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**“Best Practice pension
fund governance—the
role of leadership”**

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June 2008
Australia***



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Acknowledgements and Disclaimer

- **This presentation is based on research supported by a number of organisations and institutions including the Ford and Rockefeller foundations, the Lupina Foundation, and the ESRC. The author would like to thank those organisations for their support, and acknowledge the collaboration of Roger Urwin from Watson Wyatt and the advice and support from Keith Ambachtsheer, Ashby Monk and Tessa Hebb. None of the above should be held accountable for the views and opinions expressed herein.**



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Overview

- **“As numerous observers have noted, an obvious difficulty with describing organizational decision-making in terms of a theory of autonomous individual choice or rule following is that organizations are not individuals but rather collections of individuals interconnected in many ways. In particular, individual identities and preferences are often mutually inconsistent, producing conflict and confusion.”**

[James March 1997, p.25]



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1. Introduction

- There is widespread recognition of a governance ‘premium’ in investment management—arguably crucial to long-term pension fund performance
- In theory, governance capacity is correlated with institution size—a proxy for resources including time and expertise (Clark 2004)
- Although size is important, the governance premium is often idiosyncratic—particular to the institution
- Suggesting that best-practice governance is, in part, a matter of making the best out of what is inherited (given the difficulties of comprehensive reform)
- Here, I report recent research on governance with Oxford colleagues and Roger Urwin from Watson Wyatt.



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2. Background

- Research programmes are devoted to the design of an ‘ideal’ pension institutions and process of investment management
- Seeking to identify the principles of institutional structure with respect to the proper form and function of an institution (Merton and Bodie 2005)
- At one level, presuming that an optimal institutional structure can resolve the tensions identified by James March (1997) and others
- At another level, blaming the political process for apparent imperfections in inherited institutions (compare with Roe 2006).



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3. Trustee Decision-making

- At Oxford, research on pension fund investment decision-making was prompted by the UK Myners' Report
- In a programme under-written by the NAPF, we sought to evaluate pension fund trustee competence and consistency against Oxford students
- Using psychometric tests based upon widely recognised problems drawn from the decision-making literature (with a pending US patent)
- Formatted and calibrated to be relevant to crucial aspects of investment decision, including the value of time, the use of information, and Bayesian probability (à la Kahneman & Tversky 1979).



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4. Findings on Competence

- On average, neither the trustees nor undergraduates had well-defined discount functions; moreover, few respondents were knowledgeable of Bayesian probability (Clark et al. 2006)
- On average, neither group were effective users of information—undergraduates used too much and trustees used too little
- It was difficult to show that trustees were any better than undergraduates in terms of their competence notwithstanding their age and experience
- Suggesting that trustees' roles and responsibilities had not transformed commonsense into calibrated decision-making.



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5. Findings on Consistency

- We used a series of problems that required the consistent application of decision-techniques for solution (Clark et al.2007)
- There were a sub-set of trustees that out-performed the undergraduates—being highly educated with training in task-relevant fields such as accounting and actuarial science
- Being “experts”, they were able to recognise the underlying properties of notionally-different problems reinforcing the argument that expertise is more than commonsense
- Further, for many trustees knowing the substantive issues made a difference in coming to consistent solutions.



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6. Pension Fund Governance

- These findings help explain why pension fund boards often find it difficult to conceptualize time, probability, and make consistent decisions
- Findings also point to the potential costs of board diversity—where people come to boards on the basis of their status rather than their expertise (Clark 2007)
- Hence the importance of understanding the governance of pension funds and financial institutions in general
- Hence, our case-study research which has focused on best-practice in the public sector, the private sector, endowments, DB and DC etc.



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7. Principles of Best-Practice

- We found that it is vital to understand the nature and scope of expertise (or lack thereof) on boards, and allocate responsibilities accordingly (Clark and Urwin 2008a)
- It is important that decision-making processes utilize the available time, expertise and collective commitment in ways that match structural constraints
- This means that we must also take seriously the collective nature of the decision-making process—and its implications for best-practice governance
- We now turn to a set of findings on trustees' perceptions of their own boards and their styles of decision-making.



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8. Assessment Regime

- To do so, we have developed a diagnostic tool designed to elicit trustees' decision-styles
- This diagnostic tool is based, in part, on tests of common understanding and decision-styles that come from psychology (Baron 2008)
- Specific, again, to the trustee domain—recognising that generic tests can be inconclusive given their lack of relevance to the “environment” (Simon 1956)
- The results are illustrative of the possible dimensions of conflict and cooperation in collective decision-making based upon respondents from The Netherlands and the USA.



