THE TRANSPARENCY TASK FORCE

6th October 2016

Response to The Pension Regulator's 21st century trusteeship and governance discussion paper from some members of the Transparency Task Force

1. The purpose and status of this document

This document has been put together by members of the Transparency Task Force (TTF) to provide input to TPR's 21st century trusteeship and governance discussion paper, published 22nd July 2016.

Whilst several members of our Stewardship and Decision-Making Team have been involved in producing this document it should not be assumed that the views given reflect those of all members of the TTF as not all members of the TTF have been involved in producing it and some have contrarian views. We hope nonetheless that the content will be of some value and at worst may form the basis for further dialogue with you.

Of course, many of our members and the organisations they represent may feed in their thoughts to you independently of the TTF.

2. About the Transparency Task Force

The Transparency Task Force is the campaigning community, dedicated to driving up the levels of transparency in financial services, right around the world.

We believe that higher levels of transparency are a pre-requisite for fairer, safer and more efficient markets that deliver better value for money and better outcomes to the consumer.

Furthermore, because of the correlation between transparency and trustworthiness, we expect our work will help to repair the self-inflicted reputational damage the sector has suffered for decades. We seek to effect the change that the financial services sector needs and the consumer deserves.

The TTF is free to consider what is ultimately best for the consumer without commercial conflicts and we are perhaps unique in being made up of a truly pan-industry cross-section of members, trade bodies and professional associations. As such we are well-placed to

establish consensus that does not merely reflect the wishes of one particular “tribe” or another.

Our approach is collaborative - we seek a win/win/win; whereby consumers, market participants and the efficacy of government policy can all benefit from the work we do.

Market reaction has been extremely positive and supportive; so much so that in under 18 months we have developed three teams of volunteers, each team focused on a set of transparency-related issues and desired outcomes:

- The Costs & Charges Team
- The Stewardship and Decision-Making Team
- The International Best Practice Team

The topic of ‘the 21st Century Trustee’ is of great interest and relevance to our Stewardship and Decision-Making Team, who have commenced work on a ‘TTF 21st Century guide to good governance’ with an aim to achieve TPR’s stated objectives, hence this submission.

The TTF believes there is extensive scope for raising standards amongst trustees and that unless standards are raised pension schemes will continue to operate at a sub-optimal level, to the detriment of their members. However in order to achieve lasting improvement we need to deal with the root cause of the problem which is the lack of incentive, transparency and accountability of those who take decisions with other people’s money.

3. About the focus of our response

As the Transparency Task Force is the campaigning community dedicated to driving up the levels of transparency in financial services, right around the world, we have provided minimal response to the questions posed by TPR that fall outside our transparency-related areas of interest, knowing that other organisations will provide detailed responses.

However, as you will read, we focus mainly on the behavioural biases which works against effective trusteeship and which we believe needs to be addressed in order to improve outcomes for the intended beneficiaries and those who contribute to pensions going forward.

Background:

Despite increased regulation and burden on trustees to improve investment governance over the past ten years there is little evidence that this has had a positive impact on the protection of member benefits overall. Average deficits in defined benefit schemes have most probably increased over and above what can be explained by the artificial lowering of long term interest rates by central banks following the global financial crisis[1]. Members of default DC plans have experienced a shift from low cost passive to more expensive active management which is certain to increase fees paid to external managers and lowering the pension they

[1] Pedersen H and Rothwell R “The Hidden Cost of Poor Advice: – Part 1” found underperformance from the pursuit of ‘fool’s gold’ (i.e. excess return over and above what is available from the market via active manager selection and asset allocation) to be 1% per annum over 10 years corresponding to an increased deficit of 10% over and above a ‘do nothing’ approach to investment. These activities are widespread across the UK. Without this loss deficits would have been lower.

will receive. They are frequently opted-in and not made aware of the future expected impact on them[2]. Nor do they have any redress on the decision-maker or provider for the loss of pension they will ultimately receive from their savings.

Even large and well-resourced pension funds such as Railpen[3] have publicly acknowledged that they have accepted unfavourable and asymmetric contract terms impacting members directly or indirectly amounting to millions of pounds per annum via investment in private equity and other alternative investments that they did not understand or failed to properly analyse cost implications for prior to investing (In Railpen's case actual annual costs were £290m versus expected cost of around £75m). Unsurprisingly these investments did not deliver the additional investment returns or diversification anticipated net of fees[4]. Still, every day you read with great fanfare in the media about another pension fund about to repeat the same mistakes either on its own, or on behalf of its members[5].

We believe the time has come to do something about this to the benefit of all.

