

Tomorrow's Value

Achieving long-term financial returns:
a guide for pension fund trustees



tomorrow's
company

Contents

01	Introduction
08	Executive summary
13	Part 1 – A new view of value
14	– Introduction
17	– Why value matters
18	– How value operates in the current system
19	– Evidence for tomorrow’s value
22	– Case studies: Working towards a new view of value
27	Part 2 – Systemic pressures on behaviour
28	– Systemic pressures on behaviour
33	– Improving the chain
35	Part 3 – Fiduciary duty and the Statement of Investment Principles
36	– Understanding fiduciary duty
38	– Legal definitions
45	– The requirement to comply and explain
49	Part 4 – Developments in the pension fund system
50	– The pension fund trustee and defined contribution schemes
53	– Trustee selection process
54	The challenge for pension fund trustees by Professor Mervyn E. King SC, Chairman, International Integrated Reporting Council
56	Acknowledgements
58	Sources and notes

Other useful information can also be found online denoted in the text by





Introduction

The most fundamental duty of a pension fund trustee is to ensure that the best possible benefits are paid to the right people at the right time. This involves managing the cost-effective transformation of retirement savings into pension payments. As a pension fund trustee you are responsible for shaping investment strategies to achieve financial returns for beneficiaries. But how long-term are those returns?

In the face of current crises, your role as a pension fund trustee has become more important and, many would say, more challenging.

All too often attention is focused on the asset manager and others in a very complex system with multiple intermediaries and many behavioural pressures. If the system is to work and the interests of beneficiary are to be advanced we need to focus on those responsible for the stewardship of the scheme – the trustee or equivalent.

This guide will provide you with practical support in your role. This is a time of opportunity, as well as of challenge. In securing the long-term interests of beneficiaries, it is important to protect the interests of savers *and* to secure the long-term interests of people, profitable companies and the planet. Linked to this is a view of value, supported by evidence, which is fit for purpose and which will support the judgements you reach.

This guide covers and brings together a number of complex and related arguments – they are too important to be left to the experts! We argue that:

- a new view of value is needed and provide the evidence for it
- behavioural pressures on trustees must be recognised and challenged
- fiduciary duty, properly understood, reinforces this view of value.

We believe trustees should therefore be encouraged to ensure that 'Tomorrow's Value' is reflected in the mandates for which they are responsible.

Five key principles frame and run through the guide:

- arrangements made for pensions must meet two key goals, affordability and payment certainty – trustees need to meet and to balance short- and long-term considerations
- trustees need to understand value as integrating a number of factors over the long-term – rather than mainstream *or* environmental, social, and governance (ESG) factors, the challenge is how to embed ESG and other considerations into a new mainstream view
- trustees bear ultimate responsibility for the effective governance of the pension scheme, ensuring that it achieves its mission in a cost-effective manner
- the responsibility of pension fund trustees must be applied according to principles of good governance – trustees need to delegate to their executive
- trustees should be good stewards – supporting companies that create value over the long-term. This does not however mean 'picking winners'.

The guide is supported by an agenda and a resource for boards that want to take this forward with asset managers and other suppliers.

We are sure this guide helps you and other key players to understand why and, more importantly, how to promote long-term value creation in practice.



Tony Manwaring

Chief executive, Tomorrow's Company

We are very pleased to welcome and to be associated with the Tomorrow's Value guide for pension fund trustees. We believe the associated agenda will provide trustees with practical guidance on how to best deliver long-term financial value within their own pension schemes. This includes setting up a process, and an excellent range of questions to ask themselves and their suppliers. We are confident that this work will ensure progress is made towards the overarching goals to which we all subscribe.

The Principles for Responsible Investment (PRI) was established eight years ago by a global group of asset owners who believed that much more needed to be done to promote responsible investment which looks to the long-term. That initial vision has since blossomed, and PRI signatories now number over 1,200, representing assets of over \$34tn. We have come a long way since those early days, but the global financial crisis only highlights how much work there is left to do.

PRI supports a wide range of initiatives across the world, and we applaud the work of Tomorrow's Company which has focused on long-term success – for business, investors, and savers – for many years.

We encourage pension fund trustees to engage with this work. They are the guardians of workers' capital, a phrase which rightly highlights the nature of the assets under their stewardship.

Fiona Reynolds, Managing Director, Principles for Responsible Investment

Pension Funds – Key facts

The 13 largest pension markets held \$29,754bn worth of assets at the end of 2012, representing an 8.9% rise compared to the 2011 year-end value.

The US has the biggest pension market (56.6%). Japan is the second largest (12.5%) and the UK is third largest (9.2%).

In 2012, 89% of pension assets in the UK were held by private sector companies. In Canada, this figure was 43%. Methodology does not provide an estimate for 2013.

By 2018, nearly all workers in the UK will be automatically enrolled into a workplace pension scheme.¹

UK state pension deficit £7.1tn (2010, still lower than EU average – ONS).²

UK private sector final-salary schemes deficit £244.7bn at the end of December 2012 (January 2013 – PPF).

There are over 6000 defined benefit schemes in the UK.³

Different asset classes

At the end of 2012 the average global asset allocation of the seven largest markets was 47.3% equities, 32.9% bonds, 1.2% cash, and 18.6% other assets like alternative investments and property.

In 2013, the UK continued to have above average equity allocations at 45% (although down from 61% in 2002), 37% invested in bonds, 1% in cash and 17% in other assets like alternative investments and property.⁴

The guide focuses on the United Kingdom and on English Law. To keep the guide a readable length, we decided to focus on one jurisdiction rather than a number of jurisdictions superficially so as to include practical actions to implement the principles identified. Other jurisdictions will be able to achieve similar results, by applying the same principles while working within the remit of their legal system.

Though the guide focuses on pension fund trustees, these principles are also applicable to all other players in the investment chain.

We use a number of terms throughout the guide, agenda and resource – what we mean by these is as follows:

- **fundamental beliefs** – trustees should be clear about their fundamental beliefs and what factors they take into account when considering long-term financial objectives and investment related risks
- **board mandate** – Trustee Boards should have a shared clarity of the most fundamental principles of their *own* mandate, which helps them to formalise their strategic intent in relation to values, standards, performance outcomes and key issues of risk and forward development
- **Statement of Investment Principles (SIP)** – SIP can, in principle, provide much of this information. However, they may often be completed without the Board being clear about their own mandate
- **mandates to suppliers** – on the basis of shared clarity about fundamental beliefs, the mandate and SIPs, this will better frame the parameters of the mandates given to their suppliers.

Signatories

Keith Ambachtsheer

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

Stephen Davis

Associate Director and Senior Fellow, Harvard Law School Programs on Corporate Governance and Institutional Investors

Jessica Fries

Executive Chairman, The Prince's Accounting for Sustainability Project

Mervyn King

Chairman, International Integrated Reporting Council

Dominic Barton

Global Managing Director, McKinsey & Company

Paul Druckman

Chief Executive Officer, International Integrated Reporting Council

Catherine Howarth

Chief Executive, ShareAction

Vince Linnane

Chief Executive, The Pensions Management Institute

David Blood

Senior Partner, Generation Investment Management

Robert Eccles

Professor of Management Practice, Harvard Business School

Howard Jacobs

Trustee 2002-2012, Universities Superannuation Scheme

Daniel Malan

Director, Centre for Corporate Governance in Africa, University of Stellenbosch Business School

Mike Clark

Director, Responsible Investments, Russell Investments

Donald Fleming

Managing Director, Gazelle Pensions Advisory

Erika Karp

Chief Executive Officer, Cornerstone Capital Group

Colin Mayer

Peter Moores Professor of Management Studies, Saïd Business School, University of Oxford

Colin Melvin
Chief Executive Officer,
Hermes Equity Ownership
Services Ltd

Barry Parr
Co-Chair, Association of
Member Nominated Trustees

Daniela Saltzman
Director, Generation
Foundation

Charles Tilley
Chief Executive,
Chartered Institute of
Management Accountants

Anant G. Nadkarni
Group Vice President,
Corporate Sustainability,
Tata

Brian Peters
Partner, PwC

George Serafeim
Assistant Professor of
Business Administration,
Harvard Business School

Ed Waitzer
Partner,
Stikeman Elliott LLP

Fredric Nystrom
Key Account Manager
and Engagement
Coordinator, GES

Fiona Reynolds
Managing Director, The
United Nations-supported
Principles for Responsible
Investment

Dan Summerfield
Co-Head of Responsible
Investment, USS Investment
Management Ltd

Steve Waygood*
Chief Responsible
Investment Officer,
Aviva Investors

* Endorsed in a personal capacity and not on behalf of the organisation. These are the signatories as of 10/02/2014.

Executive summary

It is time to form a new and integrated view of value. One that is intergenerational, takes into account economic, social and environmental factors, and is measured using both financial and non-financial indicators. This is what we call long-term financial value. It is a view that considers the time horizons of both new and mature pensions and whether the pension arrangement is likely to achieve its stated goal. This guide aims to support pension fund trustees in forming and implementing this view.

The short-term view of value which underpins the current pension fund system is arguably unfit for purpose. It makes it challenging for pension fund trustees to ensure that their fund works in the best interests of its savers to deliver a high quality and low-cost pension.

Post-war growth was fuelled largely by economic drivers of value and securing financial returns. Social and environmental issues were largely seen as constraints, 'a price to be paid'.

The context has changed, compounded by general global volatility and uncertainty. This is re-shaping how value will be created in the future. It is now necessary to consider how to create **long-term financial value**. This is value that goes beyond the estimated financial returns of an asset and considers its resilience in the context of a changing business environment.

It is now more important than ever to take into account strategic risk factors which might have a material impact on future returns. This includes social, environmental, cultural, and behavioural factors, all operating over the long-term.

The current view of value is **marred by behavioural pressures** that affect all key players in the investment chain. This myopic view has resulted in inconsistent performance by funds in recent years, whether through speculation in equities, bonds or commodities.

