

The Ambachtsheer Letter

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HOW SHOULD PENSION FUNDS PAY THEIR OWN PEOPLE?

“Cheapest, say the prudent, is the dearest labor.”

Ralph Waldo Emerson, 1841

Why Address this Question Now?

Last month’s *Letter* argued that great pension funds have five critical success drivers: aligned interests, good governance, sensible investment beliefs, the right scale, and competitive compensation. Here we take a deep dive into driver #5: competitive compensation. There are three reasons to have a closer look at this topic:

1. The Global Financial Crisis has forced all financial institutions to carefully examine the relationship between risk-taking and compensation structures in their organizations. Early in 2009, we were asked by the international *Financial Stability Forum (FSF)* to address this question for their “Market and Institutional Resilience Study”. Our resulting recommendations were summarized in the March 2009 *Letter*. A knock-on effect of the *FSF* initiative has been for the Boards of a number of thought-leading pension funds to ask their compensation consultants to offer opinions on this risk-taking vs. compensation issue. Some of these consultants, in turn, have opened up a dialogue with us.
2. The ‘Say on Pay’ debate between pension funds and the corporate sector has evolved to a stage where pension funds now have to think carefully about what in fact they should say. This requires the development of an intellectual platform sturdy enough to support a coherent, consistent set of executive compensation principles for public corporations. This in turn creates an ‘eat your own cooking’ situation for pension funds themselves. Soon pension funds will have to show that they practice what they are preaching.
3. Too many funds continue to underpay for critical functions. There are historical reasons for this. The time has come to assess if these reasons are still valid, and also, to paraphrase Emerson, to formally recognize that this historical cheapness is in fact dearness. Analysis using the *CEM Benchmarking Inc.* database indicates clearly that inadequate internal investment capabilities lead to the excessive high-cost outsourcing.

Compensation consultant marketing material suggests professionals in that field pride themselves on being able to report promptly about “compensation trends and emerging issues”. That is not the goal of this *Letter*. Instead, it is to address the ‘how should pension funds pay their own people’ question from first principles, with fresh eyes and a fresh perspective.

Human Needs and Compensation

Let’s start by asking a very basic question: what do people really need? What is it that motivates human behavior? Even today, it is difficult to better Abraham Maslow’s answer set out in his 1943 paper “A Theory of Human Motivation” (Figure 1). He suggested humans have five levels of needs, starting with survival (e.g., food), then moving up to safety, (e.g., employment, shelter), followed by belonging (e.g., family, friends), then esteem (e.g., confidence, respect by others), and finally, self-actualization (e.g., objectivity, creativity, service to others). Where does compensation fit in this needs hierarchy?

Arguably, compensation plays important roles right up the human needs chain, providing the means to acquire not only tangibles such as food