

# THE INVESTMENT MONTHLY

## GOVERNANCE & PREDICTABLE SURPRISES

Pension plans have very long investment horizons requiring assumptions about how to discount the future to the present.

Many defined benefit pension plans are underfunded with insufficient assets to meet future benefits at today's contribution rate.

Some plans are better balanced than others because they make realistic assumptions about the future.

Prudent assumptions signal a shared understanding of risk between management and the board.

## WHAT MAKES FOR GOOD GOVERNANCE?

During a recent panel appearance for the Los Angeles chapter of CAIA entitled "Pension Evolution and the Impact on Pension Investment Strategies" my fellow panelists and I discussed the challenges facing US public pension plans, and the importance of good governance soon took centre stage. Governance issues surfaced as many US public sector plans report artificially high funding ratios because the discount rates used to present-value future liabilities are too high.

Plans with an unrealistically high discount rate understate their future liabilities, and many hold insufficient assets to meet future benefits. The costs of fixing problems are likely smaller today than they will be in the future, as difficulties tend to get worse over time. But any problem that requires spending to fix is often put off. Most pension plan managers and their boards know they are underfunded when they see discount rates that are several stories above the ground-floor of market interest rates. Research by Andonov *et al* has shown that an artificially high discount rate provides an incentive to take more investment risk to sustain the high discount rate, so this is not a trivial issue.

Managers take more investment risk than they should in the hope that investment returns will be large enough to close the funding gap over time. This is alarming because as pension plans age their ability to take risk diminishes. We know that many plans are already "old" because they face higher annual benefit payments than they receive in contributions. They start every year jumping a three-bar gate from a six-foot hole. And, if the bet on capital market returns doesn't work out, you can't turn back the clock and reset the contribution-benefit balance.

## Predictable Surprises

Bazerman & Watkins have something to say about this situation in their 2004 book *Predictable Surprises* which they define as “an event or set of events that take an individual or group by surprise, despite prior awareness of all the information necessary to anticipate the events and their consequences.” It is fair to say that the looming resource inadequacy of some public pension plans has been known for some time. If it is not a failure of recognition, then it is clearly a failure of response, setting the US and its aging public sector workforce up for a predictable surprise.

Six key characteristics define a predictable surprise. First, leaders know there is a problem and they know it won't fix itself. Second, that the problem is likely to get worse over time. Third, fixing the problem today will incur big up-front costs now rather than in the future. Fourth, the cost of the fix is certain today, and the benefit of today's fix accrues in the future so those that bear the cost don't receive the benefit. Fifth, there is a natural tendency to succumb to the forces of inertia and do nothing: sparking action often demands a crisis. Finally, there is often a loud minority that bears the adjustment costs, and they mount a strong and effective opposition to secure the status quo. Change becomes impossible.

Given this six-point check list, the board of any organization has a responsibility to prevent a predictable surprise, so what characteristics of a board empowers it to execute this important duty?

Koedijk, Slager and Van Dam define what it takes to become an effective board. First, the board should fly at the right altitude, second they should identify the right distance, and third from their high altitude they should see a far horizon. Next, to be accountable and exercise oversight, board members must exhibit the competence, qualifications and experience necessary to define strategy and hold managers accountable. All board members must be able to understand a complex financial organization.

The board flies at 30,000 feet to approve and be accountable for strategy: what the plan is going to do. Distance defines the division of responsibilities: boards govern and the executive manages. Boards should not be consulted over tactical decisions, but need to hold executives responsible for the tactical decisions they make. Finally, horizon. Meeting a plan's goals plays

out over very long periods of time, often twenty years or more, so the board has to be cognisant of the incentives it provides to management when it approves strategic parameters – like discount rates and capital market assumptions.

Our panel discussion was set in a US context, and the relative performance of Canadian plans entered into the discussion. Lipschitz and Water in their 2020 comparative study of US and Canadian public defined benefit pension plans note that Canadian plans have generally performed better, largely because of better design and better governance. They clearly state that politics should be kept out of the key decisions that affect the plan's long-term goals, and this goes for assumption setting.

The authors identify that the distance between the board and management is essential to ensure that the interests of all plan members – current and future – are represented. The authors set out the following as parameters for good governance design that lay at the heart of the comparatively better Canadian funding experience. They are:

- Set contributions and benefits under one roof.
- Separate who makes the discount rate decision from the group that makes the contribution and benefit decision.
- Ensure that interplay of contributions, benefits, discount rates and capital market assumptions are integrated with investment risk to ensure that future problems are minimized.
- Be prepared to course-correct along the way as investment outcomes deviate from plan.
- Ultimately all board decisions must be held to the plan's purpose: to meet liabilities at a reasonable level of investment and funding risk.

### **What Makes a Good Board?**

A predictable surprise is the result of a failure to respond, so leadership is crucial to affect a response. A key characteristic of a well functioning board is a strong chair, where the chair sets the agenda to marshal discussion and decisions on relevant topics that will affect the plan's goals. Consider the issue of age-related agency. Imagine a plan member who is also a board member, and

is one year away from retirement. Imagine that the plan is underfunded, and the return on investments necessary to close the gap is unattainable. To bring the plan back to balance, the board must decide whether to increase contributions or reduce benefits. The chair must design the agenda and keep discussion focused on the issues that will affect long-term outcomes, and dispense quickly with the lobby from vested interests that might favour this generation over future generations.

