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PETER DRUCKER'S PENSION LEGACY:

A VISION OF WHAT COULD BE

"Mr. Drucker was celebrated for his clear thinking and engaging analysis, rather than any single theory or research. He had a good eye for things to come…".

From Peter Drucker's Obituary
by Kathryn Harris, Bloomberg News
November 11, 2005

Two Hand-Shakes to Remember

The two of us stood huddled together on a pier overlooking the windy Wellington NZ harbour a few weeks ago. Suddenly the grizzled old-timer turned to me, shook my hand, and announced that he had been a steward on the Cunard liner *Queen Mary* during WWII, and had personally served Winston Churchill his morning coffee many times. He said: "You have just shaken a hand that shook Churchill's hand 60 years ago". Two months prior, I was one of three visitors to the Drucker household in Claremont, CA., where a 96-year old Peter Drucker himself had also greeted me with a hand-shake. Two hand-shakes to remember! When I arrived back home from my NZ-AUS trip, Drucker's obituary was waiting for me. I read there that Drucker's first book "The End of Economic Man" (1939) had been favorably reviewed in the *Times Literary Supplement* by none other than….Winston Churchill. The past had miraculously touched the present.

As examples of her observation that he "had a good eye for things to come", Kathryn Harris noted in her obituary that Drucker predicted the coming importance of computers in the 1950s, foresaw the rise of Japan as an economic power in the 1960s, and warned against the coming backlash against executive pay practices in the 1990s. As have most other Drucker-watchers, Harris missed his prescient observations in the 1970s about the coming 'pension revolution'. About his 1976 book "The Unseen Revolution: How Pension Fund Socialism Came to America", Drucker himself would write 20 years later "No book of mine was ever more on target, and no book of mine has been ever more totally ignored". Two *Letters* earlier this year revisited the messages of Drucker's 1976 book. Here, we expand on our earlier assessment, and evaluate how some of the globe's major retirement income systems rate today relative to the Drucker pension vision set out 30 years ago.

The Melbourne Message

The rating project arose out of an invitation to assess the quality of the Australian pension system in front of 1800 delegates to the 2005 Australian Superannuation Fund Association (ASFA) in Melbourne on November 10. Our presentation, titled "How 'Super' Are Australian Pension Funds?", commenced by constructing *The Optimal Super Scheme*. We offered that the resulting acronym *TOSS* would hopefully help representatives of a sports-mad nation fixated on cricket, rugby, water polo, and tennis maintain interest in the topic at hand. *TOSS*, of course, is the manifestation of Drucker's pension vision. Admittedly, we have re-arranged some details, and filled in some gaps. But the broad strokes of *TOSS* were already there 30 years ago.

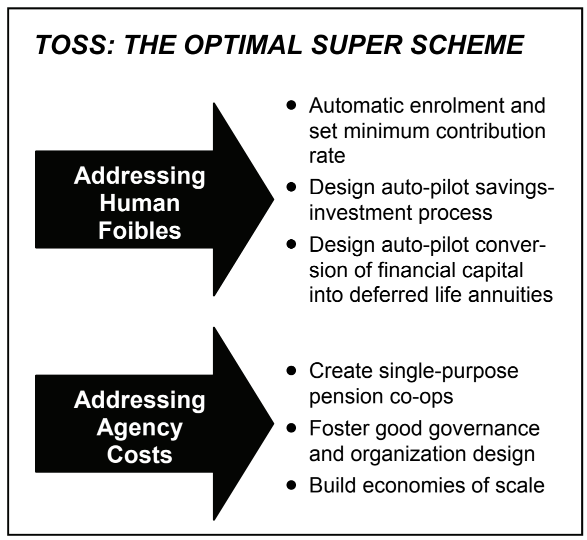
The Drucker vision starts with motivation. Developed economies should foster the adequate, stable consumption of goods and services for all citizens from birth until death. While governments can and should underwrite a basic level of universal income support through the tax system, Drucker believed that work-place pensions should also play an important role in providing adequate, stable post-retirement income to workers. To achieve this goal, work-place pension plans should cover most workers, and should address two further important challenges:

1. Pension plans should be designed so that workers are not be left to make complex savings and investment decisions on their own.
2. Pension plans should be structured so that decisions are made solely in the best interests of plan participants by arms-length, 'expert' organizations.

We noted that during the last 30 years, a significant body of research has confirmed these two *TOSS* requirements. Behavioral finance research has documented a long list of human foibles such as lack of self-control, lack of firm preferences, inertia/procrastination, overconfidence, and aversion to realizing losses. At the same time, the under-performance of mutual funds relative to pension funds seems to be largely explained by the much higher costs of mutual fund investing. These much higher costs in turn seem to be related to a fundamental conflict of interest between mutual fund managers who prefer higher compensation to lower compensation, and most of their clients who are not as sensitive to high-fee structures as they should be.

TOSS: Neither DC nor DB

The insert below lists the six critical characteristics of *TOSS*. Three address the 'human foibles' challenges, and the other three address the 'agency' challenges identified by Drucker. The result combines the best features of traditional DC and DB plans, but without their historical baggage. For example, *TOSS* is an individual-based, rather than a collective scheme, in the sense that individual participants have their own investment accounts. However, there is also an automatic, dynamic, age-based, transparent process of accumulating a portfolio of deferred annuities over time. In this sense, *TOSS* also has a collective element related to pooling longevity risk. Organizationally, *TOSS* is managed by an expert single-purpose pension co-op large enough to enjoy significant scale economies.



At the same time, *TOSS* leaves the historical baggage associated with traditional DC and DB plans behind. Gone are the 20 (or more!) investment choices and high fees still associated with so many DC plans today. Gone are the fuzzy valuations and the game theory-based risk shifting strategies still associated with so many DB plans today. Gone are the amateur, ad-hoc governance and decision-making processes still associated with so many DC and DB plans today.

