REMAPPING DEBATE
Asking "Why" and "Why Not"

What if pension funds grabbed the reins?

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Apr. 18, 2012 — Public and private pension funds in the United States collectively have trillions of dollars in combined assets. They own more than a third of all domestic equity, with stakes in most public U.S. companies, and large holdings of corporate and government bonds, real estate, and infrastructure. They are unique in that they are both very large and have a much longer investment horizon than most other types of investors.

But, with few exceptions, American pension funds do not self-manage the majority of those assets, and they ignore the flexibility that their long-term horizon can bring, experts said. They employ private firms to invest their assets for them, often with a short-term focus and at a high cost. Many of their trustees are political appointees without any experience in finance. And so, instead of being viewed as powerful financial players, with the capacity to initiate deals and lead markets, pension funds act — and are treated by the financial advisors they employ — more like large customers.

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Northern lights

Some of the largest public pension funds in Canada, though, have taken a very different approach than their American cousins. Set up as quasi-independent entities, the funds have appointed board members with strong backgrounds in economics and finance and, over the course of the last two decades, have developed and rely largely on in-house investment management teams.

Claude Lemoureaux, who was the chief executive officer of the Ontario Teachers' Pension Plan when, in 1990, it adopted a new governance structure and began to develop its team, said that one of the most obvious advantages of managing investments internally is the cost-savings that come from avoiding the high fees charged by private firms.

“When you get up to a certain size, the amount you’re paying in fees is enormous,” he said. “It absolutely does not make sense to rely completely on external management.” (See sidebar “Paying for internal expertise”.)

The in-house expertise has allowed Ontario Teachers’ to source and close dozens of high-profile deals. The fund currently owns two airports, a lottery in the United Kingdom, two water utilities in Chile, several shopping malls in the United States, and the Toronto Maple Leafs, among other investments. The fund managers will often put deals together themselves, and sometimes even raise capital from other pension funds and private equity firms, which means that the fund can take a larger share of the investment return.

Many of the other large public funds in Canada have emulated the OTPP’s approach, including the Ontario Municipal Employees Retirement System (OMERS), the Canada Pension Plan Investment Board (CPPIB), the Caisse de Depot et Placement du Quebec, and the Alberta Investment Management Corporation (AIMCo).

Over the last ten years, these public funds have made several large and profitable deals. The CPPIB, for example, invested $300 million for a twelve percent share in Skype, the internet communications provider, and earned back more than three times that amount when the company was sold to Microsoft last year.

PAYING FOR INTERNAL EXPERTISE

To retain skilled dealmakers, the Ontario Teachers’ Pension Plan pays them significantly more than American funds pay their top employees. But Lemoureaux said that the fund still saves millions of dollars a year, a claim that has been born out by several studies.

A 2010 study by CEM Benchmarking of 360 pension funds showed that funds that manage a high percentage of their assets internally had similar performance levels before fees were deducted; after fees, however, internally managed funds performed significantly better.

Direct investment also allows the Canadian pension funds to have a greater influence in the companies in which they invest, said Ajay Chadha, head of the private equity and pension practice at Pricewaterhouse Coopers, a consultant to many of the Canadian funds. “If they have an investment that isn’t performing to its potential, they aren’t just going to sit around and hope things get better,” he said. “They are quite vocal, and that’s something you don’t see from pension funds in the U.S.”

On the whole, the results have been impressive, Chadha said. Ontario Teachers’ has had the highest total returns among the biggest public and private pension funds in the world over the last decade.

Correcting a misalignment of interests

Large pension funds in the United States have become increasingly interested in what the Canadian funds are doing. Christopher Ailman, the Chief Investment Officer of the California State Teachers

Retirement System, has said that if he were to start a pension fund from scratch, he would follow the Canadian model.

While cost-savings represent one obvious reason to consider doing so, experts said that there are a number of other advantages of internal asset management and direct investment.

Experts in corporate governance have long pointed out that relying heavily on external asset managers can create a misalignment of interests between the fund managers, the plan beneficiaries, and the private firms who are managing their money: the private firms have their own goals, interests, and strategies which may not be the same as, or be compatible with, those of the funds.

One strategy that is being discussed among American pension funds is attempting to negotiate terms with external managers that would make sure that the managers do not make money if the fund loses money. But, more fundamentally, the misalignment of interests can also mean that pension funds are losing out on whole classes of investment opportunities entirely. According to Jim Leech, the current president and chief executive officer of Ontario Teachers, pension plans are a unique kind of investor. "We have the power to combine a large capital pool with a long term investment horizon, something that is extremely novel today," he has said.

Those factors create investment opportunities that are not available to many other types of investors. If a manager makes investments from the point of view of trying to help a private company maximize its own returns over a relatively short investment horizon, that manager can often miss investments that require either more initiative or a longer-term perspective, Lemoureaux said. "There are dozens of opportunities that we would have lost if we hadn't had people with the expertise looking for them." (See sidebar titled "Easy marks?")

EASY MARKS?

