The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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THE FUTURE OF PENSION MANAGEMENT

ARE WE THERE YET?

I recently addressed the 'are we there yet?' question at the first 'in person' Discussion Forum of the International Centre for Pension Management (ICPM) since 2019. Readers will recall that 'The Future of Pension Management' was the title of my most recent book, released in 2016. The Forum talk provided a timely opportunity to compare the future of pension management visualized in 2016….with actual outcomes over the course of the last six years…..and how different that future looks today from what the book visualized in 2016. This Letter tells the tale.

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Peter Drucker's Game-Changing Book on Pension Management

Winston Churchill proclaimed that those who do not learn from history, are bound to repeat it. In that spirit, let's start by looking back on some pension history, and see what we can learn from it. During my brief 1970s career advising financial institutions on integrating Modern Portfolio Theory (MPT) into their investment processes, I read Peter Drucker's only book (out of 39) on pension management that he would write during his illustrious 7-decade career as the globe's premier thought-leader on management principles and practices. The book was published in 1976 and its title was *The Unseen Revolution*.

The Book's story line was both simple and powerful. Demographics would eventually turn the outsized Boomer Generation of the 1970s into an outsized Retiree Generation with an outsized accumulation of retirement savings. Through that accumulation, the Retiree Generation would become major owners of the means of production not through a violent Marxian revolution, but peacefully through their pension funds. Would these funds be up to the job as wise stewards of society's means of production and reliable providers of retirement income streams? According to Drucker, only under two conditions: 1. 'Legitimacy', and 2. 'Organization Effectiveness'. By 'Legitimacy' he meant fair 'pension deals' and 'best interests/ arms-length' implementation organizations, and by 'Organization Effectiveness' he meant 'good governance', 'scale economies', 'clear business model', and 'expert execution'.

Implementing the Drucker Pension Model

If the 1970s were about implementing MPT for me, the 1980s were about implementing the Drucker Pension Model with its two success conditions. These efforts were low-key until the Government of Ontario opened a major disruption window in 1987. It wanted to improve the management of Ontario's public sector pension plans and formed a task force chaired by Malcolm Rowan to study the problem and make recommendations. I signed on as a principal advisor to the Task Force. A year later, the Rowan Task Force submitted a 400-page Report to Ontario Treasurer Robert Nixon titled "*In Whose Interest?*" The heart of its recommendations was to implement the Drucker Pension Model with its two success conditions of 'Legitimacy' and 'Organization Effectiveness' in Ontario's public sector.

Miraculously, Treasurer Nixon and Margaret Wilson, head of the *Ontario Teachers' Federation* (*OTF*) decided to implement the Report recommendations by creating the *Ontario Teachers' Pension Plan* (*OTPP*) as a jointly-owned, arms-length, not-for-profit entity in 1990. They persuaded the just-retired Governor of the *Bank of Canada* to become *OTPP*'s first Board Chair, helped attract eight other strong Board Members, who in turn hired Claude Lamoureux, a senior, independently-minded insurance executive, as its first CEO. He hired a strong executive team, who disrupted a tradition-bound pensions sector with new approaches to stakeholder relations, to pension design, to organization design, and to investing. Over the course of the 1990s and the 2000s, *OTPP*'s innovations spread to other pension organizations in Canada….and eventually outside Canada as well.

Two other pieces of pension history are worth noting before we turn to the future of pension management as it looks today. The first is the founding of *CEM Benchmarking* at the same time as the founding of *OTPP*. *CEM*'s motivation was another Druckerism: 'what gets measured gets managed'. Today *CEM* is the leading 'value for money' benchmarker in the global pensions space.[i] The second is the founding of *ICPM* in 2004. Its motivation was to bridge the info/knowledge gap between pension academics and pension practitioners. Today, *ICPM* is recognized as the globe's premier pension info/ knowledge transfer conduit between academia and the pension world with 45 participating pension organizations from 10 countries managing a collective $6T in retirement savings.[ii]

Now, on to the future of pension management in three dimensions: design, governance, and investing.

