Rotman

International Journal of Pension Management

Investment Beliefs, Risk Management, and Pension Funds

Rotman ICPM
International Centre for Pension Management

Volume 2
Issue 1
Spring 2009

About Rotman International Centre for Pension Management

The mission of the Rotman International Centre for Pension Management (Rotman ICPM) is to be a catalyst for improving the management of pensions around the world. Through its research funding and discussion forums, the Centre produces a steady stream of innovative insights into optimal pension system design and the effective management of pension delivery organizations. Using *Integrative Investment Theory* as its guide, research and discussion topics focus on agency costs, governance and organization design, investment beliefs, risk measurement and management, and strategy implementation. The role of the *Journal* is to disseminate the new ideas and strategies that result from the activities of Rotman ICPM to a global audience. The Research Partners of the Centre believe that this broad dissemination is a win-win proposition for both professionals working in the global pension industry, and for its millions of beneficiaries.

Unsolicited articles can be submitted to **icpm@rotman.utoronto.ca** for consideration by the Editorial Advisory Board.

Publisher and Editor
Keith Ambachtsheer

Associate Publisher and Editor
Ann Henhoeffer (icpm@rotman.utoronto.ca)

Copy Editor
Brigette Kocijancic, ABC

Design
watermarkdesign.ca

Rotman ICPM International Centre for Pension Management

151 Bloor Street West, Suite 702
Toronto, Ontario Canada M5S 1S4
Tel: 416.925.7525
Fax: 416.925.7377
www.rotman.utoronto.ca/icpm

Rotman School of Management
UNIVERSITY OF TORONTO

ISSN 1916-9833 (Print) – C$50.00
ISSN 1916-9841 (Online) – no charge

Rotman International Journal of Pension Management is distributed at no charge as an electronic journal and can be accessed by visiting www.rotman.utoronto.ca/icpm. Print copies can be purchased at a cost of C$50.00 per issue (includes tax and shipping). To order print copies please visit **www.rotman.utoronto.ca/icpm.**

Table of Contents

Table of Contents

Overcoming the Global Financial Crisis: What Role Should Pension Funds Play?

Keith Ambachtsheer

Director, Rotman International Centre for Pension Management, University of Toronto

As the global financial crisis lurches toward its third year, much ink has already been spilled explaining its causes, engineering its resolution, and devising plans not to let it happen again. A consensus is emerging that the fundamental cause of the crisis is a wide-spread failure of financial sector governance mechanisms in both government and private sectors of many developed and developing countries. These governance failures have manifested themselves in undisciplined and value-destroying risk-taking across wide swaths of the global financial sector, fuelled by inappropriate, poorly conceived compensation schemes.

If poor governance is the primary cause of the problem, then good governance is the primary solution. Most of our readers will appreciate that this logic is more easily captured on paper than accomplished in practice. In the government sector, good governance means finding the right balance between principle- and rule-based regulatory regimes, as well as between national and international surveillance, and enforcement mechanisms. In the private sector, good governance means establishing strong links between clear organizational missions, risk measurement and knowledgeable, disciplined management, and compensation schemes that properly align stakeholder interests. Hovering above, behind, and below these implications, is a requirement for organizational cultures that not only <u>say</u> these things, but actually believe and live them.

Pension funds are not the primary perpetrators of the global financial crisis, but they are not totally blameless either. Some funds dabbled in 'instruments of financial mass-destruction' that were not fully understood. Other funds ventured out on the risk spectrum without fully realizing it. Before and during the crisis, most funds did <u>not</u> play the role of forceful, knowledgeable owners of publicly-traded financial sector corporations. Fortunately, steps are now being taken to shift the mindset of the global pension fund management community from that of a passive bystander, to a far more proactive participant. Such steps should start at home inside pension fund organizations, and many of the articles in this second issue of the *Rotman International Journal of Pension Mangement* point to ways to do that.

