The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

*December 2023*

# BETTER PENSIONS FOR MORE PEOPLE:

# THE ROAD AHEAD

*"A great advantage of mathematical technique is that it allows us to describe the general character of a pattern even where we are ignorant of the correct numerical values. However, it has led to the illusion that we can use this technique for the determination and prediction of these numerical values. To act on this belief is likely to make us do much harm".*

Prof. Friedrich von Hayek, Nobel Prize Laureate, 1974

*"My paper is concerned with the much harm done by the pretense of knowledge in the evolution of pensions in Britain. There has rarely been a better illustration of the adage (ironically attributed without evidence to Mark Twain) that 'It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."*

Prof. Sir John Kay, Oxford University, 2023

**Much Harm Done**

An invitation by Prof. Kay led to my participation in a recent London conference titled "Risk and Uncertainty in the Pensions World: Correcting the Biggest Avoidable UK Public Policy Failure of Recent Decades". The quotes above came from a paper Prof. Kay wrote for the occasion. In short, he asserted:

- In the context of pension provision, life expectancy and future investment returns are both uncertainties, but differ in the sense that the former can be described by stable probability distributions, while the latter cannot. Why? Because investment returns are sensitive to radically uncertain future geopolitical events not subject to stable probability distributions.
- These uncertainties are important realities as individuals strive to maintain their standard of living over the course of their lifetimes, including in their retirement years. The key risk to be managed is that the provisions made for income in retirement turn out to be inadequate.
- This risk arises from the uncertainties of retirement savings rates, investment returns, and longevity. These uncertainties can be mitigated through auto-savings rates, investment diversification, and longevity risk pooling. The pension policy mistake the UK has made in the last three decades is to attempt to eliminate these uncertainties altogether, rather than manage them sensibly through nudges, diversification, and pooling strategies.
- Specifically, the UK has created an ineffective Pension Protection Fund, and has actively discouraged diversification by advocating the matching of specific assets to specific liabilities. Not only have these policies raised costs and diminished pension security, but they have also redirected retirement savings away from investing in businesses and real assets, towards bonds. In this, the UK has neglected the hundred-year-old insights of Frank Knight and John Maynard Keynes, who both recognized that embracing uncertainty was key to the dynamism of a market economy.

 

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In this context, Prof. Kay invited me to describe to London conference attendees how Canada managed to avoid these pension policy errors.

**The Canadian Pension Model**

Having described the Canadian Pension Model in some detail in the **November *Letter***, it can be summarized here:

- Pension delivery organizations are set up as autonomous, arms-length, large-scale entities with mandates to deliver adequate pensions at a reasonable cost. They are governed by professional boards with diverse skill/experience sets.
- Pension adequacy is typically defined as replacing (together with universal Pillar 1 pensions) some 70% of final earnings, leading to contribution rates in the 20% of pay area.
- Sustainability is achieved through triennial valuations which compare actual pension assets to target assets under a conservative set of 'going-concern' investment, inflation, and longevity assumptions. Depending on the valuation outcome, current benefits and contribution rates can be deemed appropriate, or be adjusted up or down. To eliminate unexpected surprises, any required adjustments are based on pre-determined/negotiated and widely-communicated adjustment formulas.
- This Model structure leads to an emphasis on investing globally in businesses and real assets in public and private markets. Much of it is done through teams of internally-staffed investment experts, which is a much more cost-effective strategy compared to outsourcing these investment activities to high-cost third-party agents.

There is an important caveat to the coverage of the Canadian Pension Model. It does not cover supplementary pensions in the private sector. So public sector workers are fully covered by the combination of the universal Old Age Security Plan, the Canada/Quebec Pension Plans, and their own Canadian Pension Model supplementary pension plans for teachers, healthcare workers, municipal employees, etc. In contrast, while private sector workers are covered by the same universal pension plans, and some have supplementary employer-sponsored DC pension plans, many are left to their own devices to figure out how to save and invest through individual retirement savings accounts, and how to make their pension pot last an uncertain lifetime in retirement.

**Expanding Supplementary Pension Plan Coverage**

Our April 2023 Pension Policy Paper "**Making Canada One of the World's Top Pension Countries: What It Will Take**" addressed this missing element in Canada's retirement income system. Its proposed solution (equally relevant in UK or USA contexts) should come as no surprise: expand private sector workforce participation in well-designed, well-managed, large-scaled pooled pension plans. Through the benefit of the Canadian Pension Model, we already know what 'well-designed', 'well-managed', and 'large-scaled' looks like. The challenge is finding the right sponsors to actually create, distribute, and manage such offerings.