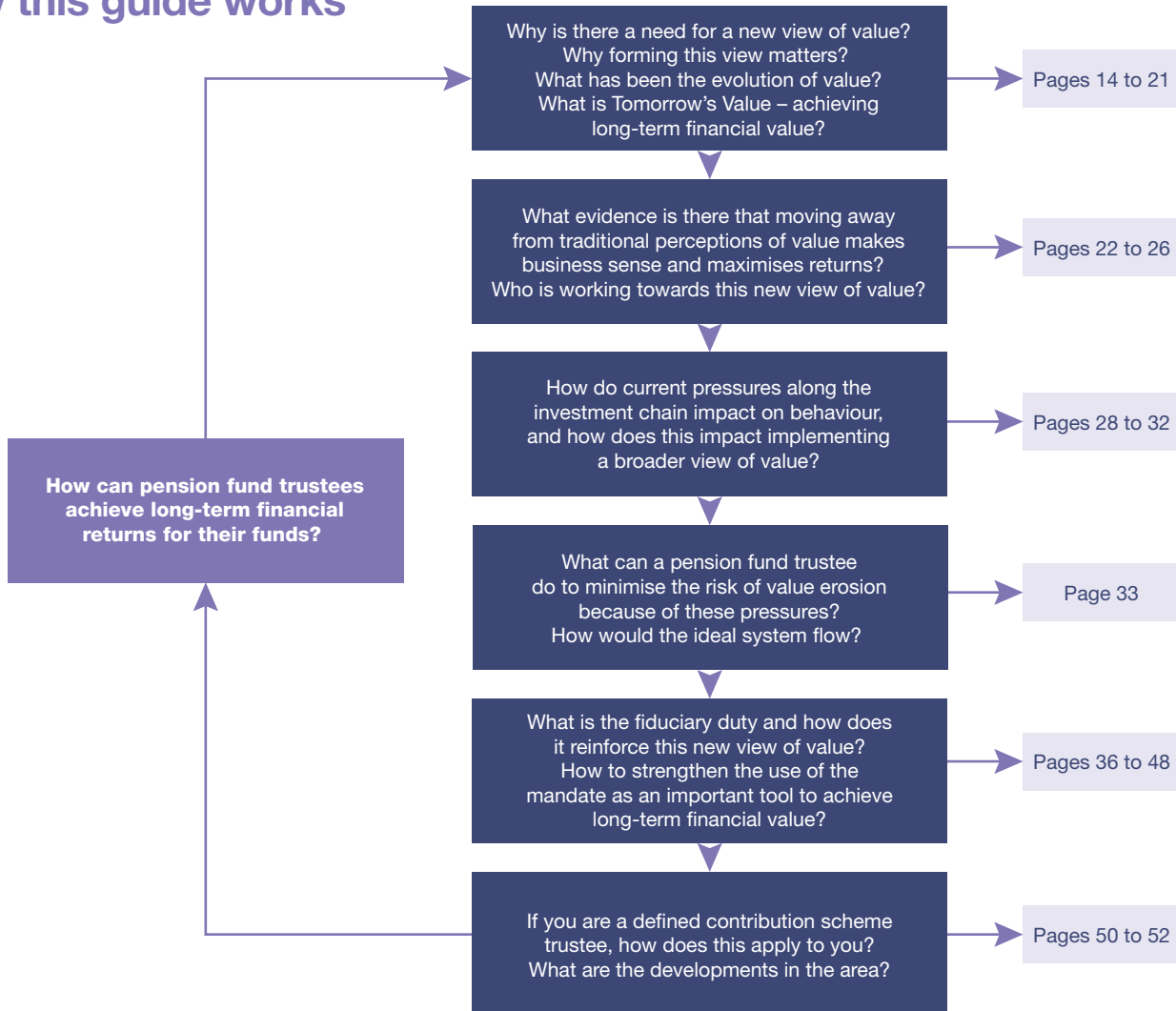
The fundamental frameworks which inform understanding and behaviours are no longer fit for purpose. The short-term economic view of value, sustainability, and a responsible approach to investment all too often sit in a separate universe. This makes it difficult to go beyond the short-term and to allow for more long-term investment strategies which would take broader factors into account.

Through our discussions with pension fund trustees, we observe that **these pressures are at times further reinforced by the belief that there is no evidence to support long-term investment and by a lack of understanding of trust law principles and fiduciary duty. A narrow interpretation of case law and narrow legal advice are common, with a fear of incurring liability.** All of this steers pension fund trustees away from making more long-term investment choices.

We argue that we need to go beyond current compartmentalised measures of success such as ESG, *Responsible Investment* (RI), *Socially Responsible Investment* (SRI) as well as mainstream views of value. Discouraging compartmentalisation will mean that every asset will be viewed in an integrated and complete way, recognising that value lies in all perspectives and how they interrelate.

This guide sets out how pension fund trustees can better fulfil their role and in doing so reset the system.

How this guide works



Pension funds traditionally have long-term investment horizons as they face the challenge of funding liabilities many decades ahead. Although day-to-day investment decisions have been largely outsourced to asset managers and equities are a smaller part of most portfolios, pension funds continue to have an ongoing interest in the health of companies through their corporate bond holdings and sponsor covenant. More thought is also being given to investments in non-traditional asset classes such as infrastructure and private equity – both long-term investments requiring increased consideration of extra-financial issues.

Pension funds therefore continue to collectively own a significant share of the economy and will do so for many years to come. Funds also understand that the assets they own and oversee can play an important role in determining the future society member's face, and thus the real value of their retirement income.

Given the increasing range of challenges which require the focus of trustees, the National Association of Pension Funds (NAPF) supports efforts to put the stewardship agenda into a context which can be embraced by funds in a simple but effective fashion. The NAPF has produced various tools for trustees to utilise in meeting its Principles for Stewardship Best Practice, and encourages funds to:

- *develop an investment policy which includes an appropriate understanding of stewardship objectives and extra-financial risks within investment decisions*
- *select managers considering how they approach stewardship and whether this is aligned to the fund's own policy*
- *structure the awarded mandates to enable accountability for stewardship activities, encourage a strong focus on the appropriate time-horizon, and establish an alignment of interest between manager and client.*

*We would encourage pension fund trustees to consider how they can make best use of *The Tomorrow's Value: achieving long-term financial returns and accompanying agenda* to enable further consideration of this important agenda.*

Joanne Segars, Chief Executive, National Association of Pension Funds

We are now in a better position to form a new view of value, one that will provide the resilience needed for continued success. But value is entrenched by a complex investment chain and is marred by systemic behavioural pressures. When understood, these can be overcome.

We can then embrace a view of value that is integrated and long-term – where performance is measured using financial and non-financial indicators against clear investment goals, taking economic, social, environmental and behavioural factors into account to generate superior and long-term risk adjusted financial returns.

Part 1:
A new view
of value

Introduction

This guide aims to serve as a useful resource for trustees in the pension fund system. It seeks to reinforce confidence in the role trustees can play in creating value that best generates long-term returns for beneficiaries.

How trustees think about value is important. It is the trustee's view that matters most in defining and advancing the interests of beneficiaries. The values and experience they bring to the role are invaluable and should not be subordinate to law or process.

The playing field is shifting. Trustees have the means and the duty to form an enhanced view of value.

The world is now undergoing a period of unprecedented change characterised by rising pressures – but also opportunities – in a multitude of dimensions. We are not arguing that a properly informed pension fund trustee should “save the ‘world’”. Rather, a deeper understanding of value may result in the world prospering, and this outcome may better secure the interests of beneficiaries.

“The disruptive threats now facing the planet are now extraordinary: climate change, water scarcity, poverty, disease, growing income inequality, urbanisation, massive economic volatility and more. Businesses cannot be asked to do the job of governance, but companies and investors will ultimately mobilize most of the capital needed to overcome the unprecedented challenges we now face.”⁵

We define this new view of value as **long-term financial value**. It gives a clearer line of sight on how to invest with the best interests of beneficiaries in mind. The current interpretation of value is too limiting. We must adapt to a new view of value which must then become mainstream.⁶ This view is integrated, multi-dimensional and long-term. It is a view which recognises that short-term economic data is still necessary, but no longer sufficient. For investment choices to be long-term, decisions need to take into account all the factors which may impact future risk and opportunity – including environmental, social and economic – in an integrated way.

The growing interdependencies between the environmental, economic, social and political systems mean that the basis of value generation is fundamentally changing. The best way to secure future value is to adopt a more integrated approach that takes people, planet, and profit into account.

Wealth and profit tend to be measured solely in financial terms. We argue that this provides a faulty compass. In this guide we encourage challenging these assumptions which underpin financial measures to secure better returns for beneficiaries, and to promote the health of the overall system.

These assumptions are typically implicit in the data presented to pension fund trustees giving a sense of false objectivity and confidence. Instead, trustees now need to question the assumptions which underlie the data they are given.

The common challenge posed by players along the investment chain is whether sustainability adds value. Sustainability does add value, as you will see in the Evidence section; the real question is how we frame this value.

Value is multi-dimensional and factors such as behaviour and accountability have an impact. Airmic's study of risk events that resulted in corporate disasters of companies such as Northern Rock and Enron show that it is important to develop a wider view of value when considering risks to businesses.⁷

The pivotal points of value creation or destruction in a business often include what are traditionally seen as 'soft' factors. These wider factors are often secondary considerations. We argue that it is imperative to integrate them into the view of value to generate long-term financial returns.

There is clear and growing academic support for this view of value. For example, Serafeim and Eccles have shown that in the long-term, companies that take into account wider factors such as sustainability outperform their less sustainable peers while maintaining more stable short-term returns.⁸

In 2012, Deutsche Bank released a meta-study that found that ‘long-term investing can be a clear win for investors and for companies’. It recommended that ‘ESG analysis should be built into the investment processes of every serious investor, and into the corporate strategy of every company that cares about shareholder value’.⁹

As a pension fund trustee, ‘following the herd’ seems like the safe option but, in our view, it will not be enough in the future. Driving by the rear view mirror may well be the surest way to fall off the cliff. Trustees should emphasise long-term value creation and stewardship as part of their mandate to asset managers.