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9. Collective Decision-making

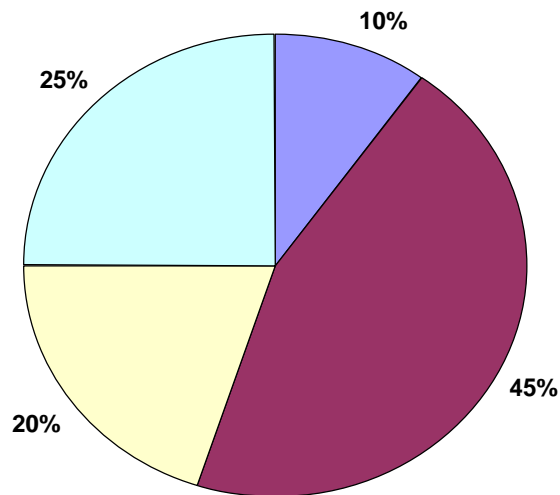
- Our intention in assessing styles of decision-making has been to better understand the scope of collegiality in boards given different styles of decision-making
- Recognising that collegiality is an important decision-resource, and that collective responsibility is important for all trustees in discharging their duties
- Like our findings on competence and consistency, there are significant, even profound, differences amongst trustees regarding their styles of decision-making (Clark and Urwin 2008b)
- Which may actually amplify disagreement amongst trustees about the proper courses of action.



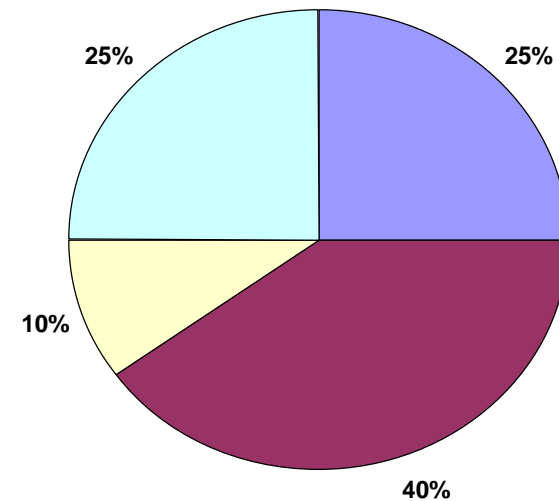
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10. Figure 1: Self-assessed competence of pension board

Do you consider that you and your fellow trustees have had sufficient training in investment decision-making?



Do you consider that the other members of your board have the relevant experience to make first-rate investment decisions?



■ Definitely ■ For the most part ■ Just about ■ Not really ■ Definitely ■ For the most part ■ Just about ■ Not really



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11. Summary of Figure 1

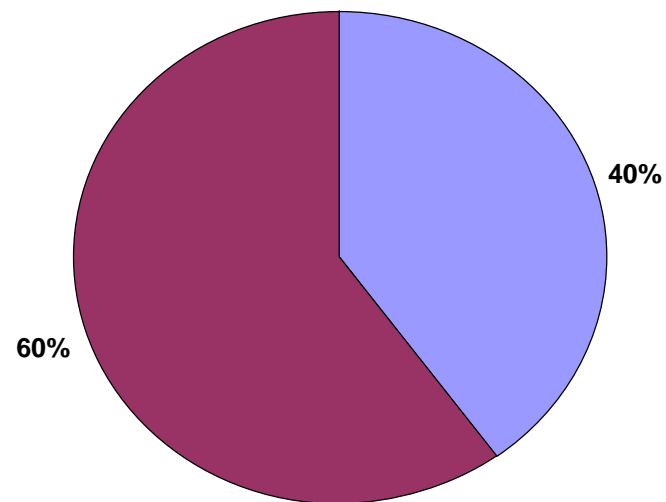
- On the issue of sufficient training, most trustees doubt the competence of their colleagues
- Collapsing “for the most part” with “just about” is not particularly encouraging just as the 25% “not really” is damning
- Likewise, on the issue of relevant experience, trustees have significant doubts about their colleagues understanding of the issues
- Further, these findings are NOT encouraging about their trust in others’ judgement.



