Improving Pension Management and Delivery: An (Im)Modest and Likely (Un)Popular Proposal

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The single-minded aim of retirement savings policy is to maximize after-cost returns to members while providing products and services to meet individual needs. In that it fails. The dominant cause of failure is ineffective and unnecessary competition. The dominant solution is greater cooperation. This article demonstrates how excessive competition has undermined investors' ability to save for retirement through inefficient pricing, agency costs, and excessive choice. To ensure more cooperation, and less competition, the authors propose a three-pronged approach: structuring management arrangements to extract maximum economic growth and investment returns; taking steps to rid the system of over-servicing; and, structuring relationships to minimize agency costs. While the authors use Australia as their institutional setting, their (im)modest, and likely (un)popular proposal has universal (un)appeal and applicability.

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A Case of Massive Market Failure

A fundamental belief of neo-liberalism is that markets know best and self-correct. Thus competition and choice are necessary for optimality, and hence intrinsically good.[1] Markets are in fact neither necessary nor intrinsically good, especially in the market for financial services where the competitive drive to outperform dramatically shortens investment horizons and lowers longer-term returns to members. Competition in an open free market should also drive prices down toward the marginal cost of production, an effect almost totally absent in financial services where there is little in the way of price competition.[2]

The economics of information exposes a more disturbing market failure. Markets with large informational asymmetries, such as those for used cars, tend to be dysfunctional (Akerlof, 1970). Unable to determine the quality of a seller's goods, buyers widen the bid / offer spread that putative transactions fail to close. In spite of financial services having the greatest informational asymmetry, transactions do close easily and typically close near the offer price. At least buyers of concrete goods such as used cars can hedge the risk of failure by developing explicit and reliable tests of quality, by purchasing guarantees, and by relying on strong regulation. Buyers of financial *products* have very few such options. Even pre-supposing total transparency, distinguishing skill from luck is beyond us. The market should therefore fail badly. Sometimes it does, as when inter-bank lending totally seized up in 2008. That it does not seize up in retirement savings[3], superannuation, and investment management suggests that financial services are generally perceived as consumption or luxury goods, which in turn encourages herding that lowers members' longer-term returns.

Choice, too, comes with costs and unintended consequences. Choice is implicitly justified by the free market shibboleth; if choice is good, more choice is better. But the paradox of choice (Schwartz, 2005) flowing from economist and psychologist Herbert Simon's insight that "a wealth of information creates a poverty of attention" is a truism applying to toothpastes, mobile phone plans, superannuation funds, investment managers, and investment strategies alike. Against the supportive backdrop of the death of Soviet communism, the financial crisis has legitimized attacks on market fundamentalism and the related self-serving populist view that people can and will make optimal choices in an intrinsically uncertain complex world, especially under the relentless persuasion of anxiety-inducing

advertising (Mullainathan and Schleifer, 2005). The cure for these ills, a healthy dose of *paternalism*, is re-gaining acceptance – even in the United States, under the cute title *Nudge* (Thaler and Sunstein, 2009).

We estimate that inappropriate, ineffective competition and choice costs members around three percent per year over and above the costs of our proposal.[4] Eliminating these leaks could, over forty years, *double* retirement savings. Two broad policy initiatives could achieve this three percent saving and move us closer to generating "optimal"[5] outcomes for members[6]:

1. Broad and deep rationalization of the retirement savings industry and its multifarious agents.
2. Substantive cooperation between funds (Guyatt, 2008) without sacrificing the genuine benefits of competition (Brandenburger and Nalebuff, 1997).

Our aim is to support these initiatives through open and frank discussion about industry structure, including forthright assessments by all agents as to whether they do add value to members' retirement savings. Most do not.