Since the trustees of many American pension funds, especially public funds, do not have financial expertise, private companies are sometimes able to manipulate them into making investments that are actually against their interests, said Keith Ambachtsheer, the president of KPA Advisory Services, which consults for pension funds on management issues.

"There is a fundamental asymmetry of information in that relationship," he said. "A lot of these experts have their own financial interests, and the people running the pension funds are not equipped to separate those interests from the goals of the fund."

One private equity executive, who declined to be named, said that pension funds are essentially treated the same way as other investors, except that, in many cases, it is understood that they are less knowledgeable. "It's kind of acknowledged that they are not going to be the smartest guys in the room," he said.

Beyond returns

Advocates of socially responsible investing, mission investing, and shareholder activism have taken notice of the Canadian model, as well. Though most of the Canadian funds have an "investment only" mandate that precludes them from considering any factors aside from risk and return, many see the more direct and active role being played by these funds as more conducive to investing with those other considerations in mind, which are often shunned by outside managers.

David Wood, the director of the Initiative for Responsible Investment at Harvard University, said that because of the potential market power of pension funds, empowering them to become more active social investors could make a huge impact. "They should be able to powerfully dictate how they act in the market," he said, "but that has not been the case so far."

Wood said that the layer of mediation created by the reliance on outside managers, who sometimes have conflicting interests, means that pension funds effectively have less agency over their investments. "How can we help them be more like market makers and less like price takers?" he said. Simply eliminating that layer of mediation "is probably the easiest way."

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Keith Ambachtsheer, the president of KPA advisory services and a professor of finance at the University of Toronto, agreed. "Right now, the outside tells the inside what to do," he said. "It's only when you build the inside strong can you tell the outside what to do, and that's always the best way to further your mission."

Because of their size, Ambachtsheer said, if pension funds were to think more broadly about their mission and make investments geared to creating long-term value, it could lead to more stable and sustainable financial markets.

The short-term investment horizon of many private money managers increases the likelihood that they will favor complex financial products, or methods like "flash trading," that do not add value to the economy over the long term — what Ambachtsheer, following John Maynard Keynes, called "beauty contest investing."

Others said that having more control over their investments could allow pension funds to put their assets to more specific uses, such as providing capital for green energy, or focusing investment on economically depressed areas.

According to Edward Waitzer, a partner at the law firm Stikeman Elliot and an expert on pension fund governance, making large, direct investments in companies allows the funds to have more control of

the companies and exert influence over their policies. “When you have internalized management, then once you decide to do something, you can do it faster and more effectively,” he said.

And though there are some legal limitations on what pension funds can do with their money, some have suggested that a type of investment known as “mission investing” — normally reserved for investors like philanthropists and foundations — would be appropriate for pension funds, as well.

For example, Sam Munger, the managing director of the Center for State Innovation, a think tank based in Wisconsin, said that, for union pension funds, reliance on external managers can make it more difficult to make labor-friendly investments, such as investing in businesses that hire only union workers.

Munger has also advocated for public pension funds to invest in ways that would provide benefits to the residents of their state. Some funds already apportion assets for in-state investments, but Munger urged trustees to think more broadly. “The people running the pension funds are not generally known as the most creative people,” he said.

Munger suggested that pension fund assets could be used to capitalize a state-owned bank, along the model of the Bank of North Dakota. The same idea, he said, could be applied to union pension funds that wish to capitalize a union-owned bank or credit union.

“We’ve [traditionally] defined the mission of pension funds very narrowly, simply in terms of safeguarding the money for retirees and, hopefully, getting some kind of investment return to add to the fund” he said. “Those things are certainly important, but I think there’s a lot of room to consider more nuanced and multi-dimensional missions.”

What stands in the way?

A variety of cultural, legal and political obstacles would need to be overcome before large American pension funds could internalize more of their asset management and increase their direct investment, experts said.

John Conley is a law professor at the University of North Carolina. In 1992, he co-authored a book with William O’Barr, a professor of anthropology at Duke University, called *Fortune and Folly: The Wealth and Power of Institutional Investing*, an anthropological study of how and why public and private pension funds in the United States make investment decisions.

“The primary finding of the book was how un-financial the whole process was,” Conley said. “Decisions were not being made on the basis of any kind of rigorous quantitative criteria. They were being made on the basis of relationships with the money managers, who were just there to sell them stuff.”

The book resulted in calls for the sponsors of pension funds to appoint people to their boards with at least a modicum of investment experience, or to provide financial training to the current trustees. But Conley said that lack of investment expertise was only one reason that trustees preferred to rely on private money managers.

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The other reason was that it allowed them to shield themselves from accountability for their investment decisions, he said. "A lot of the people on these boards are union representatives or political appointees, and if a deal goes south or the fund doesn't do very well, they don't want to be blamed for it. But if they hire people to do it for them, they can say, 'Look, I hired these expensive and reputable managers that everyone else was hiring, so you can't blame me.'"

