

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

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

“SEC Investigates Six Companies On Pension, Benefit Accounting”.

Wall Street Journal Headline
October 18, 2004

Shifting the Pension Paradigm

Last month, we observed that it is one thing to talk about a paradigm shift, but quite another to act on it. We also observed that the required shift in the pension paradigm cannot be decreed by politicians or regulators. It must be initiated by 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 a shift from ‘old’ to ‘new’ will actually occur. From there, the *Letter* went on to propose a five-point checklist to guide a conscious shift towards greater pension plan value-creation for the benefit of all stakeholder groups. Specifically, five issues have to be addressed in an integrative manner:

Agency Issues: 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: 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 ex-

ecutive team, and regularly monitors progress towards mission achievement.

Risk Issues: 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.

Investment Beliefs: the degree to which an investment organization believes prospective return components to be predictable over multiple horizons should be an important determinant of how its investment processes are structured.

Financial Engineering: integrating properly specified client/beneficiaries risk tolerances with time-variant return expectations in a noisy, complex investment arena full of fees and transaction costs is no mean task. Well-engineered, integrative investment systems can add significant value.

Last month’s *Letter* then proceeded to offer our thoughts and suggestions on attacking lurking agency issues in both corporate and industry/public sector contexts. It also offered an updated framework for thinking through how pension plan governance and organization design issues might be assessed and addressed. Finally, it commenced a re-examination of pension risk measurement, management, and disclosure.