The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

January 2023

GOVERNANCE IN THE NEW *INTERDEPENDENT INSTABILITY ERA*:

IS IT UP TO THE TASK?

"Governance is the action or manner of governing a state or organization."

Oxford Dictionary

"Governance involves a set of relationships between an organization's management, its Board, and its stakeholders. It also provides the structure through which the objectives of the organization are set, and the means of attaining those objectives and monitoring performance are determined."

Organization for Economic Co-operation and Development (OECD)

"Governance is the framework of rules, relationships, systems, and processes within and by which authority is exercised and controlled in organizations. It encompasses the mechanisms through which organizations, and those in control, are held to account."

ASX Corporate Governance Council

Focus on Governance

The **October 2022 *Letter*** introduced the *Interdependent Instability Era* as the new socio-economic backdrop for pension organizations as they invest in the 2020s and beyond. It replaces the decade-long *Mature Capitalism Era* of modest GDP growth, low inflation, and falling interest rates. The sequel **November *Letter*** went on to explore some of the people and cultural implications of this investment regime change for pension organizations:

> "*The **Interconnected Instability Era** has material organizational implications for pension funds. It will require having business and investment expertise diverse in function (e.g., governance, C-suite, IT/AI/ML), in technical knowledge (e.g., legal, scientific, engineering), and in geography (e.g., not just North America, Europe, and Oceana, but Asia, Africa, the Middle East, and Latin America as well). This kind of macro expertise differs materially from the micro 'quant' expertise needed for traditional asset management in a steady-state context.*[i] *It also requires a culture of mutual accommodation, collaboration, and well-designed incentive structures. It is no small task to create, foster, and sustain an investment organization with these features. And to create, foster, and sustain such a culture is not enough. To gain and maintain the trust of the pension organization's stakeholders, these required transformations must also be clearly communicated to them.*"

All this is context for the first *Letter* of 2023. The quote from last November's *Letter* raises questions about governance in two important ways. First, do the businesses pension funds invest in have governance functions that are up to the task of surviving and thriving in the new *Interdependent Instability Era*? Second, do pension funds themselves have the requisite governance functions to achieve their purpose? These are the two questions this *Letter* addresses.

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Madden on Corporate Governance

Business strategist Bart Madden's "Pragmatic Theory of the Firm" offers a good starting point for understanding effective governance in today's corporate context.[ii] In short:

- Capitalism creates value by facilitating knowledge building, competition, and efficient allocation of resources.
- At its heart lies a Knowledge Building Loop that leads to new insights and innovations. This Loop continuously extends knowledge through new ideas/perceptions, experimentation, actions, and feedback.
- Firms have 4 purposes: 1. Communicate a vision that inspires, 2. Survive and prosper through continuous gains in efficiency and innovation, 3. Create and sustain win-win relationships with the firm's stakeholders, 4. Take care of future generations by designing products and manufacturing processes that minimize waste and pollution.
- Firms also have 4-stage lifecycles: 1. High innovation, 2. Competitive fade, 3. Mature, and 4. Failing Business Model.

What are the implications of this 'pragmatic theory of the firm' for corporate boards and their members? Madden sees two:

- First, it means abandoning the traditional corporate governance worldview of hierarchical top-down control. Instead, at least some board members must be willing to step outside this traditional model by being radically open-minded, curious, and willing to assert there likely are unknown useful ideas and innovations out there that need to be discovered. If a corporate board does not have at least a few of these kinds of individuals, the firm is unlikely to achieve its four purposes set out above. Instead, it is likely to become a 'failing business model' candidate.
- Second, as long-term owners of the means of production, pension funds have a fiduciary duty to ensure that the boards of the firms in which they are investors have at least some members that fit the 'radically open-minded, curious, assertive' mold.

Madden references the Net-Zero-related business transformation work led by John Montgomery and Mark Van Clieaf as a clear and present example of why corporate boards need this kind of person.

Montgomery and Van Clieaf on Corporate Governance

The views of these two business thought-leaders are set out in their forthcoming 400-page Wiley book "Net Zero Business Models: Winning in the Global N-Z Economy". It is organized in five sections: 1. N-Z Context, 2. N-Z Technical Foundations, 3. Four Pathways to N-Z, 4. N-Z Plan Implementation, and 5. Beyond N-Z: Systems Change. A case study in the N-Z Plan Implementation section of the book highlights Madden's point about the critical importance radical independent thinking at the Board level:

- Eight years ago, Karina Litvak, a Board member of the Italian energy company ENI began to agitate for the company to develop a Net-Zero transition plan. While the CEO was sympathetic, her fellow Board members were not. Implementing such a plan sounded to them like a breach of fiduciary duty.
- It took her six years to bring the Board around to the view that NOT having such a plan would constitute a breach of fiduciary duty. During that period, she brought in a steady procession of outside experts supporting her point of view from both technical and legal perspectives. Today, ENI not only has a credible N-Z transition plan, but is also investing in renewable energy projects. For example, it now owns a business that produces jet fuel from food and agricultural waste.

The N-Z book also has a strong section on the need for clear systems thinking at the Board and C-Suite levels. Strategic thinking capability is essential in understanding, creating, and maintaining sustainable business models in the *Interdependent Instability Era*. The book suggests that the quality of a firm's N-Z transition plan is a good indicator of the strategic thinking capability of its Board and C-Suite.

Improving Corporate Governance: What Should Pension Funds Do?

