The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

June 2022

RETHINKING PENSION FUND INVESTMENT STRATEGY:

WHY AND HOW

Strategy: *A plan to achieve one or more long-term goals under conditions of uncertainty.*

Wikipedia

"Strategic planners pride themselves on their rigour. Strategies are supposed to be driven by numbers and extensive analysis, uncontaminated by bias, judgement, or opinion. Yet, if that is the case, why do so many have a sense that strategic planning does not produce novel strategies….that instead, it perpetuates the status quo?"

Roger Martin
"A New Way To Think"
Harvard Business Review Press

Roger Martin's New Book

Former Dean of the Rotman School of Management and one of the globe's top management thinkers, Roger Martin has just written his 13th book: "*A New Way To Think*". It offers many insights, all from the perspective that, whether we realize it or not, we all have prior mental models that guide our strategies and activities. He argues true innovation requires "a new way to think"….a way that suppresses our tendency to automatically use a prior embedded model to address whatever problem that needs a solution. Structurally, the 14-chapter book has four sections (On Context, Making Choices, Structuring Work, Key Activities).

In the "Making Choices" section, he argues that successful strategies follow from a multi-step process based on his 'new way to think' formula:

- Don't fall into the detailed data analysis trap. Instead, posit mutually exclusive solutions to the issue to be addressed. This sets up a situation of having to eventually make a choice between competing alternatives.
- What are the advantages/disadvantages of the competing solutions? This question should be taken up by teams diverse in specialties, backgrounds, and experiences.
- Specify the conditions for success: what must be true for each possibility to be a great choice?
- Identify the barriers to implementation for each choice and test their materiality.
- Only after these steps are completed, make the best strategy choice among competing alternatives.

Martin comments all this is easier said than done, because success requires three shifts in mindset: 1. Ask 'what *might* we do rather than what *should* we do', 2. Ask 'what *would* we have to believe' rather than what *do* we believe', and 3. Ask 'what are the right *questions* rather than what is the right *answer*'.

Regular readers of this publication will recall that pension fund investment strategy has been a recurring *Letter* topic. For example, it was addressed in various contexts in six of the last nine *Letters*. The goal of this *Letter* is to put our treatment of the investment strategy topic to the test. By the standards set out in Martin's book, how well have we been doing? How could we (and you) do better?

From Context to Strategy

Appropriately, Martin starts his book with an 'On Context' section with three chapters generally related to organization purpose and the stakeholders the organization serves. Framing this in pensions space, here is how we set out the broad context in the recent **April *Letter***:

- **Organization Purpose:** while the 'micro' purpose of a pension organization to deliver adequate pensions at a reasonable cost remains front-and-center, a broader multi-dimensional focus on sustainability is also a legitimate element of the purpose mix. Such a broader focus requires giving thought to issues like intergenerational fairness in risk-bearing and reward-sharing within the 'pension deal'. Also, how does the organization's investment program contribute to the sustainable long-term wealth-creation processes required to generate adequate pensions in aging societies at affordable contribution rates?

- **Governance:** what is the process for selecting pension organization Board members? Is there a mechanism to ensure the Board has the requisite skill and experience to provide expert oversight not only in traditional areas such as pension plan design, but also in emerging sustainability areas such as designing and implementing an effective Net-Zero investment program? Is there a mechanism for evaluating Board effectiveness over time?

- **Business Model:** how does the pension organization ensure that it has, and properly uses, the tools needed to achieve its stated micro and macro goals? This will require the successful integration of establishing target pension payments, designing adjustment mechanisms to steer a sustainable path between inevitable bouts of over- and underfunding, designing and implementing an effective Net-Zero investment program that reflects the risk appetites of plan members and other possible plan risk bearers (e.g., tax payers), a compensation philosophy that attracts and retains the people needed to make all this work in practice, and finally, a stakeholder communications program that elicits trust that the organization is being competently managed in the best interests of its stakeholders.

- **Performance:** how do actual outcomes compare to organizational targets? This question should be regularly addressed throughout the organization's full value-creation chain. So, following the key components of the Business Model set out above, metrics need to be defined for actual pension payments vs. target payments, actual funding status vs. target funding status, actual investment results vs. target results (e.g., rates of return, costs, carbon emissions), actual compensation vs. target compensation, and actual benefit administration and stakeholder communication quality outcomes vs. target outcomes.

- **Strategy:** while it is essential to report on backward-looking performance metrics, it is equally essential to report on forward-looking plans from here. Once again, the organization's full value-creation chain is fair game. What are possible plans for further clarifying organizational purpose? For improving governance? For improving plan benefit design? For improving and expanding the Net-Zero investment program? For compensation philosophy? For improving benefit administration and stakeholder communications?

This broad context framing sets the stage for a more detailed examination of how prior *Letters* have addressed the pension investment strategy setting question.

Pension Investment Strategy: What Has Been *KPA*'s Approach?

Roger Martin warns against falling into deep black data holes. Instead, start by articulating possible alternatives to framing investment strategy. Weigh the pros and cons of each alternative. Go with the choice, that all considered, feels closest to serving the purpose of the organization and its stakeholders. Communicate your decisions to the relevant stakeholders in plain language to maintain their trust.