Key points

- as a trustee, putting forward your view of value will be helpful to your asset managers, advisors and beneficiaries. Although you will not necessarily do this to “save the whale”, your actions may result in the “whale being saved”
- the system is marred by systemic behavioural pressures that are continuously compounded and prevent more long-term investments
- trustees should place emphasis on long-term value creation in their mandates.

Why value matters

“Tomorrow’s Value: Achieving long-term financial returns is an excellent piece of work. It combines an academic perspective with a pragmatic step-by-step approach to investment issues, and would be a useful aid to any trustee board.”

Tim Middleton,
Technical Consultant,
Pensions Management Institute

How trustees think of and perceive value matters. It is perhaps taken for granted that the market price of an asset reflects its true value. This has superseded earlier views of value based simply on the cost of labour and capital.

However, the current view of value can be challenged because it is unlikely that these market value assumptions will be sufficient to cover the ‘external’ costs imposed on society. Behavioural pressures which shape and distort judgements, such as herd-like behaviour and over-reaction to immediate market data prevent all of the material risks from being taken into account.

The problem is that key players in the investment system often assume a degree of objectivity and accuracy around short-term returns that is hard to substantiate or sustain. A new view of value, and a new way of measuring it, is required to secure those returns in the future. This means that pension fund trustees will have to form and make their decisions in a different way.

A new view of value and achieving long-term financial returns

Our views on what constitutes value have evolved over time, and now they need to evolve again. For hundreds of years the dominant view of value was rooted in the real economy, such as the spice trade, instead of the current focus on financial products. This emphasises the notion that value is not ‘eternal’, rather it is profoundly connected to the social and political system.

There are many reasons why the current view of value is misleading from the limitations of mark-to-market accounting to the limitations of valuing assets in fiat currency. This new view of value surpasses these limitations and is applicable and useful in the judgement of all asset classes.

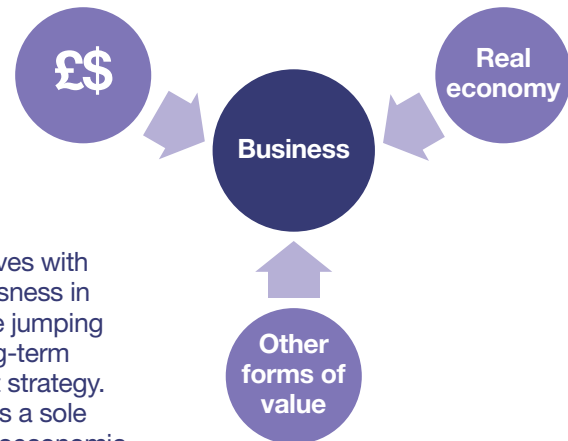
How value operates in the current system

It is businesses that create value and it is the financial system that provides the financing for that to happen. However, all too often over recent years the financial system has operated as an end in itself, seeking to maximise short-term gain by redistributing value within the system.

The negative impacts are cumulative, sucking capital out of the system which might have otherwise produced broader positive impacts. For instance, investing in government infrastructure projects would not only generate financial returns but also create additional social value. This creates value that is balanced in terms of short-term gain and long-term sustainability.

The role of the pension fund trustee when judging the value of an investment decision should not consist of an exclusive focus on the short-term or on detailed profit and loss analyses. The question that trustees need to ask their managers is a broader one: *what am I actually investing in; what does it do, how does it make money, and what does it produce in the short and long-term?*

The current system encourages investments that are an end in themselves with value arising only from the immediate transaction. This results in restlessness in investment behaviour that seeks only to capture short-term profits while jumping from one transaction to the next. **Tomorrow's Value** seeks to draw long-term financial value from adopting a more integrated approach to investment strategy. We argue that the projected return on investment should not be taken as a sole indicator of value. Rather, understanding the asset by considering macroeconomic trends or applying ESG analysis will provide a more accurate view of its real value.



Evidence for tomorrow's value

It is a commonly held view that long-term investing does not yield superior financial returns. However, there is clear and credible evidence to suggest otherwise.

There is increasing and abundant proof that investing with a more integrated view of value makes financial sense. Many academic and investor-led studies reinforce the case for long-term investing, through the inclusion of ESG factors into the investment process or corporate culture.

Sustainable Investing: Establishing Long-Term Value and Performance, Deutsche Bank Group, 2012

This is one of the most complete studies done on long-term investing. The study is a review of 100 academic studies of long-term investing, 56 research papers, two literature reviews and four meta-studies. It concludes 'confidently' that:

- long-term investing has often been described as yielding mixed results or as not adding much value for a variety of reasons that the Deutsche Bank report illuminates and refutes. For instance, in the SRI category, fund managers, who tend to use exclusionary screens have always found it difficult to capture the outperformance of SRI investments. Processes such as this one help explain why it has taken so long for long-term investment to gain traction with investors
- 89% of the data on long-term investing shows that companies with a high ESG rating outperform the market and 85% show that these companies also outperform their counterparts in accounting-based measurements. They find that companies with high ratings for corporate social responsibility and ESG factors have a lower cost of capital and pose a lower risk to investors.

The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance, Robert G. Eccles, Ioannis Ioannou, George Serafeim (Harvard Business School), 2012

This study finds that ‘High Sustainability’ companies significantly outperform their counterparts over the long-term, both in terms of stock prices and accounting performance. The outperformance is more distinct in sectors where ‘customers are individual consumers; sectors where companies compete on the basis of brand and reputation, and in sectors where companies’ products significantly depend upon extracting large amounts of natural resources.’

Does it pay to be good? A meta-analysis and redirection of research on the relationship between corporate, social and financial performance, JD Margolis, 2007

This study finds a positive correlation between Corporate Social Performance and Corporate Financial Performance.

The state of responsible business: Global corporate response to environmental, social and governance (ESG) challenges, Bob Gordon, Stephen Hine, Niaz Alam (EIRIS), 2007

In the long run, incorporating ESG factors into investment analysis will result in higher productivity and reputational advantages.

Corporate Environmental Governance: A Study into Influence of Environmental Governance and Financial Performance, Environment Agency, 2004

This study concludes that there is a positive relationship between responsible environmental practice and financial returns.

The question for pension fund trustees is: How much of my portfolio considers long-term financial performance and business resilience, and how much of my portfolio is concerned with immediate returns? To what extent is a focus on immediate returns consistent with our long-term commitment to beneficiaries?

Key points

- it makes financial sense to integrate other factors into your investment decisions such as ESG factors
- increased global volatility means that from a strategic risk perspective it becomes important to take all factors into consideration when forming investment strategies
- financial returns will always be priority but it is important to form a balanced opinion where you have considered different aspects of value and given thought to the long-term sustainability of your investment strategy
- as a trustee, there is an opportunity to create value not just redistribute it
- the value of an investment decision and strategy need not solely rest on a short-term focus and profit and loss (P&L) analyses
- value is multi-dimensional and there is abundant evidence to support the strength of long-term investment, which will lead to long-term financial value.

Case studies: Working towards a new view of value

Various large organisations and countries are adopting this new view of value, best illustrated by the excellent CalPERS report '*Investment Beliefs*'.

Here, we present a number of case studies drawn from conversations we have had with various companies and investors. For the full case studies and an extensive list of institutions that implement a wider view of value, please visit Tomorrow's Value's online platform.

Syntrus Achmea

Syntrus Achmea is one of the largest Dutch pension fund providers and offers fiduciary management, asset management, and pension administration. They manage nearly €60bn for pension funds and institutional investors.

Syntrus Achmea states in its investment philosophy that “responsible investing pays off in the long-term.” This is supplemented with its vision that “a good pension is without value if the world is not viable.” Part of its mission is to contribute to an affordable and long-term pension system. Responsible investment fits very well within this and is in line with the objectives of its clients – pension funds with a long-term investment horizon. This also applies to all layers of the investment portfolio.

They believe that responsible investments are necessary, and will be increasingly rooted in society and become an integrated part of the investment process in the future. Their strategy for a consistently responsible investment portfolio is a two-pronged approach:

- they are active asset owners seeking to influence through engagement and shareholder rights
- they integrate ESG factors into investment analysis and decision-making. Thus, value is sought in ESG factors.



<http://www.calpers.ca.gov/eip-docs/about/pubs/board-offsite.pdf>



<http://tomorrowcompany.com/tomorrows-value-pension-fund-guide>



<http://www.sustainablereturns.org.za/>

Code for Responsible Investing in South Africa (CRISA)

CRISA is an institutional investors' initiative that aims to encourage investors to integrate ESG factors into their strategy. It aims to give the pension fund industry a revised framework to ensure that money which South Africans contribute to their retirement is invested diligently in line with government priorities such as economic transformation, development, and growth.

Regulation 28 of the South African Pension Funds Act has been in effect since January 2012 and impacts members of every retirement fund. This regulation limits the extent to which retirement funds can invest in particular asset classes. This protects investors from the effects of poorly-diversified investment portfolios, over-exposure to higher-risk asset classes, as well as overly-complex financial instruments and portfolios. It also outlines a fund's fiduciary duty to *"give appropriate consideration to any factor which may materially affect the long-term performance of a fund's assets, including factors of an environmental, social and governance character."*

BT Pension Scheme

The BT Pension Scheme (BTPS) is sponsored by the BT Group PLC and is managed and administered by the trustees of the BT Pension Scheme. The BT Pension Scheme Management Limited (BTPSM) is the executive arm of the trustee and provides advice and services in five areas: investment asset allocation, fund manager selection and monitoring, risk and liability management, governance, and operations. The trustees believe that long-term factors, inclusive of ESG factors, will impact the returns of the scheme. The scheme is moving towards a full integration of the BTPS sustainability policy into all their Investment Manager Agreements. Currently, they have introduced a range of ESG questions in their due diligence questionnaire in relation to investment manager selection, as well as on encouraging managers to report and show examples of how ESG factors have affected their investment decision-making during quarterly reporting and meetings.

Tata

Tata Asset Management (TAM) is one of the oldest private fund managers in India. It has a client base of over 1 million people and has as one of its long-standing core values being responsible to the communities in which it works. A main focus for TAM thus is the financial and economic security of its employees.