Peter Drucker would heartily approve!

TOSS and Investing

As Drucker's obit noted, he was a grounded, clear thinker and analyst rather than a theorist. So, like Keynes before him, he was profoundly skeptical of the institutional investment processes he observed. While he didn't use Keynes' 'beauty contest' metaphor, he also observed the futility of investment managers trying to outperform each other in a giant zero-sum investment game less fees. Yet, Drucker observed that at the same time, workers were becoming the indirect owners of the means of production through their participation in pension plans. It was this observation that inspired his 1976 book title "The Unseen Revolution: How Pension Fund Socialism Came to America".

All this logically leads to the definition of the three functional 'investment styles' we have been writing about. Risk-minimizing (RM) strategies match investment flows from interest and principal maturities to payment obligations. Short-horizon risky (SHR) strategies exploit the behavioral foibles of retail and institutional 'beauty contest' investors to generate material returns at modest levels of risk. Long-horizon risky (LHR) strategies acquire or create uncertain long-horizon cash-flows at prices that reflect risk-based required rates of return (hurdle rates). It is these LHR strategies that logically lead to Drucker's conclusion that pension funds must begin to act like the owners of the means of production. Collectively, they increasingly <u>are</u> the owners of the means of production.

Another logical extension of this investment framework is that *TOSS* pension funds need to only manage two portfolios over time. The RM portfolio continually mimics the portfolios of deferred annuities already purchased by plan participants. The SHR/LHR portfolio is the combination of SHR and LHR strategies that continually maximizes expected net excess return per unit of risk relative to the RM portfolio, subject to a pre-determined risk budget. Younger plan members have largely SHR/LHR portfolio exposure. Older plan members (especially retirees) have largely RM exposure.

TOSS and Governance

Drucker stated the obvious when he observed that if pension funds are going to become the dominant owners of society's means of production, they need to be effective owners. But pension funds can only become effective owners if they themselves are effectively governed. That in turn requires that pension fund boards of trustees be effective bodies that collectively understand the meaning of 'good governance', and have the mandate and the motivation to implement it. Drucker correctly identified this latter requirement as the potential Achilles heel of his 1976 vision of 'pension fund socialism'.

Drucker was right to be worried. In the first formal assessment of the quality of pension fund governance that we are aware of (1992), anthropologists William O'Barr and John Conley concluded that the pension fund governance practices they observed were like "looking into an airliner cockpit at 30,000 feet and finding that there is no-one in there". Subsequent studies in which we were personally involved confirmed that there were indeed identifiable elements of dysfunction in pension fund governance practices around the world. A new 2005 study sponsored by the Rotman International Centre for Pension Management (*ICPM*) at the University of Toronto confirms that even today, board of trustee selection and board effectiveness evaluation processes continue to be problematic, including in many of the globe's largest pension funds.

Yet, good pension fund governance is not rocket science. It is a matter of being true to the following four principles (from Ronald Capelle, 2004 *ICPM* Colloquium):

1. Board is accountable for ensuring work to further stakeholder interests is done optimally.
2. Board does <u>not</u> do this work itself.
3. Board member selection criteria are i) appropriate skill/knowledge sets, ii) value the work, iii) constructive behavior, and iv) strategic reasoning capability.
4. Board must establish self-management and self-evaluation capability.

Is your pension fund applying these four governance principles today?

TOSS and the Real World

So finally, here is the report card evaluating the globe's pension systems against the *TOSS* standard:

- Human Foibles: The Dutch and the Australians lead the way in enforcing high workforce coverage, encouraging high contribution rates, and designing auto-pilot savings-investment processes. DC plans everywhere (with a few notable exceptions) still lack automatic annuity transition mechanisms.

- Agency Issues: The Dutch and the Australians also lead in the creation of large, arms-length, single-purpose co-ops to manage their pension arrangements. North America continues to have material pension components that are politically-tainted or company-sponsored, and mutual fund-managed.

- Governance: Governance processes are improving everywhere, but there are still only a hand-full of pension funds around the world today that could pass Drucker's 'good governance' standard with flying colours.

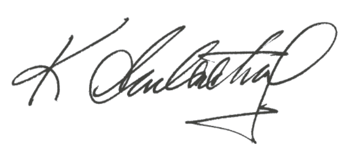
- Investing: Not surprisingly, it is the globe's large, well-governed, single-purpose pension co-ops that are leading the way in driving 'beauty contest' investing out of their investment processes. These institutions are also beginning to behave as the responsible owners of the means of production that Drucker envisaged.

So Drucker might observe today that students of his 1976 pension manifesto around the globe are showing considerable progress in some areas, but that much work remains to be done.

The Drucker Visit

As our visit with Peter Drucker commenced in late August, it was immediately clear that his health was failing. Yet, he still spoke with passion about the importance of a life-time commitment to learning, and about the importance of effective not-for-profit organizations in sustaining civil society. I asked him how he thought his now 30-year old 'pension revolution' was unfolding. He observed that risks were being individualized, and that it would take a major economic set-back to assess how strong today's pension systems really were.

I reminded him that he had praised *TIAA-CREF* (the American *TOSS* poster child) as an effective pension organization in his 1976 book. With a slight smile he responded: "Yes, and they still send Doris and me our pension cheque on time every month". A poignant reminder why the pension revolution must go on.



Published by KPA Advisory Services Ltd., 151 Bloor Street West, Suite 702, Toronto, Canada M5S 1S4
Tel: (416) 925-7525 Fax: (416) 925-7377 e-mail: kpa@kpa-advisory.com website: www.kpa-advisory.com