The Future of Pension Design

Preparing for this talk, I reread my *The Future of Pension Management* book for the first time since signing off on the printer's proof seven years ago. My initial reaction was that most of the future of pension management I foresaw writing the book in 2015 is still the future of pension management in 2022. That was not a surprise….things move slowly in the pensions world. More importantly, there have been notable developments in each of the three parts of the book: 1. Pension Design, 2. Pension Governance, and 3. Pension Investing.

Starting with Design, a major global challenge has been, and continues to be, to enroll entire workforces and retiree cohorts into well-designed, well-managed workplace pension plans. But what does 'well-designed' really mean? The good news here is that we are finally moving beyond the tiresome 'DB vs. DC' debate…..towards a more valid, useful description of 'well designed'. That description follows logically from applying Nobel Laureate Jan Tinbergen's economic policy principle that there must be at least as many policy instruments as there are policy goals to pension economics. The two goals in pension economics are 1. Affordability, and 2. Reliable post-work income for life. For individuals, the relative importance of these two goals changes with age….affordability first….and reliable post-work lifetime income later. So logically, 'well-designed' workplace pension plans have separate accumulation and decumulation pools, with plan participants moving their exposure from one to the other as they approach the post-work part of their lives.

The good news is that this is finally happening. Australia's *QSUPER* launched its *LifeTime Pension* offering in March 2021. Member response has been positive, and the offering has already won two industry innovation awards. Canada's *Purpose Financial* has followed with its *Longevity Pension Fund*, and additional 2-instrument pension plan offerings are expected to launch in Canada soon. *TIAA* in the USA has had a 2-instrument offering for decades, with other US pension service providers finally expected to follow. Looking across the Atlantic, *NEST* and other new multi-employer plans in the UK will also follow suit as they mature. There is also bad news in this move to 2-instrument pension designs. 'Path-dependency' makes it difficult for collective 1-instrument pension designs (e.g., defined benefit, target benefit, collective DC) to switch to a 2-instrument pension design.

The Dutch are learning this the hard way by actually attempting to do this. They would have been far better off following the lead of Canada's public sector target benefit plans who learned how to get their 1-instrument plans to mimic the ideal 2-instrument alternative without actually splitting the total fund into separate accumulation and decumulation components.[iii]

The Future of Pension Governance

Commentary on the behavior of governance bodies (e.g., boards, committees) overseeing investment processes for collective asset pools (e.g., pension or endowment funds) goes back a long way. For example, in Chapter 12 of *The General Theory of Employment, Interest, and Money* (1936), John Maynard Keynes famously wrote: "*Worldly wisdom teaches that it is better for reputation to fail conventionally … than to succeed unconventionally*". In an echo, almost 60yrs later, anthropologists William O'Barr and John Conley in their 1992 *Fortune and Folly* study of the Board behavior of nine major US pension funds over a 2yr period wrote: "*These Boards seemed to be more focused on blame management and responsibility deflection than on the effective oversight of a complex financial institution*".

The *Fortune and Folly* study triggered further studies into the governance of pension organizations, some of which I participated in. One such study surveyed a large sample of pension fund CEOs, asking them to estimate the 'excellence shortfall' in their investment programs due to shortcomings in their governance processes. The median response was 66 basis points. This turned out to be a good estimate based on later empirical studies using the *CEM Benchmarking* databases. Maybe the most unique pension governance survey I have been involved with was first done in 1997, repeated in 2005, and again in 2014. It found the same three governance activities to rank the lowest in CEO satisfaction in all three surveys: 1. compensation design, 2. decision delegation authority to management, and 3. Board selection and evaluation practices. Surely the time has come to fix these long-time governance problems?

Concluding on a positive note, since its launch in 2011, the week-long *Rotman-ICPM Pension Governance Education Program* (*PGEP*) has 'graduated' 315 attendees from 17 different countries. The Program has received uniformly high satisfaction ratings from attendees. After a 2yr COVID-induced hiatus, *PGEP* is going 'live' again this coming September 19-22. The governance function in pension organizations needs to continue to improve, and *PGEP* can play an important role in fostering those improvements.