We have identified the following key issues with the current regulatory approach:

1. To achieve 'good governance' one must define what good governance means, not just provide a list of boxes to tick, but by providing specific measurable performance metrics that can be reported to members. Two different funds can follow the same check-list but the output can be very different. It is the outcome that matters and which needs identifying. Behavioural biases will slowly but surely gravitate even the best intentioned trustee towards sub-optimal decisions if there is no framework in place to offset these. A lack of transparency around the impact of investment decision-making (i.e. activities) means there is a lack of transparency on whether member's interests are really represented by the actions of the fiduciaries.

2. The requirement to take advice has had significant unintended consequence and cost to UK pensions. An increasing body of academic research points to a cost of around 0.8% per annum or 10% over ten years from manager selection and unnecessary asset churn[6]. The requirement has led to a significant increase in the amount of investment activities and processes that are motived by a need for advisors to make money but have negative expected return for the asset owner, just like there is average expected negative return from going to a casino. You would expect a similar negative outcome if every individual was mandated to take guidance from a drug dealer as to whether they should be taking drugs or not. The requirement to take advice has also helped reduce accountability and increased complexity as

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[2] In a typical default DC plan a low cost passive equity index, with a gradual de-risking into inflation-linked gilts during the last 4-7 years before retirement is partially replaced with expensive active investments (such as diversified growth funds) which are being activated 25-30 years prior to retirement charging 0.75% per annum, yet the identical portfolio components (equity, bonds, cash) could be achieved with passive funds charging 0.10% p.a. ~ 10% difference in pension!

[3] See for example a recent Railpen presentation: Understanding Costs - What is it we don't see?, Paul Trickett, April 2016, or the $191bn California-based pension fund Calstrs "Calstrs: US private equity woes deepen" *Financial Times* 19 July, 2005 or "Hedge Funds Lose Calpers, and More" *New York Times* 26 September 2014

[4] See for example Pedersen H and Rothwell R "Mis-selling of alternatives by investment consultants?" September 2014

[5] See for example "Pension funds boost alternative by 5%...." *IPE*, July 2016, or "How can schemes diversify into alternatives within the charge cap" *Professional Pensions* April 2015

[6] See for example Jenkinson T, Jones H and Martinez JV: "Picking Winners? Investment Consultants' Recommendations of Fund Managers" – June 2014 or Pedersen H and Rothwell R: "The Price of short-term advice: Performance attribution of investment advisors using LGPS data" November 2014

'responsibility' is passed onto no one. It is often unclear who is actually taking the decisions and there is no measurement of the impact of poor advice on performance despite Myners[7].

3. The lack of transparency and accountability with regards to the value-add of activities or costs incurred means there is no incentive to improve or even require transparency from service providers. On average across all pension investments there cannot be any outsize returns over and above that which is provided by the market for a given level of risk and the average expected return of investment activities must therefore be negative and equal to the total amount of fees paid. The famous Warren Buffet bet that passive will outperform alternatives over 10 years is a good case in point that the impact of fees and activities over time is more likely to have a negative outcome for the asset owner, only leaving the manager better off.

4. Knowledge is generally confused with skill. However knowledge refers to learning concepts, principles and information regarding a particular subject, whereas skill refers to the ability to do something well. **Skill is observable and measurable**. It is straightforward and simple to measure it. There is not necessarily a link between obtaining knowledge and having skill. This is particularly true when future outcomes cannot be predicted (i.e. future investment returns and diversification). *"The question is not whether the experts are well trained. It is whether their world is predictable",* Daniel Kahneman[8].

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Impact analysis:

In the diagrams below we illustrate the unintended negative impact on pension investment outcomes from the regulatory requirement to take advice and for trustees to review their investment strategy every three years.

For context it is important to understand the rational behavioural motives of all agents, or stakeholders, in the value chain. Everyone in the chain will act rationally to serve their own self-interest (i.e. maximise their own income or other non-monetary benefits such as status). Regulation can become more effective if these behavioural biases are understood. By using game theory we can better understand how trustees are most likely to respond to a given requirement and how the industry will use the requirement to optimise its own revenue. The Prisoner's dilemma[9] is a standard example of a game where two rational individuals acting in their own interest will almost always end up with a suboptimal outcome.

The first diagram outlines the systemic bias in investment decision-making towards 'activity' because brokers earn higher fees if investment activity is high, investment managers earn higher fees if they provide active management and investment consultants earn more money if they constantly propose change and complexity which also helps justify their existence and fees. If a consultant recommended a stable passive strategy to his clients he would not earn fees for his employer. On the other hand the primary objective of trustees is to reduce, or