J.N. Tata, who founded the Tata Group, said

“In a free enterprise, the community is not just another stakeholder in business, but is, in fact, the very purpose of its existence”.

TAM thus operates on a very personal level and offers personalised products based on individual requirements and aspirations. TAM has also designed services to suit both individual and communal needs. TAM seeks to encourage a habit of saving to younger generations, and offers financial planning sessions catered to the individual, regardless of whether that individual is a working woman in Delhi or an industrial worker in Jamshedpur.

In addition, TAM’s ‘30-30 Challenge’ suits the challenges faced by India’s growing economy. An increase in life expectancy has paralleled an increase in the rate of inflation leading to ‘old age poverty’ in India. TAM has an ‘auto-switch’ feature which adjusts the level of risk tolerance – from progressive to moderate to conservative – as the beneficiary ages, and also adapts to the beneficiaries’ age to provide a regular cash flow after the age of 60.

Ontario Teachers' Pension Plan (OTPP)

OTPP is ranked as the world's best-performing retirement fund. It is Canada's largest single-profession pension plan with \$129.5 billion in net assets. OTPP pays pensions and invests plan assets on behalf of 303,000 working and retired teachers. Since its establishment as an independent organisation in 1990, OTPP has built an international reputation from best member services team to award-winning investors for innovation and leadership in investment management and member services.

OTPP is recognised as an innovator and leader among pension investors. Its core values involve promoting personal development, collaboration, innovation, open and honest communication, accountability, risk consciousness, and high levels of integrity. OTPP recognises that people are their drive to success and as such embrace talent, respect diversity, and recognise accomplishments.

OTPP will be paying pension benefits to today's youngest teachers 70 years or more from now on. To meet its long-term pension obligations to members, OTPP administers a defined benefit pension plan. It seeks to maximise investment returns at an appropriate level of risk, taking into account pension liabilities (the cost of future pension benefits) and challenges presented by the plan's mature demographic. In addition, it aims to close the gap between asset values and pension obligations, viewed as the best way to achieve contribution rate and benefit stability for members. In addition to retirement pensions, it provides benefits if members die, become disabled, or leave teaching before retirement.

The OTPP pension plan must have sufficient assets to meet its long-term pension obligations to members. As such, the Ontario Teachers' Federation and the Ontario provincial government has set contribution and pension benefit levels based on the plan's funding status.

Pension Insurance Corporation (PIC)

PIC provides innovative and bespoke insurance solutions to the trustees and sponsors of defined benefit pension funds, bringing safety and security to member benefits. PIC is authorised by the Prudential Regulation Authority (PRA) and regulated by the Financial Conduct Authority (FCA) and PRA.

PIC aims to meet specific requirements and tailors solutions to fit each client's needs to the highest standards. This allows PIC to help trustees of a pension fund secure scheme members' entitlements for the long-term, secure the pension insurance transaction and allows sponsors to remove liabilities from their balance sheets. This emphasis on client service is combined with PIC's sole focus on risk management and innovative, tailor-made solutions for member benefits.

PIC holds significantly more assets than is required to back its commitments and has a conservative investment strategy, ensuring it is always able to pay the pensions of policyholders as they fall due. It has insured more than 65,000 pension fund members, and has worked closely with all stakeholders involved in a transaction to provide innovative solutions to pension issues.

Part 2:
Systemic
pressures
on behaviour

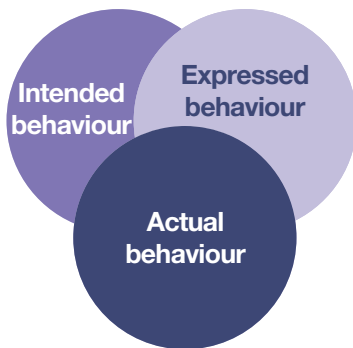
Systemic pressures on behaviour

A powerful element to be considered is that the mainstream view of value is stuck within, and entrenched by, a complex investment chain.

The investment chain is marred by systemic behavioural pressures that affect all key players in the system and make the system perform in a sub-optimal way. Even if a pension fund trustee understands the importance of long-term investment, this reality makes it difficult to go beyond the short-term and to allow for longer-term investment strategies. It can be hard for people to reflect on why they are doing what they are doing.

As explored in the government commissioned *Kay Review of UK Equity Markets and Long-Term Decision Making*, ‘short-termism’ is “*the natural human tendency to make decisions in search of immediate gratification at the expense of future returns.*”¹⁰ This can also manifest itself as ‘hyperactivity’, for example where trading in equity markets has time horizons measured in fractions of seconds.

Pension fund trustees have a duty to care for the short- and long-term interests of their beneficiaries. They occupy a privileged position in the investment chain where they can influence and perhaps challenge the system’s ‘short-termism’ and ‘hyperactivity’.



Intended behaviour +
Expressed behaviour =
Actual *expected* behaviour?

There is often a vast misalignment between intended and actual behaviour, compounded by pressures from other players in the chain, and their own intentions and behaviours.

Intended, expressed and actual behaviour

It is important to recognise the differences between intended, expressed and actual human behaviours. We have explored behavioural tensions along the value chain using PwC's behavioural model.¹¹ Tensions identified reinforce and embed different and not always conscious models of what value is. Most of these are focused on the short-term.

Pension fund trustees are principal players in the investment chain and their behaviour will have a knock-on effect on the rest of the actors along the chain. They should not, and need not, feel trapped or pressured by advisors or external influences to act in a certain way. The following table demonstrates the difference in the intended, expressed, and actual behaviour of both decision-makers and decision-influencers in the pension fund. We believe that one useful and effective tool to affect behaviour along the chain is the mandate trustees set for their investment managers.

Applying the model and results

The behavioural table on the following pages represents our summary findings from conversations with key players in the investment chain.

The findings in these tables originate from extensive discussions with, and draw from the experience of key players in the investment chain and their clients.

Using the intended, expressed and actual behavioural model as a starting point, we asked them what the differences were, if any, between the behaviours manifested in these roles.

Our findings demonstrate that there was often a vast misalignment between intended and actual behaviour, compounded by pressures from other players along the chain who have their individual intentions and behaviours. A trustee's original intent can therefore be lost in this misalignment unless they hold firm to it and ensure others will carry out their mandate without interference.

The table below covers the pension fund trustee followed by the pension fund executive, investment manager and investment consultant. On the right, we go on to consider external factors that affect behaviours and results, such as company/plan sponsors and legislation.

Decision makers	Intended	Expressed	Actual
Pension fund trustees	Safeguard assets and invest them. Mandate defined by trust deed but trust law gives broad discretion on how to invest.	Common interpretation of duty to safeguard assets leads to an unnecessarily narrow, short-term, risk-return stance.	Narrow risk/return behaviour is the industry standard. Trustees lack the confidence to use their powers and there is a systemic bias to follow advice without posing adequate challenge.
Pension fund executives	Translate the trustees' objectives into an action plan.	If investment resources are modest the PFE merely carries out directions. If significantly resourced the PFE can seek to build a third party business with a sales focus.	Modest resources can lead to insufficient management of external suppliers (managers, investment consultants etc.). Greater resources can lead to better alignment with the trustee's intended/expressed behaviour.
Investment managers	Meet the client's objectives. Be profitable, invest in the IM's business.	Can be willing to accept unreasonable client performance goals to attract business: misaligns expectations at outset.	Business goals (asset growth) may not be aligned with client objectives; retention more important than outperformance.

Influencers	Intended	Expressed	Actual
Investment consultants	Advise trustees on how to meet their objectives. Be profitable, invest in the IC's business.	Provide information and educate. Can become "we will tell you what you need to know."	Can strongly influence trustees so the advice becomes the process. Can lead to a close-to-executive role that may supplant the interests of the trustees. Lack of balance between "you should do" and "you could do a), b) or c)".
Companies/plan sponsors	Maximise value for money of pension arrangements. Ensure funding cost is affordable and manage related risks.	Manage (constrain, defer) the funding cost to the company. Tension between the company's desire for high asset returns and the trustee's desire for security.	Reasonable alignment, although involvement in lower level investment decisions can hinder trustees' decision-making.
Regulators & policymakers	Protect beneficiaries. Resist tax avoidance. Question when trust law framework is inadequate.	Political imperative encourages voter protection, distorting the risk allocation of the simple trust law model – convert discretion into entitlement.	Political goals tend to impose additional costs and have unintended consequences. These are borne by employers that then lessen support for arrangements.

Table summary and conclusions

The main issues are:

Pension fund trustees: Uncertainty over responsibilities and what they can/should ask of Investment Managers and Investment Consultants.

Investment managers: Challenge of keeping active management (engagement/proxy voting); challenge of keeping returns high while keeping in line with trustee's mandate/risk/objectives.

Investment consultants: ESG consultants not fully integrated into mainstream investment teams so view of analysis and wider range of options may not be integrated.

Companies: Sponsors may come into conflict with trustee board – these need to be aligned. Third party mediation can also be an issue.

Regulation: Too many layers – confusion with complexity and multiple streams of guidance.