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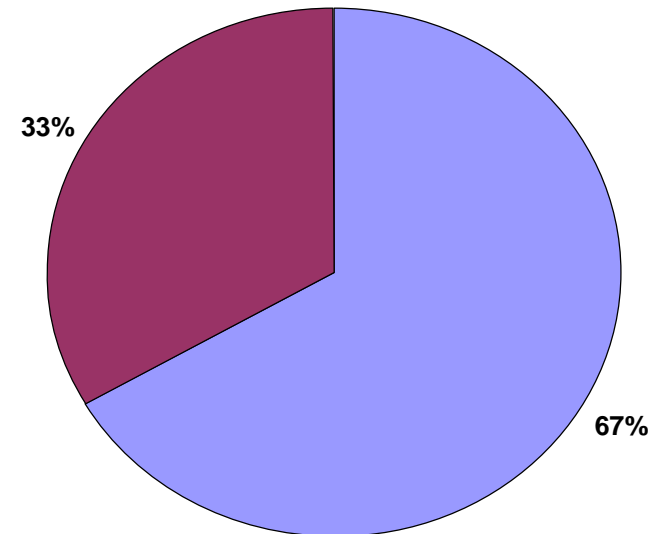
12. Figure 2: Self-assessed preferred mode of action and planning in decision making

How do you prefer to act and plan?



- I prefer to work in a planned way - I feel stressed by working under pressure and I want to make sure I am finished in good time
- I often prefer to leave finishing things until the last minute, I find I do much better, more creative work when there is pressure from a deadline

How do you prefer to act and plan?



- I am reliable and decisive
- I am spontaneous and flexible



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13. Summary of Figure 2

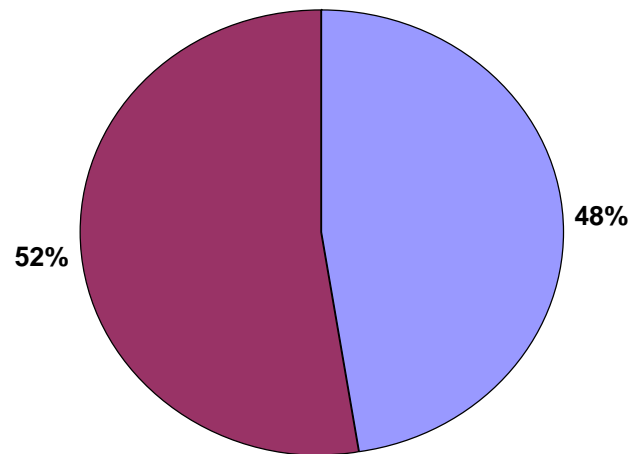
- Here, we sought to distinguish between trustees who have very different styles of acting and planning
- On the left-hand side, the largest group use deadlines to structure their planning—time is a stopping-rule NOT a resource
- On the right-hand side, though, a significant group of those same people saw no problem reconciling their response with being “reliable and decisive”
- Perhaps being “spontaneous and flexible” carries with it social approbation in the pension and investment community (suggesting “arbitrary”?).



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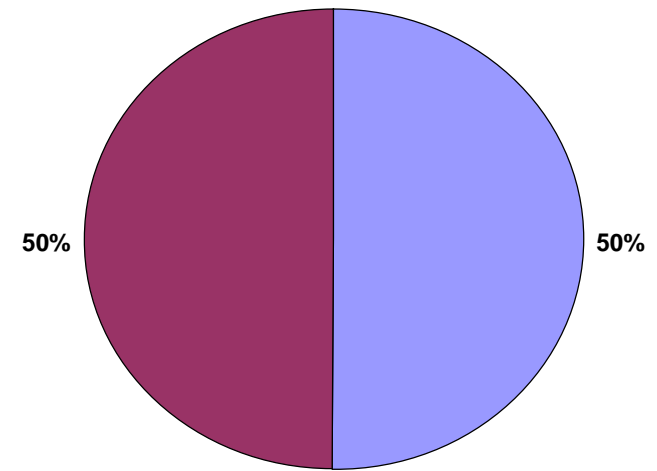
14. Figure 3: Self-assessed confidence in personal and collective decision-making

How do you prefer to focus your attention?



- If I have a problem I like to talk it through with people I trust, talking it through helps me to get things clear in my own mind
- If I have a problem I need to think it through for myself before I talk about it with others

How do you prefer to reach a decision?



