The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

February 2022

SCALE AND GOVERNANCE:

NEW INSIGHTS INTO THE DRIVERS OF PENSION FUND PERFORMANCE

"The largest funds have delivered the highest excess returns, on both a gross and net basis. Gross of costs, being more actively invested is the largest driver of value-added. Once costs are considered, the advantages of scale and the related ability to implement internal management programs, particularly in private assets, are revealed."

"A Case for Scale"
CEM Benchmarking Inc.
February, 2022

"There is a saying that the three things which matter most in buying real estate are location, location, location. Well, the three things that matter most to the success of an institutional investor are governance, governance, governance."

"Asset Allocators are Mired in Bureaucracy –But They Don't Have to Be"
Institutional Investor
February, 2022

Insights from Two New Studies

If you were asked what you believe the top two drivers of pension fund performance to be, how would you answer? My guess is that many of you would put 'scale' and 'governance' at the top of your list. But if you were pressed to defend your choices, what would you say then? The goal of this *Letter* is to provide you with both the logic and the empirical evidence to support your 'scale' and 'governance' choices, using the new research findings described in the two publications cited above.

The **"A Case for Scale"** paper was written by four colleagues at the global pension research organization *CEM Benchmarking Inc*.[i] *CEM* has extensive databases on pension fund returns, return benchmarks, organizational structures, and costs starting in 1992 to present. These databases were used in the paper to study the relationships between scale and performance in a number of different ways. While I had been aware of the *CEM* 'scale' study for some time, I came across the *Institutional Investor* 'governance' article by chance, as it was referenced in another paper I was reading.

The *Institutional Investor* article is more interesting than its title **"Asset Allocators are Mired in Bureaucracy - But They Don't Have to Be"** suggests. Written by investment industry veteran Christopher Schelling, he defines 'governance' as a body of rules, practices, and processes by which an organization is directed and controlled. The article opens by referencing 19th Century political economist Max Weber's three bases for leadership authority: traditional, charismatic, and rational. Schelling argues that generating strong organizational performance needs a rational basis for building effective governance structures, but that pension funds seldom get it. He offers empirical support for his assertion that most pension funds need to raise their governance game from a surprising source.

Scale and Pension Fund Performance

The logic for scale being an important driver of pension fund performance is straight-forward. Not only will asset management unit costs decline as scale increases, but larger funds also have greater ability to attract and retain investment and IT specialists. This allows them to build and employ data-intensive investment decision models, as well as exploit private markets opportunities by placing their own experts on the ground in investment centers around the world. This logic has been the basis for steady movement to creating larger pension organizations around the world, with Australia, Canada, Netherlands, and the United Kingdom all offering concrete examples.

But does actual experience support this logic? With its extensive databases capturing the actual structural and performance experiences of 100s of pension funds around the world over an almost 30-year period, *CEM Benchmarking Inc.* is well-placed to address this question. The key investment 'performance' metric in their study is the excess of the actual return of a given pension fund over its benchmark return, where the latter return is based on the passive implementation of the fund's strategic target asset mix. Two annual excess returns are calculated for each fund: one gross of expenses, and the other net of expenses. Overall, the study is based on almost 9,000 annual datapoints.

Here are the key study findings, with 'large' funds defined as having asset values exceeding $10B and 'small' funds having asset values under $1B:

- The average excess return for large funds was 83bps on a gross basis, and 29bps on a net basis. The comparable values for small funds were 47bps and -3bps.
- Can this performance differential be explained by large funds taking more active risk than small funds? If yes, this would show up in the form of a higher excess return standard deviation (SD) for the large fund sample compared to the small fund sample. In fact, the reverse was true: the large fund excess return SD was 190bps versus 291bps for the small funds. This suggests that on average, the large funds were actually taking less active volatility risk than the small funds.
- What about net investment performance drivers more finely defined as just raw scale? The study researchers posited three: 1. % Exposure to Active Management (now defined as the stated fund policy position), 2. % Exposure to Insourced Management, and 3. Pure Economies of Scale. The respective coefficients for the Active Management, Insourced Management, and Economies of Scale performance drivers were: 22bps (at 100% active), 19bps (at 100% insourced), and 20bps (per 10x increase in asset value). All three coefficients were statistically significant. These findings suggest that on average, the three performance drivers made roughly equal contributions to net investment performance. In short, the largest funds in the *CEM* database with the highest proportions of active management and insourcing generated the highest net excess returns.

So is generating good investment performance simply a matter of being large, active, and insourced? Of course not. It also requires "*a body of rules, practices, and processes by which an organization is directed and controlled*". Christopher Schelling's cited *II* article reminds us that good organizational governance doesn't just appear out of thin air. It must be consciously designed and deliberately created.

From Scale to Governance Structures

According to Schelling, Max Weber posited three types of leadership authority: traditional, charismatic, and rational. Both the traditional ('We've always done it this way') and the charismatic ('The great leader always knows best') are problematical.

Agreeing with Weber, Schelling asserts that generating strong organizational performance in the 21st Century requires a rational basis for building effective governance structures, but that pension funds seldom get it. Instead, most are mired in traditional 'we've always done it this way' modes. The results, in his words, are "*internal challenges, bureaucratic morasses, perverse incentives, and adverse selection biases*".

