

The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

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EFFECTIVE DECISION-MAKING IN FINANCIAL INSTITUTIONS:

HOW PENSION FUNDS CAN LEAD THE WAY

“The significant problems we face cannot be solved with the same level of thinking that created them...”

Albert Einstein

Preventing ‘Predictable Surprises’

Last month’s *Letter* defined ‘predictable surprises’ as extreme negative impact events that were predictable (and predicted) before-the-fact. The predictions were simply not acted on. We showed that the sub-prime crisis and its fallout qualify as such an event. Its likely occurrence and consequences were clearly laid out as early as 2005. The ‘predictable surprises’ concept raises an obvious question: if extreme negative impact events are predictable and predicted before-the-fact, why are no actions taken to prevent them before they unleash their destructive forces? Strategic analyst Michael Watkins offers four powerful reasons:

1. Decision-making under uncertainty is intrinsically difficult.
2. Agency factors misalign economic interests.
3. Winners and losers are asymmetrically distributed (e.g., a few concentrated winners, many diffused losers).
4. Preventive collective action is difficult to marshal.

We noted that these four reasons offer a useful mirror through which the global pension fund community can examine its own management practices. Specifically, how can decision-making under uncertainty in pension funds be made more effective? How can agency-driven misalignments of interest be neutralized? What can be done to distribute risk and return symmetrically? How can collective action best be marshaled? This *Letter* addresses these questions, and shows the way to raising the bar on what defines best pension fund management practices today.

Decision-Making Under Uncertainty in a Pension Fund Context

So what can we do to make decision-making under

uncertainty in a pension fund context as effective as possible? A simple question with no simple answer. A reverse-engineered design perspective offers a useful starting point. What outcome do we want to create? What are the key success-drivers to creating that outcome? How can those success-drivers best be assembled? How do we measure results? And maybe most importantly: where are the weak links in this design chain? Our short best answers to these questions today in a pension fund context are:

1. Desired Outcome: deliver target pension payments at expected cost.
2. Key success-drivers: realistic investment beliefs, broad investment opportunity set, sustainable pension design/adequate contribution rate, relevant risk measurement and management, relevant information production and distribution, qualified/motivated people.
3. Success-driver assembly: functional organization design and decision delegation, balanced compensation structure.
4. Result measurement: measure what should be managed (i.e., account for risk and costs as well as returns), link outcomes to compensation.
5. Weak links: conventional thinking/herding, poor integration across key functions, unfocused results measurement (especially regarding risk and cost-effectiveness), insufficient/inadequate human resources.

Each of these short answers deserves further elaboration. Figure I helps by graphically linking some of the individual design answers from above together. A picture of the key strategic elements of an integrated pension fund decision-making process begins to emerge, as do a new set of critical questions.