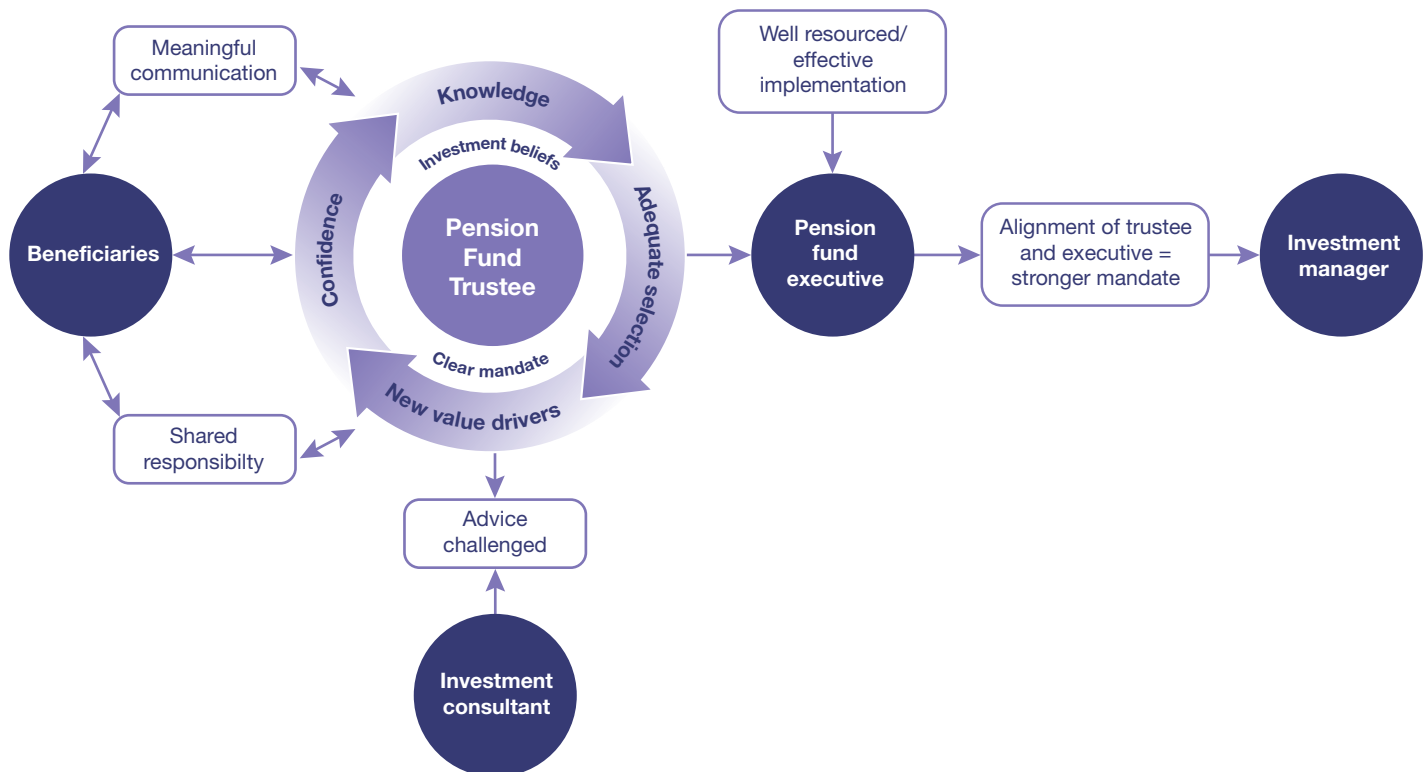
Based on these results we can observe that the misalignment between the different types of behaviours often stem from the fact that:

- responsibilities and expectations are ambiguously or loosely defined. This leads to a lack of confidence in challenging poor advice and risky behaviour, ultimately undermining the judgement/interests of trustees. Consequently, poor investment portfolio decisions may result over time
- there can often be a conflict between self-interest, the fund's interests and the client's interests. For instance, the company may want high returns while the pension fund trustee prioritises financial security
- given all the pressures outlined in the table, pension fund trustees are not confident enough to use the tools available to them to proactively shape investment strategies on behalf of beneficiaries.

Improving the chain

An improved system that implements some changes such as a better understanding of fiduciary duty, an understanding of new value drivers, a stronger mandate, meaningful communication with beneficiaries and a purposeful selection of pension fund trustees, will ensure that there is a better balance between long-term and short-term investment decisions.

The ideal system is one where the intention of trustees is formed, and this intention can follow through and is supported by every key player along the chain. The system then flows.



Key points

What does this mean for value?

- trustees feel that they do not need to form a view of value because they sub-contract this responsibility to others
- even if they do form such a view, it risks being diluted along the investment chain and the behaviour that comes from it does not reflect their original intention
- this leads to value erosion because intent is progressively lost in the complex web of interrelationships prevalent in the system.

What can be done?

We need to recognise the magnitude and power of behavioural pressures in the system. Intentions are barely formed, and if they are they get lost in the complexity of the investment chain. Instead, we strongly believe that as a trustee you can and should encourage advisors and investment managers to make decisions that reflect your values – and thereby your view of value – and that of your beneficiaries, by having a strong and focused investment mandate.

Part 3:
Fiduciary duty and
the Statement
of Investment
Principles

Understanding fiduciary duty

Discussions around fiduciary duty are numerous, and have often concluded that trustees cannot take a broader view of value. We argue that fiduciary duty not only allows for extra factors to be taken into account, but requires these additional factors to be considered. The behavioural pressures described in the previous section, as well as a lack of understanding of fiduciary duty, have prevented a wider interpretation. As these pressures are powerful we will argue that some regulatory intervention at an EU wide level could help ‘nudge’ the system in the right direction.

Here, we contend that pressures faced by the pension fund trustee are reinforced by an unjustified fear of incurring personal liability – a fear arising from prevailing assumptions about fiduciary duty which have lost sight of underlying trust law principles. This leads to a narrowing of factors considered relevant to investment decisions, affects the ability to make more long-term investment choices, and perpetuates short-term behaviours. Confidence about the legal principles combined with an understanding of why the paradigm of value has to shift, will enable pension fund trustees to make different and improved investment choices.

Furthermore, a better understanding of their legal duties will better equip trustees to challenge legal advice which tends to err on the side of caution.

The Kay Review argues that ‘all participants in the investment chain should observe fiduciary standards in their relationships with their clients and customers’ and that the application of the legal concept of fiduciary duty to investment matters should be clarified so that ‘trustees be reassured that what they do is in accordance with good practice and the law’ and that indeed trustees who ‘insisted on a narrow view of fiduciary duty were often hiding behind risk-adverse legal advice.’¹²

These developments should reassure trustees that, so long as they exercise their judgement prudently and in good faith on behalf of their beneficiaries, they are unlikely to fall foul of the law. Trustees do not need to wait for legal clarification: they can and should take a broad approach to securing value for their beneficiaries, and feel empowered to use their discretion to determine how best to deliver this.

To most effectively exercise their fiduciary duty a trustee should be sensitive to all modern global trends – economic, environmental etc. – and also consider emerging risks when deciding on an investment strategy.¹³ It is precisely the lack of awareness of new potential environmental and social risks that may have an impact on pension funds’ assets that could be interpreted as a breach of fiduciary duties.¹⁴ Arguably, it is the more cautious approach that might put trustees at risk of breaching their fiduciary duty as argued by Mervyn King later in this guide.

“If long-term investments like pensions are to fulfil the expectations of their beneficiaries, it is vital that their investment activities focus on long-term value creation rather than zero-sum games. Our understanding of fiduciary duties urgently needs to change to reflect this reality. At present, a legal concept that should be part of the solution to dysfunctional capital markets appears to be part of the problem. Part of the answer must lie in reasserting trustees’ discretion to judge what will best serve their beneficiaries’ interests, rather than feeling hidebound by narrow interpretations of the law.”

Christine Berry, Head of Policy & Research, ShareAction

Legal definitions

In common law legal systems, **trust law** is a relationship where a property or asset is held for the benefit of a third party by one or several trustees. A trustee has legal title over the property whereas the beneficiary holds an equitable title over it and the trustees owe the beneficiary a **fiduciary duty**.

A **fiduciary duty** – historically originating in Roman law¹⁵ – is an obligation to act in the best interest of another party. Pension fund trustees have *prima facie* the fiduciary duty to look after the beneficiaries' best financial interests, as has been confirmed by UK Courts. Pension fund trustees therefore have a duty to invest the assets of the trust prudently in the long-term best interests of beneficiaries. Indeed, failing to do so could expose them to liability. As the markets and the world have changed, so has the scope of what constitutes prudent investment. As the world continues to change, it is becoming increasingly prudent to balance portfolios and consider longer term investments in order to avoid value destruction and skirt liability. The primary duties are the **duty of care** and the **duty of loyalty**, encompassed by a general **duty of prudence** and **duty of impartiality**:

- **Duty of care:** The duty of care requires a trustee to discharge their duty with the care that an ordinary prudent person in an equivalent position would exercise under similar circumstances. For instance, the duty of care relates to how a board of directors makes decisions and how it exercises its supervisory and monitoring obligations.
- **Duty of loyalty:** This duty also requires that a trustee administer the trust in good faith, solely in the interest of beneficiaries, with undivided loyalty and not for their own personal benefit or the benefit of others. The duty of loyalty is breached when, for instance, fiduciaries divert corporate assets, opportunities, or information for personal gain. A breach of fiduciary duty is a civil act and is easier to prove than fraud as beneficiaries need not suffer an actual loss, but damages may be recovered for negligence, mismanagement, or waste of corporate assets. A judgment in a recent case stated that the "*distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.*"¹⁶

- **Duty of prudence:** Though this rule is enshrined in statute in numerous jurisdictions, the common law rule in *Re Whiteley* remains as the primary source of authority in the UK as it applies to the exercise of investment power by pension fund trustees. The rule states that the “*duty of a trustee is [...] to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.*”¹⁷ Earlier interpretations of this rule focussed on a risk-averse prudent approach to investment, rather than one that sought to solely maximise return on investments. Indeed, until relatively recently it was considered imprudent to invest in equities, and many jurisdictions effectively banned fiduciary investors from doing so. Section 6(1)(a) of the Trustee Investments Act 1961¹⁸ created a positive duty on trustees stating that trustees should “have regard to the need for diversification” in their investment strategy. The Pensions Act 2004¹⁹ further removed constraints on trustees and case law has recognised the importance of modern portfolio theory²⁰ vis-à-vis the application of the duty of prudence. The duty to diversify in relation to pensions has also been codified in EU law under the IORP Directive.²¹

These developments signified that the duty of prudence came to be interpreted as trustees having the duty to ensure a sensible investment portfolio as a whole. It can be deduced that there is no particular duty to maximise return in relation to individual assets.²²

- **Duty of impartiality:** This duty, often forgotten but still judicially alive, further shields the trustee that makes investment decisions that deviate from traditional short-termism. A “*full appreciation of (this duty) would require trustees to act for the long-term in order to ensure intergenerational equity between their youngest and oldest members.*”²³

Significant case law

Cowan v. Scargill

In this 1984 case concerning the scope of trustees' discretion, the court held that trustees cannot ignore the best financial interests of their beneficiaries and would be in breach of their fiduciary duty if they did so.²⁴ This decision has been regarded as an obstacle to trustees wishing to employ a wider spectrum of investment choices and has entrenched a fear of potential liability if the investment focus is on anything other than maximising financial returns.