The Future of Pension Investing

A key investment message in the 2016 book worth repeating is that we cannot rely on *Modern Portfolio Theory*, the *Efficient Markets Hypothesis*, and on history repeating itself to drive today's and tomorrow's pension fund investment policies. Instead, the emphasis should be on understanding where capitalism and financial markets have been, where they are now, and where they might go from here. I have been doing this for some 40yrs now, with the help of many out-of-the-box thinkers along the way. They include Andrew Lo with his *Adaptive Markets Hypothesis*, Thomas Piketty with his *Capital in the 21st Century*, William Bernstein with his *Paradox of Wealth*, Bart Madden with his '*Life Cycle of the Firm*' framework, and the Carbon Crowd with its burgeoning literature on the investment implications of climate change.[iv]

A unifying reality underpinning this array of insights is that interest rates, GDP volatility, and equity risk premiums have been trending downward for centuries, but especially over the course of the last 40yrs. This has two important consequences: 1. Realized investment returns have been generally high ex-post, and 2. Prospective investment returns are now, by historical standards, more modest ex-ante. Given the looming accelerating impact of climate change across the investment spectrum, prospective investment returns may also be more diverse than has historically been the case. I believe these realities justify a major rethink of how we organize and staff the investment functions of major asset owner organizations, including pension funds.

At a macro level, strategic thinkers are needed to carry on the work of the Los, the Pikettys, the Bernsteins, the Maddens, the Carbon Crowd, to help reimagine the investment function as a whole, and to break down the traditional silos in these organizations. At a micro level, more specialists are needed with scientific, technical, and business backgrounds to really understand the cashflow potential and sustainability (or lack of it) of the organization's actual investments, as well as of those under consideration to become future investments.[v]

In Conclusion

Peter Drucker's pension revolution is 'unseen' no longer[vi]…..but is certainly not over. Serious 'to do' lists remain in all three of its dimensions….design, governance, and investing. I close with the final line from Andrew Potter's book with the depressing title *On Decline….Why Every Year Is the Worst One Ever*. However, he ends with a hopeful message:

> *"THE FUTURE IS NOT YET WRITTEN……THERE IS NO FATE BUT WHAT WE MAKE FOR OURSELVES"*

Applied to the future of pension management, the message is that there is much we can do to improve current practices….if we choose to do so.

Keith Ambachtsheer

Endnotes:

i. *CEM was cofounded by Virginia Atkin, John McLaughlin, and this author in 1991. Tom Scheibelhut was its CEO from inception until 2021, when he passed the baton to Rashay Jethalal. Today, the organization covers 525 funds in 25 countries with $15T in assets.*

ii. *ICPM was cofounded by Brendan Calder and this author in 2004. He was its first Board Chair and I was its first Executive Director. Rob Bauer succeeded me in 2014, and Sebastien Betermier will succeed him in 2023.*

iii. *The key challenge is to split the total fund asset pool into individual plan member components using methods that are both fair and explainable…..and to further split those individual plan member fund components into accumulation and decumulation sub-components using methods that are also fair and explainable. For more on this, see our August 2020 Letter titled "**Has a 'Sustainable Pension Plan' Become an Oxymoron? Lessons from Canada, the UK, and the Netherlands**".*

iv. *For more on this, see our October 2021 Letter titled "**Grappling with an Unknowable Future: Statistics or Stories?**"*

v. *For more on this, see our June 2022 Letter titled "**Rethinking Pension Fund Investment Strategy: Why and How**".*

vi. *In addition to being Board Chair of ICPM, Brendan Calder was also Board Chair of the Peter Drucker Canada Foundation. This led to an actual meeting with the great man in 2005. In that meeting we were able to tell him that his Pension Revolution was unseen no longer. The Drucker Pension Model had effectively been implemented in Canada, and was being adopted in other countries as well. CEM Benchmarking had been created to measure what should be managed, and ICPM had been created to foster further research and development into the application of the Model. Drucker was 96 when we met in August 2005. He died three months later.*

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