The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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'ASYMMETRIC INFORMATION' IS THE BIGGEST PROBLEM IN PENSION FINANCE:

IMPLICATIONS FOR PENSION DESIGN, REGULATION, AND GOVERNANCE

"George Akerlof's 'The Market for Lemons' paper was rejected by the first three academic journals it was submitted to for being "trivial" and "incorrect". It was finally published in the Quarterly Journal of Economics in 1970. Today, it is one of the most cited papers in modern economic theory. It has profoundly touched virtually every field of economics, from industrial organization and public finance, to macroeconomics and contract theory."

Wikipedia, 2022

"Ever since Adam Smith, the central teaching of economics has been that free markets provide us with material well-being, as if by an invisible hand. We deliver a fundamental challenge to this insight, arguing that markets harm as well as help us. As long as there is profit to be made, sellers will systematically exploit our psychological weaknesses and our ignorance through manipulation and deception."

George Akerlof and Robert Shiller
From their book "Phishing for Phools", 2015

The Power of Knowledge

While 1776 is usually associated with the American Declaration of Independence, to most economists around the world it was the year Adam Smith published his famous 'free markets' treatise "The Wealth of Nations". It proclaimed that free market forces would ensure the production of the right products through the right allocation of resources at the right price, to the benefit of all.

With his 'Lemons' (i.e., faulty used cars) paper, Akerlof poked a big hole in Smith's free markets argument. A key assumption in Smith's manifesto was that the buyers and sellers in his free markets manifesto both had complete information about the characteristics and attributes of the product being bought and sold. Akerlof simply asked: 'what happens if that is not the case?'

In his used car market example, he started with the fact that the sellers of faulty used cars (i.e., 'lemons') know a lot more about the product they are selling than the buyers know about what they are buying. The logical consequence of this 'asymmetric information' situations is that buyers will overpay relative to the true value of a 'lemon'. Generalizing from the faulty used car market, this overpaying problem will exist in any market where sellers know more about what they are selling than buyers know about what they are buying.

In which markets is this 'asymmetric information' problem likely to be most pronounced? In markets that (a) require technical knowledge for buyers to make good decisions, and (b) are large enough in relation to the size of the economy to be material. In his 1976 book "The Unseen Revolution", management philosopher Peter Drucker pointed to the market of retirement finance as meeting both criteria. It requires technical knowledge about investing and the mathematics of pension finance to make good decisions, and it potentially impacts a country's entire workforce.

This *Letter* examines the implications of the 'asymmetric information' problem in the retirement finance market, and what can be done to address it.

Peter Drucker's Pension Manifesto

Back in the 1970s, while the outsized 'boomer generation' was still young, Drucker shared his thoughts on the coming challenges in retirement finance. He set the stage in his "The Unseen Revolution" book by pointing out that Karl Marx was wrong a century earlier, when he claimed that capitalism would self-destruct through violent revolution, leading to workers eventually taking over ownership of the means of production. Instead, Drucker argued, they would do so peacefully through the investment of their retirement savings.

However, he argued, the success of that coming retirement savings-based 'revolution' would hinge on the presence of two foundations:

1. 'Legitimacy': Drucker's success 'sine qua non' was that the retirement income system would be managed in the sole best interest of the workers. Inserting conflicts of interest into that management process would sound its death-knell. Clearly, Drucker was well-aware of the 'asymmetric information' problem Akerlof set out in his 1970 'Lemons' article.

2. 'Organizational Effectiveness': pension organizations will not be exempt from the universal dictates of organizational effectiveness. Achieving economies of scale is one implication, as costs matter in how pension organizations are run. Good governance is another implication. To achieve their purpose, pension organizations will need not only clear purpose, both also strong board oversight and skilled executive management.

Regular readers of this *Letter* know we have been a long-time advocate of ensuring pension organizations are built on these two foundations. For example, they underpin the creation and evolution of the **Canadian Pension Model**. Multiple studies have praised the Model for its value-creation potential.

Measuring the Value of 'Legitimacy' and 'Organizational Effectiveness'

Was Drucker right in predicting that the absence of 'legitimacy' and 'organisational effectiveness' would have material value-destroying implications for retirement savers? The short answer is 'yes' and 'yes'. For example, consider these empirical findings:

1. 'Legitimacy': value-destruction estimates of its absence can be based on investment return differences between pension funds managed in the best interests of members, and mutual funds managed in the best interest of their providers, with similar asset mix policies, over extended periods of time. Detailed studies using Australian, Canadian, and USA data bases indicate pension funds outperform mutual funds by an average 2%/yr. due mainly to much lower distribution and operating costs.[i] That additional 2%/yr. translates into the average worker receiving the same lifetime pension at a 50% reduction in the required contribution rate (e.g., 15% of pay rather than 30% of pay).[ii] Stated differently, the extra distribution and management costs in the mutual fund sector double the cost of a target lifetime pension for the average worker.

2. 'Organizational Effectiveness': a separate question is the value-enhancement prospects of scale and good governance. The databases of *CEM Benchmarking* permit the calculation of a pension fund's Net Value-Added (NVA), its excess return over a passively-implemented investment policy benchmark. Out of an international sample of 77 pension funds with the most recent 20yrs. of continuous data, 53 (70%) generated a positive 20yr. NVA, with the top fund generating 1.4%/yr. Further statistical analysis identified three factors positively

correlated with NVA: scale, %actively managed, and %insourced. Without a direct *CEM* governance quality metric, it is not possible to calculate a direct governance quality coefficient. However, arguably, %actively managed, and %insourced are both reflections of good pension fund governance. Also, more direct governance quality impact studies (e.g., using CEO rankings of Board quality, Board member profiles, and Board meeting minutes) all found positive correlations with fund NVA. Given all this, it is reasonable to attach a 1%/yr. return increment to the 'organizational effectiveness' factor, which translates roughly into a further 25% reduction in the required contribution rate (i.e., from 15% of pay to 11% of pay).