However, on a closer reading of the case, it *“does not support the idea that non-financial issues are automatically off limits for trustees. Indeed, the judge in Cowan v Scargill explicitly confirmed that non-financial benefits might under some circumstances be a legitimate consideration.”*²⁵ The interpretative onus of this decision, as relevant to the current global context, should be on the trustees' duty to ensure that the decision process behind their investment choices is sound, reasonable and motivated by the beneficiaries' best interest. This leaves legal space for trustees take into account other factors when seeking to achieve long-term financial value. Indeed it could be argued that failing to take the most reasonable investment strategy (one that recognises the multiplicity of value, its wider definition that is fit for purpose today and that goes beyond pure financial factors) would be in breach of their fiduciary duty.

Bishop of Oxford v Church Commissioners²⁶

Investment risk is often associated with individual stocks, markets and asset classes. The highest risk would be to invest in a single company share, while a much lower risk profile would be achieved by diversifying the portfolio through different asset classes spread across different markets. For many years, the same concept was applied to ethical investment, based on this 1991 court judgement.

This case was based on the premise that it was unacceptable for the Church of England to invest in companies that were clearly at odds with their charitable objects and their ethical investment policy (one guided by Christian morals), such as arms, tobacco or gambling. As a result, the Charity Commission accepted that charities could reasonably desist from investing in companies whose activities were diametrically opposed to the charity's objects, and which might also alienate their supporters to the extent that voluntary income would be negatively affected. However, it also stated that moral acceptability as a measure for choosing what investment to make can be ambiguous and should it too severely limit the portfolio or be of financial detriment to the charity, the trustees could be in breach of their legal obligations.

In summary

Although these cases have served as guiding tenets to trustees and others working along the investment chain, it can be seen that these decisions are based on a context that now has little to do with the current global situation and furthermore, they do not at any point make a binding rule that non-traditional investment is in breach of fiduciary duty. Arguably, there has been confusion and over-reliance on this small number of legal decisions that has led to an investment mind-set that is fearful of anything other than short-term investment approaches.

An investor's tendency to herd, or to follow what is generally accepted must also be acknowledged. This group-think leading to short-term investment decisions can often be observed in capital markets and "investors assume a level of collective reassurance and sense of safety in numbers."²⁷

These paradigms, however, are changing and necessarily need to change. Indeed, in a recent U.S. case, it was ruled that "*a trustee's duty is not necessarily to maximise the return on investment but rather to secure a 'just' or 'reasonable' return while avoiding undue risk.*"²⁸ It is now more prudent and more risk adjusted to diversify an investment portfolio with a broader definition of value in mind, while also understanding that maximising return also requires taking into consideration avoiding value destruction. These decisions do not preclude that this reasoning can be justified in court.

New developments

Since the financial crisis, regulation and commentary about what leads to superior risk adjusted returns has moved at a faster pace than case law and legislation. However, legislation is catching up. On 22 October 2013, the Law Commission published a consultative paper on the fiduciary duties of investment intermediaries which acknowledges the argument of this guide. This consultation was in response to the Kay Review's recommendation to 'review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers'.²⁹ A report from the Law Commission with recommendations to Government (but no draft Bill) will be published by June 2014.

Implications in the context of 'Tomorrow's Value: Achieving long-term financial returns'

Each of these views interprets the concept of fiduciary duty and suggests how to achieve superior risk adjusted returns differently. UNEP-FI recommend voluntary integration of ESG factors into pension funds investment strategies, Regulation 28 of the South African Pension Funds Act makes it compulsory, ShareAction (formerly FairPensions) Green Light Report argues for a wider application of fiduciary duty and legal clarification, and the Kay Review emphasises the importance of trustees having a long-term perspective and how this will influence their behaviour and decision making process.

Today managing potential risk is no longer limited to analysing financial factors, ESG factors, and/or a long-term perspective alone, nor should any of these separate views stand alone at the core of an investment strategy.



http://lawcommission.justice.gov.uk/docs/cp215_fiduciary_duties.pdf

Some stakeholders argued that trustees should give investment managers more specific mandates, requiring consideration of wider investment factors.

Tomorrow's Company comments that:

“as a trustee you can and should encourage advisors and investment managers to make decisions that reflect your values and those of your beneficiaries, by having a strong and focused investment mandate.”

Section 3.29
Law Commission *Fiduciary Duties of Investment Intermediaries*
(Law Com No. 215, 2013)

Trustees should be guided by the reality that pension saving is inherently long-term and multi-faceted: most beneficiaries will receive their pension several decades after they become members of a scheme. To most effectively exercise their fiduciary duty a trustee should be sensitive to all modern global trends – economic, environmental etc. – and also consider emerging risks when deciding on an investment strategy for the next decade.³⁰ It is precisely the lack of awareness of new potential risks that environmental and social impacts may have on pension funds’ assets that could be interpreted as a breach of fiduciary duties.³¹

Trustees should keep in mind that what delivers long-term value and what is valuable changes over time. Therefore, fiduciary duty is a dynamic concept that evolves as paradigms in social norms, concepts of value, and the impact that this has on financial markets shifts. For instance, paying equal wages for men and women and subsidising public transport were held as breaches of councillors’ fiduciary duty to local taxpayers in the past, but this no longer holds true.³²

To better understand what forms long-term financial value, trustees should not feel bound by prevailing investment norms, but should rather employ a wider sense of responsibility when making decisions. That is, they should be open to considering several factors that might be material in the long-term and in their beneficiaries’ interest, and this way correctly exercise their fiduciary duty. Courts support this: they see there is a wider spectrum of prudent approaches instead of only one prudent strategy.³³ In addition, the current complex investment chain should not diminish the core idea of trust law. Ultimately, trustees are duty bound towards their beneficiaries, and they must have the adequate skills and knowledge to make the investment decisions that best serve their beneficiaries’ interests. As stated by the **duty of impartiality**, a trustee is required to *“act for the long-term in order to ensure intergenerational equity”*.

Key points

- behavioural pressures, cautious legal advice and a lack of case law mean trustees fear incurring personal liability
- this leads to a narrow interpretation of fiduciary duty and to short-term risk/return investment strategies
- a better understanding of fiduciary duty reveals that in effect it allows for wider factors to be taken into consideration
- case law also shows that non-traditional investment is allowed by fiduciary duty and courts do accept a wider spectrum of prudent approaches
- as the world changes so has what has been considered to be a breach of fiduciary duty
- to most effectively exercise their fiduciary duty a trustee should take into account all global trends and adjust investment strategies according to these new risks
- ultimately, trustees must serve their beneficiaries' long-term interests.

The requirement to comply and explain

As we argued fiduciary duty, if properly understood, is no barrier to long-term investment. Though the behavioural pressures we explored also mean that trustees can often lack confidence in implementing their wider views of value into their investment mandates, this would allow for a more risk adjusted investment portfolio and long-term financial returns.

As behavioural pressures on the pension fund trustees are numerous, systemic and powerful, a better understanding of fiduciary duty may not be enough.

We have discussed a potential solution to this with a number of key players in the UK pension fund system and across Europe. We have observed that in terms of regulation, tools currently within the system such as the SIP have simply become part of a compliance response, which provide little by way of meaningful explanation of the investment strategy to the beneficiaries. SIPs do not require trustees go to the heart of ownership of the mandate. Indeed, Section 4 (2) (g) of the Pension Protection Fund (SIP) Regulations 2005 merely requires that the SIP state:

“the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.”

This is not sufficient and we advocate substantive intervention. There is a case to implement a mandatory comply-and-explain tool, where pension fund trustees would have to fully disclose which factors they have taken into account when formulating their mandates, and why.

“The financial crisis has focused attention on the role of banks in the financial system, and continues to do so. But there is a deeper discussion underway about the role of the financial system in wealth creation. Within that system, institutions channel the savings of long-term investors into economic activity that needs to deliver strong, long-term returns. Yet we seem to have an inadequate understanding of the process of value creation, and capturing that value for long-term savers. Business models and misaligned incentives can hinder the delivery of those returns. There is a growing body of investors who seek to work through these challenges. This initiative seeks to encourage and assist pension fund trustees, and others, to do just that”.

Mike Clark, Director, Responsible Investment, Russell Investments

“The calculation of value is at the heart of the debate. Scholars and others can differ about the elements of any value calculation and the weight to give to each element but, as a matter of principle, calculations of value in the 21st century must give appropriate weight to integration, the long-term and the sustainable or they will be defective. As a trustee, there is no inhibition or restriction on the view of value you can take. Empirical data largely supports the correctness and importance of the principle. With the principle adopted, practical implementation can begin.”

Howard Jacobs, Trustee (2002-2012), Universities Superannuation Scheme

“Pension fund trustees have a duty to themselves and to beneficiaries to make clear what the criteria for their mandate should be.”

Donald MacDonald, Director of the Trustee Board of the BT Pension Scheme & Chairman at the Institutional Investors Group on Climate Change (IGCC)

The mandate

We propose that the mandate of the pension fund trustee board should set out its beliefs, aims, limits, and its investment policy in line with the trustees’ fiduciary duty. This should be formed with the beneficiaries’ best interests at its core.

Pension fund trustees can and should be required to demonstrate conscious intent and thoughtful consideration when forming investment strategies. The board’s mandate should be the highest expression of this intent. It also serves as a powerful tool that when in the hands of the pension fund trustee, can be used to change the investment system.