A Troika of Leaks

Retirement saving systems built on the faulty foundations of competition and choice experience three types of leaks:

1. *Inefficient pricing (estimated incremental cost: one percent annually):* Retirement savings funds' competitive drive to outperform each other, largely but not exclusively through listed equities[7], is a heavy and unrecognized source of leakage. Competing on performance, especially short-term performance, forces managers to rely heavily on momentum and other non-information-based strategies. The resulting price-taking causes significant mispricing away from fundamental value which results in sub-optimal capital allocation.[8] This generates weaker economic growth,[9] which lowers long-term returns (Bird et al., 2008). A somewhat contrary view is hinted at by Keynes' notion that "animal spirits" are necessary for economic enterprise (Akerlof and Shiller, 2009). His likely argument, which appears to favor some mispricing if not bubbles, is that – especially at times of rapid technological change – markets cannot pick the precious few ultimate winners. Unprecedented uncertainty about the viability of companies whose putative earnings are driven by the new technology makes momentum the (rational?) strategy of choice. The resulting lure of a plentiful supply of capital and high share prices induces the formation of even more new companies. Although a mere handful will survive and thrive, the net effect will add to the productive enterprise. Bird et al. (2009) address this issue but still estimate the net effect of bubbles on economic growth is to lower long-term returns through delayed investment following implosion, and to a lesser extent through momentum-driven misallocation. The total leakage is estimated to be 100 basis points.
2. *Agency costs (estimated incremental cost: one percent annually):* The plethora of agents (trustees, fund staff, managers, consultants, custodians, lawyers, planners, regulators, ratings agencies, government, academics, placement agencies, journalists, etc.), far more than in other industries, create substantial indirect and direct costs.[10] This plethora is driven by the ready availability of money; massive and intrinsic uncertainty; and, growing complexity, sometimes intentional. The latter two scream out for someone to play a reassuring role; the former ensures generous pricing. *Some* agents are necessary because most people do not have the time, the expertise, the comparative advantages, or the inclination to manage their own superannuation and investments. Estimating the indirect costs of an excess of agents is especially difficult because (almost) all agents genuinely believe they are adding value net of their costs, just as each of us believes we are in the top quartile in intelligence and driving ability. This belief justifies agents resisting market forces aimed at reducing their number. We expect total unnecessary agency costs to be substantial. The most evident and the dominant direct agency cost is active (equity) management, a predictable consequence of competing on performance. Because active management is effectively a zero-sum game,[11] aggregate retirement savings are reduced by at least the cost of one percent per annum of playing the game.[12] For two reasons the solution is *not* the (very cheap) alternative of totally passive indexing. First, some level of fundamental active management ensures the efficient pricing needed to further grow the *investment pie* through improved capital allocation. Still, it beggars belief that, for instance, over eighty active Australian equity managers offering over one hundred fifty (broadly similar) strategies are needed to achieve efficient pricing in such a small market. Second, because indices are cap-weighted, new cashflows create momentum and hence further inefficient pricing. Nonetheless, we expect that the large bulk of global equity exposure should be passive, and that the large bulk of active managers are unnecessary. We also expect a quite small number of managers will suffice, perhaps ten percent of the current population, each with a modest exposure due to the diseconomies of scale suffered by active management.
3. *Excessive choice (estimated incremental cost: one percent annually):* Leaks from excessive choice have

two sources. First, there are three hundred eighty-one Australian institutional retirement savings funds with assets in excess of AU$50 million, almost all with substantial choice of investment strategies – some have over fifty strategies from which to choose. Yet almost all funds are essentially identical, and almost no fund or investment choices are exercised (Fear and Pace, 2009). Thus for no substantive benefit, members bear the direct and indirect costs, including management time and effort on marginal activities, of competition-induced excessive choice. We estimate leaks due to excessive choice at around 50 basis points (Chant West, 2008). The excessive number of funds induces a second cost because their small average size is well below that needed to effectively capture economies of size and scope including lower fees, greater investment opportunities, and lower implementation costs. We estimate leaks due to an excess of funds at around 50 basis points (Ambachtsheer, 2009b; Deloitte, 2009).[13]

Can these leaks be plugged? That is the question we address next.