The April Paper listed three possible sources:

1. Startups such as the *CommonWealth* and *Purpose Investments* ventures in Canada.
2. Outreach by not-for-profit pension organizations such as *CAAT Pensions*, the *Saskatchewan Pension Plan*, and others in Canada ( *NEST* would be a UK example).
3. New initiatives by commercial financial institutions such as asset managers, insurance companies, and banks.

A helpful aid to increasing supplementary pension plan coverage for private sector workers is auto-enrollment. Countries like Australia and the Netherlands began to require such supplementary pension coverage for all workers decades ago. The UK and the USA both have successful more recent autoenrollment initiatives underway. Canada should join them.

**What Gets Measured Gets Managed**

So far we have taken a 'top-down' approach to addressing the 'better pensions for more people' challenge. There is also a complementary 'bottom-up' approach: 'value for money' benchmarking. The belief that this kind of benchmarking leads to better outcomes goes back a long time. Its application to the pensions sector began with the founding of *CEM Benchmarking* in 1991. Today *CEM* has relationships with 500 funds in 25 countries with a cumulative plan membership of 50 million people and cumulative plan assets of over US$14 trillion.[i] There are 4 benchmarking subscriptions on offer today:

1. Investment Benchmarking Subscription (IBS) for Institutional investors including DB Funds, SWFs, and Other Large Investment Pools: rigorous data cleaning, 31yr history, compares investment returns, value-added, operating costs, transaction costs, org structure and FTE counts at the total fund, asset class and mandate levels. There is also a Global Leaders IBS offshoot for large funds with complex investment programs.
2. Pension Administration Benchmarking Subscription (PABS) for DB Plans: 20yr evolution of service metrics, activity costs, and staffing models. PABS also offers an annual global conference, access to a digital peer sharing network and a best practices research program for participating plans. PABS for DC is slated for launch in 2024.
3. Transparency Benchmarking Subscription (GPTB): trust is an important asset in pension management, and it is built through transparency. Through its benchmarking process on the quality of reporting in performance, costs, governance, and responsible investment disclosures in 15 different countries, *CEM* is helping pension organizations raise the trust levels of their members.
4. DC Benchmarking Subscription: rigorous data cleaning, 25 year history, compares plan structure, total plan and investment option returns, value-added, risk, and costs to those of a customized peer group. This subscription is being enhanced by adding such decumulation-related questions as the sponsor's role in the decumulation phase of DC plans, whether there is a retiree education program, what percent of assets stay with the sponsor, what income replacement rate do the withdrawals represent, whether there is a lifetime income option, and if so, is it guaranteed or variable pay?

What insights have *CEM*'s benchmarking efforts produced so far? Here is a list[ii]:

1. Investment Pools in the IBS database: average returns net of expenses have marginally exceeded the returns of passive strategies with similar risk exposures (e.g., in the 20bps area). Large funds outperform small funds due to lower unit costs. Canadian Pension Model funds outperform other large funds due to greater insourcing and greater use of private markets in equity, debt, real estate, and infrastructure.
2. DB Pension Administration: large plans have lower unit costs than small plans due to scale economies. Plan members have rising pension service expectations. Increased digitalization and increasing use of robotics/AI are helping meet those rising expectations. However, most pension plan websites are still not very user-friendly.
3. Transparency: overall disclosure transparency is improving in pension organizations, with the governance and responsible investing areas showing the most improvement. Cost disclosures continue to be the most problematic. Norway and Canada were the top two countries for pension transparency in 2022.

4. DC Plans: historically, average net returns have been lower than those of DB plans due to higher cost structures. More recently, DC plan investment returns have improved materially with the introduction of low-cost, passively-managed target date funds that have had large exposures to listed US equities. DC plans could benefit from private markets investing as long as the management costs are reasonable. As noted above, adding a decumulation benchmarking component will generate important additional insights into designing and cost-effectively managing DC pension arrangements.

So where to from here?

**The Road Ahead**

Profs. Hayek and Kay remind us that a good place to start is to see the world as it is, and not as we would like it to be. The overall quest is for the effective provision of adequate lifetime income, including through the post-work phase, in a world of uncertainty about investment returns and the length of that post-work phase. For policy makers and implementers, that means ensuring their country's universal and workplace -based pension pillars are properly integrated, and up to the task of providing adequate and affordable post-work lifetime income for all its citizens.

This *Letter* reminds us that dedicated, well-designed pension institutions play a central role in achieving such an outcome. The good news is that we know how to build such institutions and how to ensure that they continue to produce 'value for money' in the years ahead. It is up to us to put that knowledge to good use.

*Keith Ambachtsheer*

*Endnotes:*

i. *I am a co-founder of CEM Benchmarking and continue to be a co-owner and Board member.*
ii. *For more complete descriptions of research findings based on the CEM databases, go to:* ***https://www.cembenchmarking.com/insights.html***



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