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VALUE-CREATION IN PENSION PLANS: A FIVE-POINT CHECKLIST (I)

“Research on the global pension industry shows that pension funds tend to be worse than average on organization design factors....”

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Shifting the Pension Paradigm

It is one thing to talk about a paradigm shift. It is another thing to act on it. This *Letter* (and its sequel) is addressed to the people who not only understand the need for a paradigm shift in pension fund management, but are prepared to do something about it. Events over the course of the last four years have brought the validity and sustainability of the ‘old’ pension paradigm into serious question. In its traditional DB form, the fuzziness in the underlying ‘pension deals’ has been laid bare, as have deficiencies in governance, organization design, risk measurement and management, the underlying investment beliefs structure, and policy implementation effectiveness and efficiency. Its traditional DC counterpart is offering too many investment choices to an unknowing clientele at too high a cost, ultimately leading to an inability to replace earned income with an adequate stream of pension payments down the road.

So where should ‘doing something’ about this unsatisfactory state of pension affairs start? Some people say ‘the government should do something’. That is a nice thought, but not very realistic. The only source from which leadership towards constructive change can come is the people who lead the organizations that sponsor and manage pension plans. If enough of them are prepared to take ownership of a ‘new’ pension paradigm that addresses the defects of the ‘old’, then the shift from ‘old’ to ‘new’ will actually occur.

Where to Start?

So where to start? We propose a review of pension arrangements through the prism of five drivers of value-creation. We introduced these drivers in our July *Letter* as *A*, *G*, *R*, *IB*, and *FE*. They are briefly summarized again below:

Agency Issues (A): agency issues can hinder beneficiary value creation in a number of ways. All these ways lead to beneficiaries being financially disadvantaged by agents working on their behalf. Thinking through what can be done to minimize agency problems can pay large dividends for the clients/beneficiaries of financial services organizations.

Governance (G): good organizational governance goes beyond simply aligning the economic interests of a financial services organization’s clients/beneficiaries and its management. It also sets the context for the organization’s mission, delegates planning and implementation to a competent executive team, and regularly monitors progress towards mission achievement.

Risk Issues (R): we have noted that academia has moved the yardsticks of relevant, practical risk definitions and measurement considerably since the early portfolio theory days. As importantly, the governors of pension and endowment funds must insist that specific risk definitions and risk management are relevant to the context of their clients/beneficiaries.