Plugging the Leaks

These leaks can be plugged through the broad policy initiatives outlined earlier: substantially rationalize superfunds and investment choices, and drive meaningful cooperation. A Stalinist rationalization with a single monolithic national fund and no investment choice, as proposed thirty-five years ago, is also sub-optimal because it would be too big to fail; be exposed to substantial concentration risk; suffer from sizeable diseconomies of scale; and, miss the genuine benefits of competition such as efficiency and innovation. For example, there is a telling difference between the Australian banking industry and its retirement savings industry. The bi-laterally supported banking policy which sees four large banks, augmented by a small and limited number of regional banks, seems to work reasonably well for a country of its size. It provides many of the benefits of competition, albeit imperfectly, without suffering the costs of excessive competition. Critically, that structure and stronger regulation mitigated the effects of the financial crisis. As another example, through a carrot and stick policy, the Australian government forced a rationalization of an excessively competitive, highly costly and inefficient car industry some twenty-five years ago.

Thanks to the global financial crisis, government is again seen as having a legitimate and positive role to play, which makes now a uniquely propitious time to restructure the retirement savings industry for the benefit of members. Based on cost / benefit trade-offs we expect that around ten percent of existing funds will suffice. *Some* choice is needed because there are a small number of meaningfully different needs and expectations. Modest choice should also increase efficiency and innovation.

All this leads to our (im)modest, likely (un)popular Three-Point Proposal[14]. It seeks to reorient funds towards greater cooperation through joint research and ownership of managers while retaining the genuine benefits of productive competition:

1. *Retirement savings funds will be* ***strongly encouraged*** *to rationalize*, through tax and other incentives.[15] Market fundamentalists believe rationalization will occur through competition, and indeed funds have been merging or disappearing. But that trend is slowing and will not go far enough. For example, two sub-scale AU$1 billion funds merging to form a single self-satisfied, but still sub-scale AU$2 billion fund is not the solution.
2. *The handful of remaining funds will cooperate* through funding a research centre charged with creating and managing an ongoing research program (outlined below), and improving and adapting structures and strategies as economies, markets, and societies change; appointing, allocating to, and monitoring the optimal number and configuration of active managers; and, jointly owning all managers, at arm's length, to share profits and to establish meaningful alignment. Examples include the Australian Industry Funds Management and AlpInvest (private equity firm jointly owned by the Dutch funds APG All Pensions Group and PGGM).
3. *Funds and their managers will compete*[16], but only in productive ways that lead to greater returns for members. The benefits of effective competition include innovation, lower costs, and greater efficiency.

A series of carefully structured research activities is central to the successful implementation of our proposals.

Necessary Ongoing Research Programs

Two high priority challenges for the research centre[17] will be designing structures and cultures that ensure productive competition (i.e., competition with no negative welfare costs), and stability. Regarding competition, key questions include: How will funds deal with new asset classes and new opportunities, especially those with limited capacity? Should funds compete on performance generated by different asset allocations, or does the zero-sum argument apply there too? Regarding stability, funds need disincentives to defect from cooperating. Defection would quickly lead back to the current sub-optimal state. In principle, managers should have no incentive to defect because pricing will be sufficiently close to optimal that out-performance generated by momentum will be unsustainable beyond very short time horizons. However, retail managers outside the

cooperative structure will cause some pricing inefficiency. Whether this will be sufficient to undermine the benefits of rationalization and cooperation is a further question for the research centre.

Immediate research activity will focus on programs that focus on agents, managers, funds, and competition. The *agents* program should assess the value added or subtracted by each agent in the ever-lengthening chain between members and their money. The *managers* program should, at each stage of the market cycle, estimate the optimal number of active managers of each type / style[18] needed for optimal price-discovery, liquidity, and capital allocation, and the optimal allocation to each. The *funds* program should estimate the optimal number, size, and configuration of institutional retirement savings funds. The *competition* program should determine the basis for and instances of productive competition between retirement savings funds.

Further Benefits

We are under no illusions as to our proposal's likely success. A century ago Upton Sinclair captured the nub of the principal / agency challenge: "It is difficult to get a man to understand something when his salary depends on his not understanding it." The context then was the dangerously unhealthy state of the American meat-packing industry. His famous muck-raking novel, *The Jungle* (1905), resonated with a reforming government which imposed tight regulation on the industry for the benefit of all. We are at a parallel state regarding the financial services industry. Its produce is necessary but far from healthy, while the financial crisis has spawned an environment conducive to change. The could-have-been slogan from 1905, "healthy meat-packing processes for the benefit of carnivores," readily transposes to a 2009 cry of "healthy investment and advice processes for the benefit of retirees."[19]