A competition for managing pension fund assets ‘*As if the Long-Term Really Did Matter*’ was launched in 2003 by USS (Universities Superannuation Scheme) and Hewitt Bacon & Woodrow. As it stands, mandates are typically subject to rolling three-year performance objectives and performance can be reviewed quarterly. This process can lead to mandates that are continually reviewed and leads to short-term behaviour and a narrow view of risk.³⁴

The ICGN Model Mandate Initiative offers some guidance on areas which trustees might wish to consider when drafting a mandate or negotiating contract terms with their fund managers. These include the standards that they wish their managers to adhere to that ensure their time horizons are aligned and reflected in risk management, integration of long-term factors, and stewardship responsibilities. The document also offers an example of model contract terms.

Starting with a SIP that provides a full explanation, trustees can then create better mandates for their investments ultimately leading to more long-term financial value. In the agenda for boards, we will lay out key considerations to be taken into account when formulating the mandate.³⁵

Section 172 of the Companies Act 2006 provides an example of what this new piece of regulation might look like, and provides a basis on which to build. We are proposing that pension fund trustees show that they have taken into consideration wider factors and all material considerations to ensure long-term financial returns, when creating their mandates – and if they have chosen not to, to explain their decision to not do so.

Ultimately, promoting transparency will mean that behaviours will begin to change and subsequently so will the system based around the implementation and practice of securing long-term financial value.

Some would argue that this intervention should happen at the national-level in the UK, but there is also a strong case being made for the creation of a new EU directive that would create a level playing field across Europe. We hope this report contributes to a debate on whether and how best this proposal might be implemented.

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- a) the likely consequences of any decision in the long-term*
- b) the interests of the company's employees*
- c) the need to foster the company's business relationships with suppliers, customers and others*
- d) the impact of the company's operations on the community and the environment.³⁶*

Section 172(1)
Companies Act 2006

Part 4: Developments in the pension fund system

The pension fund trustee and defined contribution schemes

This publication and agenda for boards focuses on developing arguments around improving the defined benefit (DB) scheme. Nevertheless, we do think it is of value to look separately at current developments in the growing use of defined contribution (DC) schemes.

The long-term investment principles in this publication, as well as in the agenda for boards can and should be utilised by those involved in running DC schemes. The ultimate goal is the same: safeguarding the interests of the beneficiaries by creating long-term financial value.

At the heart of a good pension scheme is good governance. DC schemes will prove challenging in this aspect. The transition from DB to DC will be difficult, but the pace of that change is accelerating so it is worthwhile considering some key issues that lie ahead.

Defined contribution schemes

DC schemes are becoming increasingly important and prevalent as providers of pensions. However, at several stages along the DC process, value is eroded. The role that trustees of DC schemes can and should play is critical in avoiding this diminishment of value.

Many of the issues of DC are addressed in the recent guidance published by The Pensions Regulator, 'Principles for Investment governance of work-based DC pension schemes'.³⁷ This report goes a long way in addressing some of the issues inherent to DC schemes. However, we feel that further exploration of some key principles is needed to protect pensioners in DC schemes.

Issues

Defined Benefit versus Defined Contribution schemes

There are key differences between DB and DC schemes, notably a difference in levels of governance and regulatory discipline.

In our view, there should be concern over the fact that DC can be governed solely by a contractual agreement rather than trust law. As such, the governance of DC is significantly weaker.

Ultimately, in a DB scheme the employer bears the risk, while in a DC scheme the employee is the risk-bearer. In our opinion, the growing proportion of DC schemes coupled with its inadequate governance structure should be a cause of concern to pension beneficiaries.

A new governance framework for DC

A DC scheme has several options available in terms of structure. The employer can connect to the pension fund either through trustees or directly via a contractual arrangement. The degree and form of interaction between these two options is very different. With a contractual arrangement, there is no one in place to look after the members of the scheme and to monitor the investments being made on their behalf. Furthermore, members tend to lack understanding and/or are apathetic about these investments and generally do not see it as their responsibility to monitor the investments themselves.

If the employer fails and a DB scheme is underfunded, members may be offered a degree of financial protection by the Pension Protection Fund (PPF). In contrast, DC schemes do not promise anything more than the obligation to pay contributions within their due dates.

Although more costly, it is beneficial to have trustees in place with clear responsibilities and an insightful mandate that considers all material factors relevant to long-term value creation. Trustees can monitor investments, regularly review investment managers and keep members informed.

Alternatively, a DC scheme could have an independent external body, such as an investment committee, that ensures the company's aims are clear and also takes care of the members' interests. This body would hold investment managers accountable and monitor adherence to the mandate. In addition, having these safeguards in place signifies that members under a trust-based DC scheme are protected by trust law's more stringent principles, rather than simply by contract law.

Hybrid pension plans

There are new developments in the structures of pension schemes away from DB and DC schemes such as hybrid schemes.³⁸ However, these schemes equally follow the same principles outlined in this report.

Engaged beneficiaries

The success of a good pension depends on clear and relevant communication to its pension members. However, it is difficult for trustees to find out what will be read and understood by beneficiaries without feedback. There is a need to further explore how to effectively engage beneficiaries. This is especially important because of automatic enrolment into contract-based schemes where beneficiaries are responsible for their own pensions.

Trustee selection process

The trustee of a pension fund has become even more important as more beneficiaries depend on their pension for security in an unstable economic environment. The skills required for a board of DC trustees is different to the skills required by a board of DB trustees. This is namely because DC schemes involve more processes and more choices. However *both* types of boards need a range of different skills available across the membership. Most importantly, a trustee should understand both the processes and the risks so that he or she has the ability to fully represent members.

Boards could:

- carry out a skills assessment evaluation of their board
- identify the skills they do possess
- identify the gaps in skills
- challenge the scheme sponsor to provide the board with trustees with those missing skills.

This also represents a great opportunity for a younger and more diverse group of people to step up and become trustees. Although, we do recognise that there is a need for balance – experience and proven performance as well as innovation is necessary for a group of trustees.

The criteria companies use for appointing pension fund trustees may be a somewhat neglected area of corporate governance though these criteria are essential for effective scheme governance.

Companies typically appoint trustees who are reaching the end of their careers and have few responsibilities. Perhaps by appointing younger more forward looking people, who are ambitious and on their way to becoming senior corporate officers, the system would be energised and reinvigorated improving communications and investment decision-making.

The challenge for pension fund trustees

Professor Mervyn E. King SC, Chairman, International Integrated Reporting Council

Today's pension fund trustee has the onerous task of ensuring that he or she makes an informed assessment that the business of a company will sustain value creation. This to ensure that there is no mismatch between the investment and the realisation thereof on the date when it is needed by the ultimate beneficiary which will be in the long-term, such as in thirty years' time.

In the changed and changing world in which we live, arising out of the financial crises, climate change crises, ecological overshoot, radical transparency, greater stakeholder expectations and population growth, to make that informed assessment to endeavour to ensure that there will not be a mismatch between the investment made and its long-term return, almost requires a certain prescience.

As none of us is prescient, in order to discharge their duty of care trustees have to adopt a fully developed responsible investment approach. And it is ever more important to develop integrated thinking and insight that will allow one to do that.

As **Tomorrow's Value: Achieving long-term financial returns** correctly points out, we need a new holistic view of value in order to move forward, and a wide view of the barriers and pressures the trustee faces when discharging his duties.

There needs to be a shift towards long-term decisions. In the recent Australian Centro judgment, the High Court found directors had failed in their duty of care in regard to approving financial statements describing certain loans as long-term rather than short-term. The phraseology adopted by the court is instructive: the court said the directors knew or ought to have known that the loans were short-term from their years on the board of the company. Alternatively they should have been aware or ought to have been aware that this was so.



I paraphrase that judgement as follows:

“As a director you know or you ought to know that the planet is in crisis and that humanity has a dependency on natural assets which is generally being ignored in the scramble for the acquisition of declining natural assets. You ought to be aware that this is so.”

When making investment choices, trustees need to be asking themselves several questions about the companies in question, such as, have they done an integrated report? If not, why not? Has the company done a sustainability report? If not, why not? Does the company have a supply chain code of conduct and is it being monitored? Factors, other than purely financial ones, have to be included in the trustee’s investment analysis.

In short, trustees have to be aware that short-term capitalism is yesterday’s game and they have to aim for sustainable capitalism with a matching investment and realisation in the changed world in which we live. In the Tomorrow’s Company ‘Triple Context’ referred to in **King III**, trustees have to ensure that they are making investments in the equity of a company on an informed basis about the impacts of the company’s business model and its product financially, socially, and environmentally. That is why responsible investment as proposed by the UNPRI and large pension funds such as Calpers will drive companies towards integrated reporting. Integrated reporting is a vital resource and practical way to develop and embed this integrated view of long-term value, which I commend to you: for further information, please refer to the online resources.

Tomorrow’s Value: Achieving long-term financial returns is an additional and important resource for pension fund trustees in this changed and changing world where the way in which investment decisions are made have to take into account an integrated and long-term view of value creation.



Professor Mervyn E. King SC,
Chairman, International Integrated Reporting Council

Acknowledgements

Many people have collaborated on the Tomorrow's Value guide, agenda, and other resources for pension fund trustees. This is to thank them and to say something about what inspired this process of co-creation over two years.

In terms of the how, what you are looking at now emerged from conversation, experience, research, a lot of hard work and many iterations of many drafts. However, the *why* and the *who* tells you a lot more about the richness and depth of this process, enabling challenging issues to be raised, acknowledged, and then worked through.

Tomorrow's Company "*works with business leaders and owners to shape the future of business success to create lasting value*". To achieve this in practice means we must recognise the vital role of the pension fund trustee or their equivalent. There is now much more appreciation of the complexity of financial markets. However, alongside this there seems to be a view that has developed that we need to work around the trustee rather than to support them in achieving their full potential. This is what inspired the guide, and what brought together key arguments and evidence to instill confidence in and provide frameworks for trustees to perform to the best of their abilities.