In general, the board chair needs to keep the board aloft at its 30,000 feet cruising altitude. The main responsibility is to keep the board's focus on the horizon over which the investment strategy plays out, giving appropriate consent to the investment management framework, and defining the investment framing variables such as investment beliefs and investment philosophies. Most importantly, they must take great care in approving any assumptions that affect the asset-liability balance and the funding ratio, as these will assuredly define the plan's long run success.

Alternatively, should the board be concerned about day-to-day decisions on small tactical investment decisions that will not affect the fund's overall goals? No. Focus on the big stuff and get it right. But to get it right means you know what decision you are being asked to take, and have the knowledge and competency to take it. A good board chair needs highly qualified and knowledgeable members to support them in their journey to secure the right decisions for plan members, and keep the board out of the management weeds.

Organizational problems stemming from poor standards of management and inadequate governance that go unattended will eventually come to the surface, and can multiply in force over time to be devastating to the organization. The board horizon and the capital at hand are both important variables to grasp. Contrast risk management decisions between a pension plan and a corporation. Corporates rest on a small base of capital, and in the face of a sudden loss their capital base can be wiped-out. Enron is the obvious example, which took down Arthur Anderson with it, and is cited by Bazerman and Watkins as an organizational collapse that typifies a predictable surprise.

Pension plans in contrast sit on a large and broad base of capital, so do not face the prospect of instantaneous collapse from the consequences of poor management and inadequate governance. Instead, those consequences can take decades to emerge. The impact is felt not by the current generation of managers and board

members who preside over unattended problems, but by future generations of members who will face lower benefits and higher contributions. Consciousness of this special dimension of time should be internalized by all current and future board members.

The board members must make decisions not as a plan member delegate, but as a representative who makes decisions based on their assessment about what is right for the plan even if their decision is unwelcome by current members. Board members represent plan members' interests based on the individual board member's judgement rather than promoting a constituent's preference. In the multigenerational context of a pension plan, a board member must concern themselves with the next generation's interests as well as today's.

### **Pension Plan Design and Decision Trade-offs**

Defined benefit pension plans are increasingly a reserve of the public sector. Pensions in the private sector are now mostly funded by defined contribution, as corporates have shifted the risk of shortfall to their employees. This means that individuals govern themselves.

Defined contribution is best understood as receiving a variable (or perhaps unknown) benefit for fixed contributions. They must live off of the capital value at the end of their working life, and if this is insufficient, they must continue to work or live frugally.

Defined benefit is best understood as receiving a fixed retirement benefit for variable contributions, the risk of inadequate retirement income in defined benefit pension plans is pooled and individuals cannot govern the plan themselves.

Pension plans have three variables to make them work: contributions, benefits and investment returns. In the political economy context of pension plans, resistance to benefit reductions and contribution rate increases is the unmoveable

object meeting an irresistible force, leaving investment returns as the pressure relief valve.

The consequences of decisions taken on how to balance the load put on these three variables take a long time to play out. The decisions taken today need to be prudent; problems cannot be wished away by discounting liabilities at an interest rate that is three-times the market rate, and assuming expected rates of return on assets that defy historical reference. Moreover, if board members allow unrealistic expectations to seep-in, then they not only push the problem into the future but they also increase the scale of the challenge for the following generation. The future eventually becomes the present, and in this intertemporal bargain it's a future generation's present and thus their problem.

An experienced and competent board matters because of complexity, which is everywhere. While complexity in investment management might well be necessary to get the most out of a plan's investment resources, complexity makes it difficult for the board to hold management to account, slows the board's decision-making pace, and can obscure the purity of the information on which decisions are based.

Board members need to be skilled professionals, with a mixture of skills and experience to rival the plan's executives. They must have the knowledge to understand and evaluate management strategy, objectives, tactics and activities. They must understand the power of incentive, and think carefully about what incentives they create when they define the parameters that the executive applies to navigate the investment journey.

Board members should not and cannot involve themselves in the day-to-day management of the organizations' activities. Theirs' is an oversight role that holds management to account; neither should they attempt to do management's job nor tell management how to do so.

When the board comes together, it is essential that the board work as a cohesive unit, working to a consensus that provides successful oversight. Consensus is an outcome, it is not a process, so any board must develop its own processes for coming to decisions. Board members must interact well, they must be prepared to be independent and provide leadership: and leadership is a lonely journey, just as accountability is often borne alone.

Board members must come to the board with a willingness to adhere to a process that facilitates and evaluates management, one that is fair and objective; board members cannot exercise oversight in the interests of the organization as a whole if they bring a subjective view point that is subordinate to preferences that are not central to the organizations' purpose.

In conclusion, boards need to be professional; they need a well-defined process to make decisions and they need the leadership of a strong chair that sets direction, defines the agenda, and keeps board attention focused at the right altitude. The board needs to focus its time on strategy and executive supervision, constantly testing the executive on execution.

At the end of the day, the board needs to be accountable for a job well done so that today's members can have confidence that they will get the pension they expect.

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