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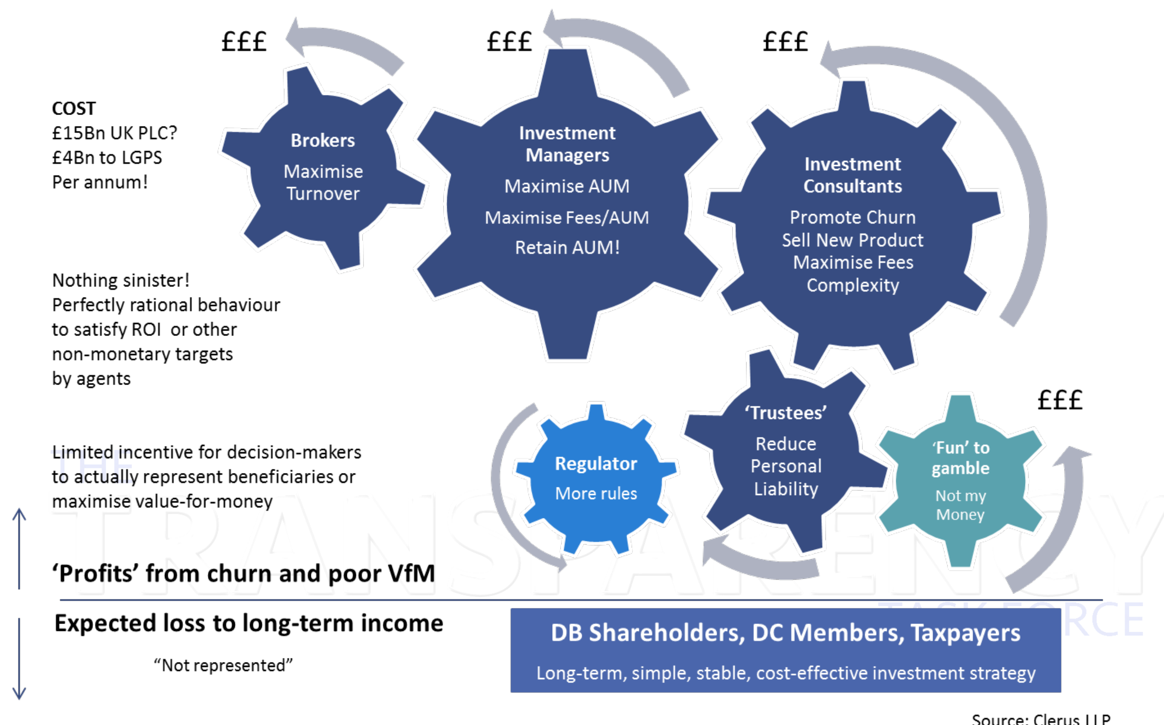
[7] HM Treasury: Myners principles for institutional investment decision-making: review of progress – December 2004 and Institutional Investment in the UK Six Years On – January 2007

[8] Daniel Kahneman "Thinking fast and slow, on the illusion of investment skill", 2011, pp.212-221

[9] See for example Wikipedia – Prisoner's dilemma

minimise personal liability. At the same time, feeling the need ‘to do something’ is consistent with normal cultural and behavioural biases that favour activity[10]. As a trustee you may even win an industry award if you are the first one to invest into a new high fee product that investment managers want to sell. Finally for many it is ‘fun’ to select managers in particular as they do not have to deal with the consequences when the money is lost as long as they took advice. The key distinction here is that if trustees invest their own money all these behavioural biases are fine, but when investing other people’s money then it is not.



As we can see the reason that past regulation have not worked as intended is because it has not altered the incentive for decision-makers to stand-up for the intended beneficiaries or in some cases the sponsor as they are not represented in this process.

In “the Slow Pace of Fast Change” by Bhaskar Chakravorti from Harward Business school, game theory is also used to help identify why existing market equilibriums are so hard to shift, even if the overall benefits are well established. In Pensions the current equilibrium is unsustainable for society in the long run as future wealth is reduced.

