-establish its governance and decision-making processes to get back in shape*."

So what is the message here? It appears to be that *CPP Investments* has good governance and hence has good investment performance, and that *CALPERS* had bad governance and hence bad investment performance, but then figured out why it had bad governance and has now fixed the problem. However, the book does not pursue the question of what 'good governance' is, and where it comes from, nor the question of what 'bad governance' is, and how that problem should be addressed. This *Letter* examines both of these fundamental questions.

The Foundations of Good Governance

The cited Ambachtsheer-Ezra 1998 book "Pension Fund Excellence" was motivated by a 1992 study by American anthropologists William O'Barr and John Conley on the behavior of the boards of nine large pension funds in the USA. They found:

- Board behavior seemed to be driven by organizational culture and history rather than by value-creation. A strong motivator was avoiding blame.
- An extraordinary amount of attention was given to maintaining and nurturing good personal relationships with outside services suppliers.
- There was no interest in the governance of the organizations the funds invested in.

These 1992 findings led to the design of the pension fund CEO survey described above, first conducted in 1997, and repeated in 2005 and again in 2014. Note that the reported CEO survey findings were consistent with O'Barr and Conley's original 1992 observations about pension fund boards.

So what are the foundations of good pension fund governance? What are the steps required to create competent, motivated pension fund boards with the right skill/experience sets? Our 1998 "Pension Fund Excellence" book listed five:

1. Create a Board Member Job Description: ability to clarify the organization's mission, to understand the policies most likely to achieve it, constructive involvement in CEO selection and performance monitoring, assessing overall organizational performance and effectiveness.
2. Design and Implement a Board Member Selection Process: the process must lead to people capable of fulfilling the board member job description and valuing the work.
3. Offer an Ongoing Board Education Program: even the most competent board is going to have knowledge gaps that need to be filled.[ii]
4. Support the Board with consistently high-quality executive and operations work: this raises the level of trust between board members, management, and the rest of the pension organization.
5. Support the Board in evaluating their own effectiveness: even good boards know that there is always room for improvement.

This 5-step 'good governance' formula takes us back to the Slager-Vos governance comparison between *CPP Investments* and *CALPERS*. *CPP Investments*' board selection process for its 11 members is very much in line with Steps 1 and 2 above (i.e., skills/experience-based). The *CALPERS* process, on the other hand, is not. Instead, the selection process for its 13 members is political: people are either elected by its plan membership or appointed 'ex officio' by virtue of holding a political position in state government (e.g., State Treasurer, State Controller).

What Do Effective Boards Actually Do?

The **March 2020 *Letter*** addressed the 'what do effective boards actually do?' question directly. According to organization design expert Ron Capelle, they must do five things[iii]:

1. Provide appropriate context and prescribed limits: this could relate to stakeholder relations, legal and ethical issues, and the identification and management of substantive risks.
2. Ensure the establishment of expected organizational results: quantities, quality, timelines, business plans, and benchmarks.
3. Ensure appropriate resources available to do the work: the right people, physical and financial capital, and IT.
4. Appropriate delegation of authority: within the set context and limits, the CEO must have the appropriate authority get the work done.
5. CEO selection and termination: as well as CEO coaching, feedback, compensation, and performance evaluation.

Do the pension funds where boards do these five things well actually generate stronger organizational results? Does good governance really matter?

Governance Quality and Pension Fund Performance

The short answer is 'yes, it matters'. Despite the difficulty of quantifying governance quality, there is strong empirical evidence supporting the 'good governance matters' proposition:

- A 1998 study by Ambachtsheer, Capelle, and Scheibelhut: motivated by the noted 1992 O'Barr and Conly study which was highly critical of the quality of pension fund governance. The 1998 study reported positive relationships between net excess fund returns, the subjective governance quality rankings based on fund CEO responses, and an objective organization design quality score as captured by a proprietary Capelle methodology.[iv]

- A 2017 study by Andonov, Bauer, and Cremers: found a negative relationship between the degrees of political and elected member representation on the boards of US public sector pension plans and their funded status.[v]
- A 2018 study by Ambachtsheer: based on data from *CEM Benchmarking Inc*., 7 out of 8 (88%) 'Canada Model' funds outperformed their benchmarks over the 2006-2015 period versus 80 out of 132 (61%) for the other funds. The average outperformance for the 'Canada Model' funds was 0.6%/yr. vs. 0.1%/yr. for the latter. 'Canada Model' funds use the strategic governance model first adopted by *Ontario Teachers' Pension Plan* in 1990. Over the 1990-2018 period, *OTPP* has generated a 29yr. net annual return of 9.7% vs. 7.7% for its benchmark.[vi]
- A 2018 study by Andonov, Hochberg, and Rauh: found negative relationships between the degrees of political and elected member representation on the boards of US public sector pension funds and their investment returns.[vii]
- A 2019 study by Merker and Peck: found a positive relationship between the returns of US public sector pension funds and a Fiduciary Effectiveness Quotient (FEQ) constructed and calculated by the authors. The FEQs are based on information contained in multiple years of Board Minutes, extracted on a fund-by-fund basis, focusing on factors such as Board composition, engagement, professionalism, knowledge, structure, diligence, and transparency.[viii]

In Conclusion

So to conclude. By emphasizing decision-making in their book, I believe Slager and Vos mischaracterize the primary board role in pension organizations: providing enlightened but firm organizational oversight. Stated differently, I believe the board's role is to ensure the organization is capable and motivated to make value-creating decisions for the benefit of the organization's stakeholders. The worst thing a board can do is to usurp those managerial responsibilities by making decisions that should be delegated. The research findings summarized above support this view.

Keith Ambachtsheer

Endnotes:

i. *In chronological order, the books are "Pension Funds and the Bottom Line" (1985), Pension Fund Excellence (with Don Ezra) (1998), Pension Revolution (2007), and The Future of Pension Management (2016). There has also been a stream of related published articles in the Financial Analysts Journal, the Journal of Portfolio Management, and the Rotman International Journal of Pension Management over the course of the last 50 years. Finally, KPA Advisory Services has published the monthly Ambachtsheer Letter on Pension Design and Management since 1985. This current Letter is the 446th since inception. Many of these Letters covered governance-related issues and research findings.*
ii. *The Rotman-ICPM Pension Governance Education Program is an example. See the* ***October 2023 Letter****, for more on this Program.*
iii. *From the book "Optimizing Organization Design", Jossey-Bass, 2014.*
iv. *From "****Improving Pension Fund Performance****", FAJ, 1998.*
v. *From "****Pension Fund Asset Allocation and Liability Discount Rates****", The Review of Financial Studies, 2017.*
vi. *From "****The Canadian Pension Model: Past, Present, and Future****", JPM, 2021.*
vii. *From "****Political Representation and Governance: Evidence from the Investment Decisions of Public Sector Pension Funds****", Journal of Finance, 2018.*
viii. *From the book "The Trustee Governance Guide", Palgrave Macmillan, 2019.*

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