Conley said that this culture results in a kind of "herd behavior," in which pension funds are reluctant to do anything that they have not seen their peers doing first, but are quick to "jump on the bandwagon" when another fund changes their practices. "From what I have observed, it seem that is even more true today than it was when we wrote the book," he said.

One reason that the Canadian funds have been able to adopt a different management structure is that their investment managers operate at a level that is more removed from their boards of trustees and government sponsors than American public funds, Lemoureaux said. "We were given a degree of freedom, but at the same time, we knew that if we did not perform well, we would be completely accountable for it," he said. "If we made a few bad decisions in a row, we were going to be out of a job."

The paradox of fiduciary duty

Pension fund trustees are bound by "fiduciary duty," a legal relationship that binds them to act in the best interests of those whose money they are managing. For private pension plans in the United States, fiduciary duty is codified in the Employee Retirement Security Act (ERISA), while for public pension funds, each state has its own set of laws defining fiduciary duty.

According to David Wood of Harvard, fiduciary duty in the United States has generally been interpreted very narrowly. On both a formal and informal level, the exercise of fiduciary responsibility — "prudent investing" — is most frequently associated with a heavy emphasis on maximizing returns through conventional, short- and medium-term investments.

Ron Davis, an associate professor of law at the University of British Columbia and the author of *Democratizing Pension Funds: Corporate Governance and Accountability*, explained that a narrow interpretation of what can be considered "prudent" — in addition to political pressure on funds to maximize their investment returns — has limited the willingness of large funds in the United States to make longer-term investments that take many years to realize a gain, or may yield slightly lower returns, even if the investments were low-risk and could easily be characterized as prudent. Funds compare their returns with the returns of other funds in their peer group, which can make them less likely to initiate deals that would include even a small amount of long-term risk.

"If they don't see the other funds doing it, then they are much less likely to consider those kinds of investments," Davis said. "The safest position for a fiduciary is to put on a lamb's coat and walk around bah-ing like all the other sheep."

The hurdles posed by fiduciary duty are even larger when it comes to investment decisions that consider factors besides risk and maximizing return. Some pension funds have made modest efforts to engage in socially responsible investing, in-state investing, and shareholder activism, but they are constrained by the fear that the employees and pensioners covered by the fund might sue them for failing to produce the highest possible returns, Davis said.

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"Anything that would be perceived as mission investing would be seen as a clear breach of fiduciary duty," Davis said. "Fiduciary duty is critical because it has been interpreted as being extremely restrictive."

Additionally, public pension funds are also subject to state laws that can restrict their investment decisions further, and make it more difficult for them to hire skilled investment managers. In California, for example, a hiring freeze on public employees would apply to the pension funds, and state law mandates that a representative of the pension fund is not able to sit on the board of a company that the fund has invested in.

Finally, there are political obstacles. Joseph Dear, the Chief Investment Officer of the California Public Employees Retirement System, has said that he does not believe that voters would permit a public employee to make the kind of salary that it would require to attract and retain the quality of investment managers that would make developing an in-house team possible, even though public funds are likely paying more to outside managers, an arrangement Ambachtsheer characterized as "more than a little ironic."

Not set in stone

Though the cultural, legal and political obstacles to releasing the power of pension funds are formidable, experts argued that none of them was inherently insurmountable.

"If the governance were changed" — to allow the funds more flexibility and independence — "and we changed our understanding of fiduciary duty," Waitzer said, "these funds could become very formidable in several ways," including flexing their muscle to initiate longer-term deals and to consider social responsibility and shareholder activism.

> Critics argue that years of pressure to cut the welfare rolls has left an obstacle-ridden program that chases off the poor, even when times are difficult.

Waitzer said that the narrow interpretation of fiduciary duty was likely the most difficult obstacle to broadening the mission of pension funds, but even here, he said, there exist possibilities for change. The concept of fiduciary duty, he said, "is incredibly dynamic. Our understanding of what it means to be a fiduciary, what factors they can consider, has evolved significantly over the years. It is certainly not set in stone."

Indeed, the labor departments of different presidential administrations have frequently issued "interpretive bulletins" that explain how the administration will be interpreting the fiduciary duty of the trustees of private pension funds. The Clinton Administration issued a bulletin that specifically allowed funds to engage in "economically targeted investment," or investment that is still considered prudent but that is targeted to a particular end, such as community development. The latest interpretive bulletin, issued by the Bush Administration, is significantly more restrictive.

In regards to public pension funds, states have also adopted a variety of laws that dictate how the funds may and may not invest their assets. Most state laws simply clarify whether the fund is permitted to target investment within the state itself, but some go further. For example, laws in Wyoming and North Carolina allow the state pension funds to "consider benefits created by an investment in addition to investment return" so long as "the investment providing these collateral benefits would be prudent without the collateral benefits."

If the interpretation of fiduciary duty were broadened on a larger scale, Davis said, it could lessen the propensity for herd behavior among funds, and increase the likelihood that states would be willing to the give the funds a greater degree of autonomy.

"The potential is there for pension funds to play a much larger role," Davis said. "I think we have been blinded to the possibilities that they offer."

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