Two welcome side benefits of our proposal could increase economic growth further. First, fewer agents and less destructive competition will force a sharper focus on members' longer-term interests. The curse of short-termism will be ameliorated; its damage to the economy and to members' retirement savings lessened. Second, with fewer opportunities, more appropriate compensation, and far less glamour, fewer people will be attracted to finance and investments and might just direct their talents to more productive sectors of the economy, to add real value by increasing economic growth. A smattering of evidence hints at this occurring already. As British Business Secretary Peter Mandelson put it in May 2009, "We need less financial engineering and more real engineering."

Endnotes

1. The most egregious and destructive example of a religious belief in the virtues of competition is the American "optional federal charter" under which insurance companies (AIG, for instance) are relatively free to *choose* their regulators. An Australian instance was triggered by the Financial Planning Association (FPA) statement against trailing commissions. FPA rival National Association of Personal Financial Advisers made the laughable, self-serving declaration that trailing commissions are necessary for consumers to be able to exercise their "fundamental right to choose."

2. Over the past twenty years prices have come down but show no signs of being asymptotic to the marginal cost of production. For an Australian equities manager to take on a new AU$100 million standard mandate, the cost is a handful of basis points – far below the management rack-rate. Because compensation accounts for the large bulk of manager's costs, a major barrier to fee reduction is the well-known "stickiness of compensation."

3. In Australia the unfortunate Dickensian name "superannuation" is used for compulsory, defined contribution-based retirement savings policy. See Fear and Pace (2009) for further details.

4. Poor governance is a further source of leakage of around 50 basis points (Ambachtsheer and Ezra, 1998).

5. Throughout, read "satisficed," in Simon's sense, for "optimal." Were there a less ugly word we would gladly use it.

6. Some of these ideas are influenced by and overlap with Ambachtsheer (2009a) and Bauer (2009).

7. Listed equities account for around seventy percent of typical allocations. Similar arguments apply to most other asset classes.

8. For instance, companies investing in longer-term research and development / innovation will find it harder or more expensive to attract needed risk capital.

9. Sometimes retirement savings policy has increased economic growth as one of its aims. There are two problems with this. One technical problem involves causality: does saving lead to growth or does growth encourage and lead to saving? A deeper problem is that growth is limited by the planet's finite resources.

10. In his inimitable folksy style Warren Buffett (2005) spins an allegory of the *Gotrocks* family which, due to an *extraction* of agents (our collective noun) is forced to change its name to *Hadrocks*.

11. This key assertion assumes that almost all stock is under the control of equity managers. Both assertion and assumption need to be explored under the *manager* program at the research centre. Managers create a *tragedy of the commons* by competing for scarce outperformance. In principle the game *should* be positive-sum as active managers *should* better allocate capital which *should* increase the pie. In practice the *ideal-actual* spread is probably substantial.

12. Members of one fund *will* be better off if their fund outperforms, but at the expense of members of other funds that underperform. The one percent leakage does not account for the increased savings accruing to fund managers and other agents. French (2008) contains detailed estimates of the costs of active management, at least in the retail world.

Endnotes (cont'd)

13. Lower insurance premiums are a further and significant benefit of scale. Beyond ~ $300b investment *dis*economies probably dominate.

14. The parentheses underscore our belief that the Proposal will be seen as Immodest and Unpopular by almost all agents, but would be seen as Modest and Popular by all principals… if only they knew.

15. The number of funds over $50m declined by thirteen percent in the year ending December 2008, while the number of all four hundred seventy-four institutional funds declined by eighteen percent. Recent tax changes make mergers easier by allowing capital losses from one fund to be offset against capital gains in the other.

16. For instance, funds will be encouraged to apply the Research Centre's insights in different ways. On the other hand managers will be penalized for herding.

17. Both will likely rely on insights from Game Theory.

18. This includes level of specialization, e.g., small cap.

19. For yet a further reason the timing is right. Baby boomers entering a *decumulation* phase will alter their needs, objectives, asset allocations, and demand for products such as annuities, which in turn will require changes in fund structures and processes.

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