3. The Greater Good: likely, this micro 'value-creation' calculation understates the positive impact of 'organizational effectiveness'. Reasonably, stronger pension governance makes pension organizations more effective investors, which in turn positively impacts the productivity and sustainability of the corporations they invest in….to the benefit of the entire economy and its participants.

Given that 'legitimacy' and 'organizational effectiveness' are material value-creators in the retirement income generation space both in theory and practice, what are the policy implications?.

Policy Implications

We look at Australia and Canada in some detail, and end with some Rest of World observations:

- Australia: We addressed the legitimacy/effectiveness question this past April 28 at the annual conference of the *Australian Superannuation Fund Association* (*ASFA*). As a talk-opener we noted that the recent Haynes Commission criticized Australia's financial services industry in general, and parts of its $3.5T superannuation sector in particular for 'extracting fees for no service'.[iii] Somewhat naively, the Commission recommended that all providers of superannuation services should be "fair, provide 'fit for purpose' services, and always act in the best interests of members". The Commissioners would have done better to cite Akerlof's 1970s 'Lemons' paper and acknowledged that only high-legitimacy 'profit for members' structures can eliminate the persistent 2%/yr. return reduction in the $0.7T retail segment of the super industry due to its high sales, distribution, and management costs. On the positive side, the 'Your Future/Your Super' performance test being implemented later this year will be helpful in putting the worst-performing super funds out of business.[iv] Also on the positive side, there have been observable trends in the 'profit for members' sector of the superannuation system of smaller funds merging with larger ones, and of strengthening the governance and executive functions in those larger funds.

- Canada: The contrast between the $2T high-legitimacy 'profit for members' segment of the Canadian retirement savings industry and its $2T retail 'profit for providers' counterpart is even more striking than in Australia. The former segment (largely public sector-related) is managed by organizations using the globally-renowned Canadian Pension Model which has the triple advantages of legitimacy, scale, and good governance. In contrast, the latter segment (largely private sector-related) has none of these attributes. Instead, there is a politically-powerful commercial financial services sector generating high fee-related levels of revenues from that $2T of retail retirement savings (e.g., 2% of $2T amounts to a $40B/yr. revenue stream). What can be done to improve the financial prospects of the millions of Canadian workers and retirees who are currently not benefitting from being under the Canadian Pension Model umbrella? The answer is as simple as it is obvious: allow Canadian Pension Model organizations to offer their pension and investment management services to private sector workers and retirees. Happily, active discussions are underway to examine how this might come about.[v]

- Rest of World: USA-based private sector workers are in the same position as their Canadian counterparts, except that there are no prospects of being saved by already-in-place Canadian Pension Model organizations. However, a number of states have initiated state-wide retirement savings initiatives that could eventually evolve into Canadian Pension Model-type organizations. In contrast, the UK wisely introduced a compulsory auto-enrolment into a qualifying retirement savings scheme a decade ago, and also established the *National Employment Savings Trust* (*NEST*) as the default 'profit for members' provider of the requisite investment management and benefit administration services. A healthy competition has developed between *NEST* and other large and still-growing 'profit for member' Master Trust providers such as *The People's Pension* and *NOW Pensions*. Continental Europe is far less exposed to the 'legitimacy' issue due large retirement system components that are either largely universal pay-go (e.g., France and Italy) or 'profit for members' workplace-based (e.g., the Nordic countries and the Netherlands). At the other side of the world, China is about to launch a retail-based retirement savings initiative. Chairman Xi Jinping would do well to read Akerlof's "The Market for Lemons" and Drucker's "The Unseen Revolution" first.

Akerlof and Drucker were at their prescient bests when they wrote "The Market for Lemons" and "The Unseen Revolution" some 50 years ago. Our job now is to transform their wisdom into effective pension systems and sustainable capitalism.

Keith Ambachtsheer

Endnotes:

i. *See, for example Ambachtsheer and Bauer (2007) "**Losing Ground: Do Canadian Mutual Funds Produce 'Fair Value' For Their Customers?**" Canadian Investment Review, Bogle (2008) "**Bringing Mutuality to Mutual Funds**", Rotman International Journal of Pension Management, Sy and Liu (2009) "**Investment Performance Rankings of Superannuation Funds**", SSRN.*

ii. *See, for example, Cross and Hamilton (2018) "**Risk and Reward in Public Sector Pension Plans: A Taxpayer's Perspective**", Fraser Institute.*

iii. *Fans of the great movie 'Casablanca' may recall the scene of police chief Louie saying "I am shocked to find that there is gambling going on in this establishment" as he is at the same time pocketing his winnings.*

iv. *Two failures of the test (an NVA under -0.5% for an 8yr. holding period) requires a fund to stop offering the failed product (e.g., the MySuper default option). A study by CEM Benchmarking and McKinsey titled "What Is the Value of the 'Your Future/Your Super Test'" shows this test is modestly predictive in weeding out persistent underperformers, which tend to be small and outsourcers of their investment functions.*

v. *Also, a growing proportion of retail retirement savings are invested in passively-managed offerings, which has been lowering the impact of the traditional 2% fee trap. Another exception is the retail-based Purpose Longevity Pension Fund with a 0.6% management fee. I am a member of its Advisory Committee.*

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