- When I am evaluating the information someone has given me, I like to check for any flaws or gaps in their argument
- To really understand a situation I want to get a feel for the motivations and values of the people involved



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15. Summary of Figure 3

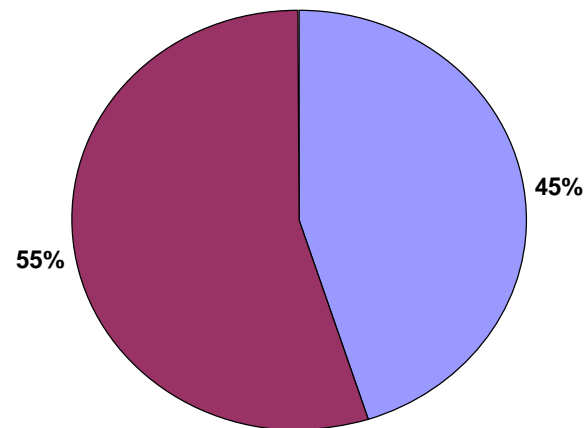
- Are trustees actually collegial or do they rely upon their own judgement?
- Here, it is apparent that trustees are split almost evenly between two “types”—talking with others may help some but confuse others
- Trust in others is important, for some; self-reliance is also important, for others
- Equally trust may be hard to come by if a significant number of trustees assess others’ motive and values rather than the logic of their arguments.



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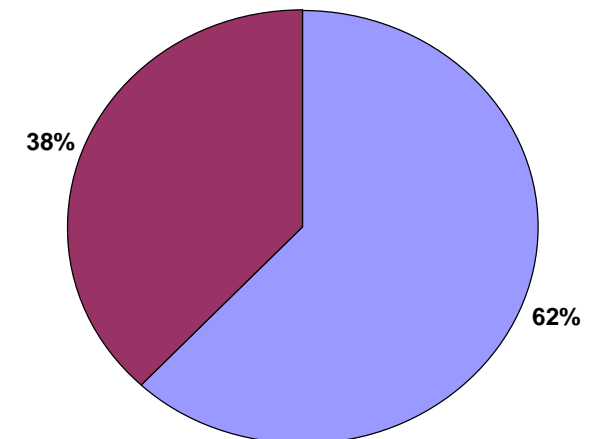
16. Figure 4: Self-assessed use of information in the decision-making process

How do you prefer to use information?



- I am most interested in understanding the overall picture, the connection and implications
- I am most interested in understanding the facts, the detail of what is actually happening

How do you prefer to use information?



- I want to understand the theories or models that illustrate the situation
- I want precise, factual information, that has practical application to the situation in hand



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17. Summary of Figure 4

- We noted previously that ‘experts’ tend to look for patterns, rather than begin with the data and attempt to classify cases
- In this Figure, though, it is apparent that when forced to choose between a (“facts”) or b trustees gravitate to the “big picture”
- In the other instance, however, they want data that has immediate applicability
- Either way, one interpretation is that there is a significant group of trustees that avoid the hard graft of understanding the current situation (what would Greenspan say?).



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18. Overview of Results

- From our research it is clear that many boards are quite variable in terms of skills and aptitudes and contain quite different styles of decision-making
- For some, trust in others is an important element in assessing the issues; for others, trust is less important than others' perceived motivations and values
- Moreover, there are clearly trustees who would use time to constrain decision-making whereas others would use time to inform decision-making
- Equally, there are trustees that are more comfortable with the 'big picture' than the hard graft of making sense of the data against underlying theories.



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19. Implications

- In this context, our latest work has been focused on the role of leadership in managing the decision-making process
- As you can see, though, leadership in these types of organisations can be very challenging
- At one level, the role of leadership is to mobilise the available decision-resources like time and expertise
- At another level, though, leadership must also focus on the collective commitment of trustees not withstanding very different styles of decision-making.



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20. Leadership Qualities

- **In the light of our findings we have drawn tentative conclusions about the desired qualities of institutional leadership**
 - **An apparent and systematic commitment to the institution**
 - **An ability to structure the decision-making process and, in particular, set priorities regarding the time devoted to decisions**
 - **An ability to articulate and mediate between the various decision-making styles evident on the board**
 - **An ability to bridge time horizons and integrate short-term imperatives with the logic of long-term investing.**



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21. Conclusions

- Our research has reinforced our belief that ideal “structural” solutions to the pension fund governance issue are often misplaced
- Theories of institutional form and function often imply a perfect world wherein form can reconcile competing claims
- In any event, there may be quite profound differences between trustees in their styles of decision-making
- The collective process of decision-making is an essential element if the potential value of institutional structure is to be realised.



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