Cleaning their own houses also gives pension funds the legitimacy to engage in broader national and international discussions on financial system reform now underway. This is where collective action becomes a powerful tool and can take on different forms. Most countries have their own pension fund associations. Coalitions with other institutional investor groups offer another avenue. Informal networks of like-minded academics and professionals offer yet another. University-based research and discussion forums such as those organized by Rotman International Centre for Pension Management and articles in this *Journal* can also play important roles. It is encouraging to see the international pension management community using these avenues to constructively rebuild the global financial system to a sustainable state.

In this Issue

We noted that many articles in this issue focus on the culture and behaviour of pension funds as global financial system participants. Lead articles by Jack Gray, and by Kees Koedijk and Alfred Slager, examine the fundamental question of investment beliefs that are typically never formally addressed. Gray takes a philosophical approach in this time of crisis, urging readers to stand back, take a deep breath, and truly examine the intellectual foundations that underpin their investment process. Koedijk and Slager present the results of a worldwide survey of the stated investment beliefs of institutional investors. They observe that very few institutional investors actually state their beliefs. Pension funds with clear beliefs about asset pricing and risk diversification show better return-risk performance measures and lower costs.

Articles by Don Raymond, and by Robert Bertram and Barbara Zvan, address another fundamental question often left unexamined. How does a pension fund best connect the dots between organizational mission, governance, risk-exposure, and incentive compensation? The authors explain how this difficult question is answered at Canada Pension Plan Investment Board and at Ontario Teachers' Pension Plan respectively. Blending good design theory with the practical reality of running highly visible, high-performance organizations is key to their success.

Articles by Philip Davis and Yu-Wei Hu, and by Keith Johnson and Frank Jan de Graaf, remind the reader that pension funds do not operate in a vacuum. For better or worse, regulatory and legislative contexts can erect material barriers to what pension funds can, and cannot do as investors. Davis and Hu argue that investment theory favours principle-based rather than rules-based regulatory approaches and that empirical evidence supports that conclusion. Johnson and de Graaf argue that the time has come to liberate pension funds from the outmoded trust law confines that continue to restrict their ability to act as knowledgeable twenty-first century investors. Current restrictions lead to value-destroying, lemming-like behaviour, which accentuates economic financial booms and busts.

The final three articles provide further context for decision-making in pension finance and investing. Don Ezra reflects on four important lessons about the cost of retirement, annuitization, investment education, and decision-making he has learned as a veteran observer of the global pensions scene. Roy Hoevenaars, Theo Kocken, and Eduard Ponds use option valuation techniques to compare the respective values to participants of Defined Benefit (DB) and Defined Contribution (DC) pension arrangements. Such techniques are especially valuable in negotiations where the employer wants to convert a DB to a DC plan. Carolina Fugazza, Maela Giofré, and Giovanna Nicodano show that industry-specific pension plans in North America may want to consider tilting their investment policies towards, and away from, certain types of investments to hedge labour income risk specific to their industry.

The Next Issue

The Fall 2009 issue of the *Journal* will focus on the management implications of the pension reform measures being taken or contemplated around the world.

Our Research Partners

Rotman ICPM has a goal to work with 20-25 thought-leading Research Partners from around the globe on a long-term basis. Each Research Partner makes a financial commitment of C$25,000 to further pension research, as well as to fund the organization and execution of the Discussion Forums. These commitments are renewed annually at the option of each organization.

2008 / 2009 Research Partners

Australia
Australia Future Fund
Australian Prudential Regulation Authority
SunSuper
Victorian Funds Management Corporation

Canada
Alberta Local Authorities Pension Plan
Caisse de dépôt et placement du Québec
Canada Pension Plan Investment Board
Ontario Municipal Employees Retirement System
Ontario Teachers' Pension Plan

Denmark
Danish Labour Market Supplementary Pension (ATP)

Japan
Nomura Research Institute

Netherlands
All Pensions Group
Cordares
Mn Services
De Nederlandsche Bank
PGGM
Syntrus Achmea Asset Management

New Zealand
New Zealand Superannuation Fund

Sweden
The Second Swedish Pension Fund (AP2)

United Kingdom
Universities Superannuation Scheme

United States
TIAA-CREF
Washington State Investment Board

Rotman
ICPM
International Centre for
Pension Management

www.rotman.utoronto.ca/icpm

Rotman School of Management
UNIVERSITY OF TORONTO