The Madden and Montgomery/VanClieaf stories make it clear that corporate Boards need 'outside-the-box' thinkers to avoid group-think paralysis. Achieving this goal will require collective action solutions fostered by strategic leadership. Can this be done? Two very public cases suggest the answer is 'yes':

- ***CP Rail***'s persistent financial underperformance relative to its competitor *CN Rail* drew the attention of activist investor *Pershing Square Capital Management*. It began acquiring *CP* shares in September of 2011, and by January 2012 had built its position to over 10% of shares outstanding. During this period, *Pershing* initiated organization change discussions with *CP*'s Board and senior management, which broke down in January 2012, setting the stage for a proxy battle at *CP*'s AGM in May 2012. *Pershing* gained significant support for its position from proxy advisory firms *ISS* and *GL*, as well as from Canada's institutional investor community. In the end, its three Board nominees were elected, a new CEO was appointed, and eventually, *CP*'s financial performance and stock price improved materially.
- ***ExxonMobil***'s persistent financial and environmental underperformance relative to its peers drew the attention of activist investor *Engine #1*, and it became an *Exxon* shareholder in the Fall of 2020. Soon after, the investor published an 82-page document listing *Exxon*'s shortcomings in its governance, management, and business strategies, and how these problems should be addressed. The document and its recommendations gained broad support in the global institutional investment community, leading to three of *Engine*'s nominees being elected to *Exxon*'s Board at its May 2021 AGM. Since then, *Exxon* has revamped its business models and strategies to bring them more in line with future economic and environmental realities. Its stock price has responded favorably.

These two success stories suggest the 'smart leadership/collective action' formula can be an effective tool to re-energize 'stale' corporate governance functions. A more explicit process for identifying where these regeneration processes are needed could lead to many more such success stories. For example, *South West Airlines'* (*SWA*) highly publicized recent operating meltdown was due to using aging IT infrastructure that had not been updated for over two decades. Yet, its Board approved over $9 billion in share buybacks in the last eight years, with which *SWA*'s institutional investor base was quite pleased. Where was the 'out-of-box' thinking Board member who could have seen this IT disaster coming and blown the whistle?

What About Pension Fund Governance?

If pension funds have a fiduciary duty to ensure the firms they invest in have robust governance functions, what does that say about their own governance structures and processes? Surely these too should pass reasonable effectiveness tests? What might such tests look like? Our prior research and writings on pension fund governance offer a good starting point to address these questions. The ***February 2022 Letter*** titled "Scale and Governance: New Insights into the Drivers of Pension Fund Performance" had this to say:

- Historically, both academics and pension fund CEOs have had generally dim views of the quality of pension fund governance.
- Correlations between pension fund governance quality and risk-adjusted investment returns in large databases have historically been positive. The same is true for the correlations between pension fund governance quality and plan funded status.

- There have been, and continue to be, material differences in pension fund board member selection/appointment processes. For example, in Canada these selection/appointment processes have been explicitly designed to select Board members with relevant skill/ experience/competence sets. In contrast, in USA the majority of board members are appointed either through some kind of plan member election process, or through having 'ex officio' status by virtue of the person's elected position (e.g., state controller or treasurer). Not surprisingly, these differences in pension trustee appointment processes have translated into material differences in investment performance and funded status in Canada's favour.[iii]

So where to from here? Based on what we know, two actions can materially improve the current situation:

- Design and implement pension fund board member selection processes that lead to the appointment of Board members with relevant skill/experience sets, with a proven capability for strategic thinking, and with a proven willingness to speak up and go against the grain when in her or his view, the situation demands it.
- Require Board members to attend the offerings of the *Rotman-ICPM Pension Governance Education Program* (*PGEP*). This Program has been on offer since 2011, and has 'graduated' over 300 attendees thus far. The Program has consistently garnered very high satisfaction ratings from attendees.[iv]

In concluding this *Letter,* the expression 'what is good for the goose….is good for the gander' comes to mind. Improving governance in the corporate sector is surely a value-generating activity for pension organizations, especially in the new *Interdependent Instability Era*. If that is true, improving governance must also be a value-generating activity in the pensions sector itself. Is your organization acting on this reality? If not, should it be?

Keith Ambachtsheer

Endnotes:

i. *A new book by Bril, Kell, and Rasch titled "Sustainability, Technology, and Finance: Rethinking How Markets Integrate ESG", Taylor&Francis digs deeply into these issues.*
ii. *For more detail, see Bartley J. Madden (2022) "**Understanding the Benefits of Capitalism through a New Theory of the Firm**", Madden Center for Value Creation, Florida Atlantic University.*
iii. *See Ambachtsheer (2022) "**How Peter Drucker Revolutionized Canada's Public Sector Retirement Income System: Lessons for Americans**", Harvard Law School Forum, and Weinberg (2023) "**Investing Novices Are Calling the Shots for $4 Trillion at US Pensions**", Bloomberg, for more detail.*
iv. *The next ICPM-Rotman Pension Governance Education Program at The Rotman School of Management will take place September 25-28 2023. There are two other offerings for Board members of pension organizations currently in the planning: 1. The ICPM-Oxford Asset Owner Sustainability Leadership Workshop at Oxford University June 21-23, and 2. the ICPM-Maastricht Pension Communication & Member Engagement Workshop at Maastricht University October 4-6. See the **ICPM Website** or reach out to **icpm@icpmnetwork.com** for more information.*

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416.925.7525. www.kpa-advisory.com