What has the *KPA* approach actually been in prior *Letters* and related talks/conversations? A summary:

- **An Ongoing Investment Context Narrative:** we have been addressing the 'what's going on out there?' question through story themes for decades. The stories are multidimensional, integrating socio-economic drivers, leading to judgements about capital markets pricing and related return and risk prospects. They are dynamic in the sense of trying to understand regime changes and their implications for financial markets pricing and returns. By our count, the last such a regime change occurred with the transition out of the *Double Bubble Blues* decade through the Global Financial Crisis into the *Mature Capitalism* era. The first decade of *Mature Capitalism* era saw predictably high equity returns/modest bond returns/ low inflation. However, with the combination of increasingly visible climate change impacts, the COVID pandemic, ageing demographics, rising inflation and interest rates, and Russian aggression, with possibly Chinese aggression to follow, this is an opportune time to reflect on where the *Mature Capitalism* narrative goes from here.
- **Emerging, New Models for Framing Investment Strategy:** our writings have reflected a steady movement away from the doctrines of the traditional 'small world' portfolio and efficient capital markets theories. Instead, there has been an increasing emphasis on understanding the emerging socio-economics and investment implications of the decade ahead (now the 2020s) and beyond through integrating Kay/King's radical uncertainty framework[i], Madden's corporate lifecycle framework[ii], and the new Goodfellow/Willis's net-zero corporate pathways framework.[iii] This integration process leads to a focus on visualizing the 'deep' risks and opportunities that lie ahead, and the resulting investment strategy choices facing pension and other long-horizon investment organizations. While those strategy choices have been implicit in our writings, this seems like the right time to make them explicit.

To that end Martin asks: what would I have to believe for the 'deep lens' framing of investment risks and opportunities to be a superior strategy approach for pension organizations compared to the traditional passive 'small world' approach?

Choosing the 'Deep Lens' Option

An important 'why' belief is that pension organizations have a fiduciary duty to act in the best interests of their stakeholders. As a consequence, pension organizations must be 'future makers' rather than 'future takers'. Thus they must be knowledgeable custodians of the means of production acting in the best interests of their stakeholders. This in turn means taking an active interest in the governance and strategies of the businesses they invest in. Behind this 'macro' belief lies a further supporting 'micro' belief. Logic suggests and research confirms that this kind of engaged investor has a comparative advantage over Keynes' short-term 'beauty contest' traders: their investment processes generate higher risk-adjusted returns.[iv]

Just as there are required beliefs to support the 'why?' answer in choosing the 'Deep Lens' option, there are also required beliefs to address the 'how?' question. Prospective capital impairment risks and promising investment opportunities don't just show up in our Inboxes. Identifying them requires business and investment expertise diverse in function (e.g., governance, c-suite, IT/AI), in technical knowledge (e.g., legal, scientific), and in geography (e.g., Asia, Latin America).

This kind of expertise differs materially from the 'quant' expertise needed for asset management in the traditional 'small world' investment framework of known probability distributions of investment returns, portfolio optimization, and utility maximization.

Translating the 'Deep Lens' option into a coherent strategy implementation program 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 it is not enough. To gain and maintain the trust of the pension organization's stakeholders, it must also be clearly communicated to them.

In conclusion, we agree with Roger Martin that setting and implementing investment strategy in pension organizations should be based on clearly articulated choice alternatives, and on what would have to be believed to choose the most suitable alternative. Can the investment strategy-setting process in your organization pass this test? Or, in Martin's words, are you merely perpetuating the status quo?

Keith Ambachtsheer

Endnotes:

i. *See the **August 2019** Letter for more on the Kay-King radical uncertainty framework. Its essence can be captured by this quote from the introduction to their book: "Risk in a world of radical uncertainty is the failure of a projected narrative, derived from realistic expectations, to unfold as envisaged."*

ii. *See the **October 2021** Letter for more on Madden's corporate lifecycle framework. Its essence is to assert that just like humans, organizations too have lifecycles. Four Stages to be specific: 1. 'High Innovation', 2. 'Competitive Fade', 3. 'Mature', and 4. 'Failing Business Model'. Through multiple stories he shows that successful value-creating firms generate returns above their cost of capital by surviving Stage 1 and avoiding Stage 4.*

iii. *This framework assesses the ability of a corporation to move to a 'net-zero' emissions state from current operations. Pathway 1 companies can get there with their current business models by adopting core eco-efficiencies (e.g., Apple). Pathway 2 companies need to fundamentally transform their business models to move to a 'net-zero' emissions state (e.g., fossil fuel producers). Pathway 3 companies are new ones, designed with the 'net-zero' constraint in mind. They are potential industry disruptors (e.g., Tesla). Conceptually, it is interesting to integrate the Madden and the Goodfellow/Willis frameworks. Surely some of the Pathway 1 and 2 companies are candidates for Madden's Failing Business Model category.*

iv. *See, for example, the **February 2022** and **May 2022** Letters.*

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