Instead, pension organizations need governance structures "*based on rational authority willingly granted to individuals with recognized experience and expertise in specific fields relevant to overseeing the management of pension organizations*". Do such structures actually lead to superior performance? Answering in the affirmative, he cites the work of "*the definitive expert in the field….. Keith Ambachtsheer"…..* who according to Schelling, "*has spent over 30 years researching, evaluating, and consulting on the governance of investing institutions*".

As evidence, Schelling cites much of that work, which was last compiled in the March 2020 *Letter* titled ***"Governance in Asset Owner Organizations: Still Room for Improvement"***. In summary, the *Letter* cited seven studies confirming evidence of poor governance in pension organizations and positive relationships between governance quality and organizational performance:

- Consistently Poor Rankings of Key Governance Responsibilities: in three governance quality surveys of pension fund CEOs 10 years apart (1997, 2005, 2014) performed by *KPA Advisory Services*, the same four Board responsibilities received the lowest quality ratings: compensation oversight, strategy oversight, self-evaluation of Board effectiveness, and Board selection processes.
- A positive correlation between Pension Fund Net Excess Returns and Governance Quality Ratings: reported in a 1998 *FAJ* article by Ambachtsheer, Capelle, and Scheibelhut.[ii] This study was motivated by an earlier 1992 study titled "Fortune and Folly" by anthropologists Conley and O'Barr which was highly critical of the quality of pension fund governance.[iii] The findings in the 1998 *FAJ* article were based on net excess return data provided by *CEM* and the 1997 governance quality rankings from the *KPA* governance quality survey cited above.
- A negative correlation between the degree of political and elected member representation on the Boards of US public sector pension plans and their financial funded status: reported in a 2017 study by Andonov, Bauer, and Cremers.[iv] This empirical evidence suggests that Board members placed on pension Boards through political rather than rational/deliberative processes focus on the present at the expense of the future.
- Seven out of eight (88%) 'Canadian Pension Model' funds outperformed their benchmarks over the 2006-2015 period versus 80 out of 132 (61%) for the other funds in the *CEM* database: the average annual net excess return for the 'Canadian Pension Model' funds was 60bps vs. 10bps for the latter. The 'Canadian Pension Model' funds use the strategic governance model first adopted by the *Ontario Teachers' Pension Plan* in 1990. Over the full 1991-2020 period, *OTPP* generated an average annual net excess return 170bps. Other Canadian funds began to adopt the *OTPP* governance model over the course of the 1990s/2000s period.[v]
- A negative correlation between the degree of political and elected member representation on the Boards of US public sector pension funds and their investment returns: in a follow-up study that focused on investment returns rather than financial funded ratios, a 2018 study by Andonov, Hochberg, and Rauh found that populating Boards through political rather than rational/deliberative processes not only depressed funded ratios, but investment performance as well.[vi]

- A positive relationship between the returns of US public sector pension funds and a Fiduciary Effectiveness Quotient (FEQ): in a 2019 study, authors Merker and Peck explained their FEQ (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). Their study confirmed that, on average, the higher a fund's FEQ, the higher its investment return.[vii]

While these empirical findings on the positive relationship between governance quality and pension fund performance should not surprise anyone, as with scale, they provide important confirmation that what makes sense in theory, actually plays out in practice as well.

Combining Scale and Governance

The stated purpose of this *Letter* was to provide readers with empirical support for the logic that scale and governance quality are both key drivers of pension fund performance. The *Letter* shows that in both cases, the empirical evidence is compelling.

The performance case becomes even stronger when scale and governance quality are intelligently combined. Pension plan participants deserve nothing less.[viii]

Keith Ambachtsheer

Endnotes:

i. *The four CEM coauthors are Alexander Beath, Chris Flynn, Rashay Jethalal, and Michael Reid. I should also note that I am a CEM cofounder, Board member, and shareholder.*
ii. *Ambachtsheer, Capelle, and Scheibelhut (1998) "Improving Pension Fund Performance", Financial Analysts Journal.*
iii. *Conley and O'Barr (1992) "Fortune and Folly", McGraw-Hill.*
iv. *Andonov, Bauer, and Cremers (2017) "Pension Fund Asset Allocation and Liability Discount Rates", The Review of Financial Studies.*
v. *For the complete Canadian Pension Model story see Ambachtsheer (2021) **"The Canadian Pension Model: Past, Present, and Future"**, Journal of Portfolio Management.*
vi. *Andonov, Hochberg, and Rauh (2018) "Political Representation and Governance: Evidence from the Investment Decisions of Public Sector Pension Funds", Journal of Finance.*
vii. *Merker and Peck (2019) "The Trustee Governance Guide", Palgrave Macmillan.*
viii. *After a COVID-related hiatus, the Rotman-ICPM Pension Governance Education Program (PGEP) is geared to start up again September 19-22. Since its inception in 2011, PGEP has consistently received high 'value' ratings from attendees. Contact us if you would like more information.*

Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
416.925.7525. www.kpa-advisory.com