At the core of this group has been Mike Clark (Russell Investments), Howard Jacobs (formerly USS), Duncan Brown, Andrew Cooper, Brian Peters, and Richard Sykes (PwC), Christine Berry (then FairPensions), Jessica Fries (Accounting for Sustainability), Colin Mayer (Oxford), and Stephen Davis (now Harvard). We were also generously supported by Robert Eccles and George Serafeim (Harvard), Keith Ambachtsheer (University of Toronto), Ed Waitzer (Stikeman Elliott LLP), Andrew Dickson and George Emmerson (Standard Life), Daniel Malan (Stellenbosch University), William Mohn (Norwegian Ministry of Finance), Anant G. Nadkarni (Tata), and many others including Donald Fleming (Gazelle), Dan Summerfield (USS), and Will Pomroy (NAPF).

Duncan Brown and Paul Kitson (PwC) have been wonderfully supportive in inviting us to present and discuss the key conclusions of the guide with chairs of a great number of pension fund trustee boards.

We have also been inspired by our conversations with trustees striving to discharge their responsibilities, and by leading figures who understand the significance of what we are seeking to achieve in line with their own work. We want to thank Dominic Barton (McKinsey), Mervyn King (IIRC), Vince Linnane (PMI), Barry Parr and colleagues (AMNT), Fiona Reynolds (PRI), Charles Tilley and colleagues (CIMA), and Fiona Woolf CBE (Lord Mayor of the City of London).

From Tomorrow's Company, the hard and skilful work on the production of the guide and agenda was led by Luisa Bramao Ramos together with Sonia Singh. Luisa 'got it' from the start and enabled this outstanding group of experts to come together so that the whole is truly greater than the sum of the parts. Sonia's sharp intelligence made it possible to assimilate these complex arguments. Philip Sadler, our Senior Fellow, Pat Cleverly, and Mark Goyder, provided continuous support and guidance. Special thanks to Vanessa Cheng, Aneta Dyakova, Antonios Maropoulos, Alexander Cowie, and Jasmin Tutt in finalising the guide for launch and in producing the additional resources. And also to former volunteer Yelena Novikova.

Let me finish with a story which gives some sense of the commitment and excitement inspired by working on the guide. Many will be familiar with the work of the Law Commission following the Kay Review. Recently, they published their consultative paper *Fiduciary Duties of Investment Intermediaries* which quoted from a draft of this guide. It was a highpoint of the Tomorrow's Company office in 2013!

I want to end by thanking those for whom this guide has been written: pension fund trustees. They are the unsung heroes of capitalism. Oftentimes we talk about the critical role of the 'asset owner', but we seem to forget that the asset owner is us. We need to remember that pension fund trustees or their equivalent not only represent us, but must also fulfill their considerable responsibility in safeguarding our interests. Thus, we very much hope this guide will be of practical help whilst advancing the critical cause of pension fund governance.



Tony Manwaring
Chief executive, Tomorrow's Company

Sources and notes

- ¹ Towers Watson (2013) Global Pension Assets Study 2013, (Online), Available from: <http://www.towerswatson.com/en-GB/Insights/IC-Types/Survey-Research-Results/2013/01/Global-Pensions-Asset-Study-2013/> (Accessed 07 February 2014)
- ² ONS (2012) *Pensions in the National Accounts – A fuller picture of the UK’s funded and unfunded pension obligations 2012*, (Online), Available from: <http://www.ons.gov.uk/ons/rel/pensions/pensions-in-the-national-accounts/uk-national-accounts-supplementary-table-on-pensions--2010-/art-mainarticle.html> (Accessed 24 February 2014)
- ³ PPF (2013) *PPF 7800 Index 31 December 2012*, (Online), Available from: <http://www.pensionprotectionfund.org.uk/Pages/PPF7800Index.aspx> (Accessed 24 February 2014)
- ⁴ Towers Watson (2013) Global Pension Assets Study 2013, (Online), Available from: <http://www.towerswatson.com/en-GB/Insights/IC-Types/Survey-Research-Results/2013/01/Global-Pensions-Asset-Study-2013/> (Accessed 07 February 2014)
- ⁵ Gore, A. and Blood, D. (2001) A Manifesto for Sustainable Capitalism: How business can embrace environmental, social and governance metrics, *Harvard Business Review*, (Online), Available from: <http://online.wsj.com/news/articles/SB10001424052970203430404577092682864215896> (Accessed: 30 January 2014)
- ⁶ Barton, D. and Wiseman, M. (2014) Focusing Capital on the Long-Term, *Harvard Business Review*, January-February (Online), Available from: <http://hbr.org/2014/01/focusing-capital-on-the-long-term> (Accessed: 23 January 2014)
- ⁷ Roads to Ruin – A Study of Major Risk Events: Their Origins, Impacts and Implications, *Cass Business School*, (Online), Available from: http://www.reputability.co.uk/files/press/Roads_to_Ruin_The_Analysis.pdf (Accessed: 30 January 2014)
- ⁸ Eccles, R.G., Ioannou, I. and Serafeim, G. (2012) ‘The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance’, *Harvard Business School*
- ⁹ Deutsche Bank Group (2012) *Sustainable Investing: Establishing Long-Term Value and Performance*, (Online), Available from: https://www.dbadvisors.com/content/_media/Sustainable_Investing_2012.pdf (Accessed: 30 January 2014)
- ¹⁰ Kay, J. (2012) *The Kay Review of UK Equity Markets and Long-Term Decision Making*, (Online), Available from: <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report> (Accessed: 30 January 2014)
- ¹¹ PwC behavioural model

- ¹² Kay, J. (2012) Op. Cit.
- ¹³ Richardson, B. J. (2007) Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?, *Banking & Finance Law Review*, Vol. 22
- ¹⁴ UNEP-FI (2009) *Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues Into Institutional Investment*, (Online), Available from: <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf> (Accessed: 30 January 2014)
- ¹⁵ Hudson, A. (2000) The Law on Investment Entities, *Sweet and Maxwell*, pp. 85-86
- ¹⁶ Bristol and West Building Society v Mothew (1996) 4 All ER 698. Reiterated in the Australian case Federal Court in ASIC v Citigroup (2007)
- ¹⁷ Re Whiteley (1886) LR 33 Ch D 347
- ¹⁸ Trustee Investments Act 1961, (Online), Available from: <http://www.legislation.gov.uk/ukpga/Eliz2/9-10/62/contents> (Accessed 30 January 2014)
- ¹⁹ The Pensions Act 2004, (Online), Available from: <http://www.legislation.gov.uk/uksi/2005/1108/contents/made> (Accessed 30 January 2014)
- ²⁰ Wan, S. P. *Modern Portfolio Theory*, Ch. 5, (Online), Available from: <http://www.ifa.com/media/images/pdf%20files/mpptextbook.pdf> (Accessed 30 January 2014)
- ²¹ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, (Online), Available from: <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0041:EN:NOT> (Accessed 30 January 2014)
- ²² UNEP-FI (2005) *A Legal Framework for the Integration of Environmental, Social and Governance Issues Into Institutional Investment* (Online), Available from: http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf, pp.8-9 (Accessed 30 January 2014)
- ²³ Berry, C. (2011) *Protecting Our Best Interests, Rediscovering Fiduciary Obligation*, p. 24, (Online), Available from: http://www.shareaction.org/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf (Accessed 30 January 2014)
- ²⁴ Cowan v. Scargill, (1984) 2 All ER, 750
- ²⁵ Berry, C. (2011) Op.Cit.

- ²⁶ Bishop of Oxford v. England (church Commissioner) (1992) 1 W.L.R. 1241 (UK)
- ²⁷ Emerson, J. and Little, T. (2005) *The Prudent Trustee: The Evolution of the Long-Term Investor*, p. 4, (Online), Available from: <http://www.rosefdn.org/downloads/prudenttrustee.pdf> (Accessed 30 January 2014)
- ²⁸ Board of Trustees of Employment Retirement Scheme City of Baltimore v City of Baltimore 56 2 A. 2d 720, 317 Md. 72 (1989)
- ²⁹ Fiduciary Duties of Investment Intermediaries (2013), (Online), Available from: http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm (Accessed 30 January 2014)
- ³⁰ Richardson, B. J. (2007) Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?, *Banking and Finance Law Review*, Vol. 22 Issue 2
- ³¹ UNEP-FI (2009) *Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues Into Institutional Investment*, (Online), Available from: <http://www.unepfi.org/fileadmin/documents/fiduciaryll.pdf> (Accessed: 30 January 2014)
- ³² Freshfields Bruckhaus Deringer (2005) *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, (Online), Available from: http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (Accessed 07 February 2014)
- ³³ UNEP-FI (2009) Op.Cit.
- ³⁴ Hewitt Bacon & Woodrow Limited (2004) *Investing Pension Funds as if the Long-Term Really Did Matter*, pp. 1-23, (Online), Available from: http://www.uss.co.uk/Documents/uss_report.pdf (Accessed: 30 January 2014)
- ³⁵ International Corporate Governance Network (ICGN) (2012) *ICGN Model Mandate Initiative: Model Contract Terms Between Asset Owners and Their Fund Managers*
- ³⁶ Companies Act 2006, Section 172, (Online), Available from: <http://www.legislation.gov.uk/ukpga/2006/46/section/172> (Accessed: 30 January 2014)
- ³⁷ Principles for Investment Governance of Work-Based DC Pension Schemes, (Online), Available from: <http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx> (Accessed 30 January 2014)
- ³⁸ Ambachtsheer, K. (2011) *Wealth across Generations: Can Pension Funds Shape the Future of Capitalism?*, (Online), Available from: http://www.shareaction.org/sites/default/files/uploaded_files/press/KeithSpeech.pdf (Accessed 30 January 2014)

To achieve long-term financial returns

tomorrowcompany.com/tomorrows-value-pension-fund-guide

tomorrowcompany.com/tomorrows-value-pension-fund-agenda

tomorrowcompany.com/tomorrows-value-pension-fund-resource



The paper used in this publication is from mixed responsible sources and certified in accordance with FSC® (Forest Stewardship Council), reducing the impact of landfill and energy consumption

tomorrow's company

Centre for Tomorrow's Company
Charity registration number 1055908.
Registered office: Samuel House
6 St Alban's Street, London SW1Y 4SQ



£20 Institutions/Organisations
£5 Individuals/Members/Reduced
(including p&p)

© Centre for Tomorrow's Company, February 2014

Designed and produced by  studio401