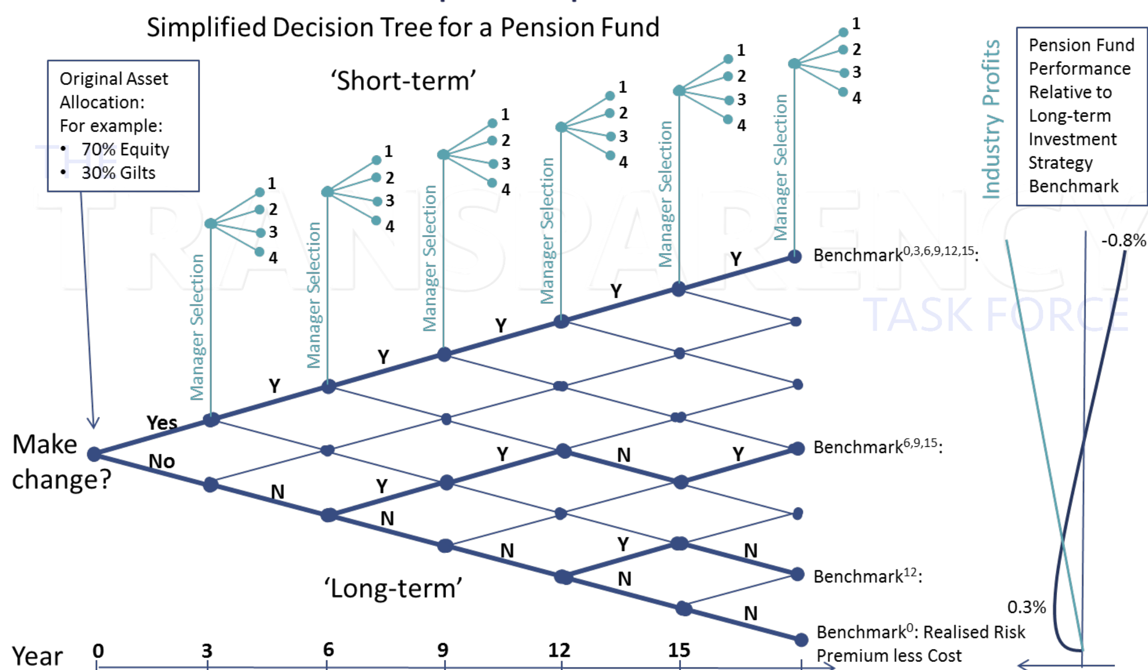
We need to examine the impact of the requirement to review investment strategy every three years and compare it with the empirical research referenced earlier. While we understand there is a desire to keep trustees aware of the suitability of investment strategy, in reality it is being used by agents to optimise income and therefore reduce outcomes. A better

[10] A good summary of the behavioural biases that favours activity in investment decision-making is provided in: Bird R, Gray J and Scotti M: “Why Do Investors Favour Active Management …To the Extent They Do?” – Rothman Journal of Pension Management, Volume 6 – Issue 2 – Fall 2013.

requirement might be to consider change only following a market dislocation, or extreme valuation of certain asset classes (t.ex. if equities have fallen 30%, or interest rate close to zero) and then to increase allocation to the undervalued asset and vice versa.

In any case an investment decision-making tree for a typical DB pension fund is illustrated below. At the outset a suitable asset allocation was decided corresponding to the risk appetite, actuarial calculations and covenant of the fund. It is understood that in the long run equities will most likely outperform gilts (historically with 3% per annum on average) but that there will be considerable swings in the funding level as a consequence. However as a long-term proposition – which ignores short-term market swings – this is approved by all.

After 3 years the trustees have to review their investment strategy and in most cases will pay an investment consultant to do a review. We can ask the first question in our game; is the investment consultant most likely to come back and say that investment strategy should remain unchanged, or is he, or she, most likely to propose some change? (**Answer**: it is rational for him/her to propose change, because additional fees can be earned by doing so).



Trustees now have the option to accept or reject this change. If they reject the proposal they now have personal risk because they did not follow advice, even if they do not think making the change is necessarily the right thing to do. Their legal team might lean on them if they continue to reject advice even if they can argue why. While the Pensions Regulator states that the purpose of the trustee knowledge and understanding requirements is to enable decision-makers to understand, discuss and **challenge** the advice that 'experts' give them[11]. In reality most trustees will tick the box on this requirement by asking one question and then accept the investment consultant's proposal no matter the answer provided because this reduce personal risk, or might satisfy some other criteria to be seen to do something.

[11] http://www.thepensionsregulator.gov.uk/guidance/guidance-trustee-knowledge-and-understanding.aspx

Having accepted the proposal they now pay the investment consultant to prepare a short-list for a manager selection exercise. We have already provided evidence of the expected impact on performance from this, but needless to say this is time-consuming and there will be additional cost to the fund from transition between old and new manager.

After another three years the scenario repeats. Of course, now the new investment made at the last review might have gone wrong and so the trustees might pay the investment consultant more money to explain what went wrong, so they can limit their own liability. There might now be increased desire to make the money back by taking another punt, but in general changes will be proposed and approved. As the chart illustrates we have now ended up with a short-term investment strategy despite the desire to have a long-term strategy from the outset. The highest chance of success was to make one, or two main decisions, yet the regulatory frame-work encourages us to take many. There is general consensus that a long-term approach is better than a short-term, yet the current decision-making equilibrium favours a short-term approach which maximise industry profits and minimise expected outcomes.

These conclusions are aligned with most academic research, summarised eloquently in a recent Ambachtsheer Letter[12]. It cites similar conclusions with regards to prioritising box-ticking over value creation, and identifies governance challenges in three main areas: agency/context issues, board effectiveness issues and investment/risk management issues. Amongst a number of recommendations it is suggested that reporting on (investment) board effectiveness (not self-assessment) is made a regulatory requirement.

The 21st Century Guide to Good Governance:

We believe that for TPR to achieve its objectives it should focus on promoting clarity and transparency as better regulatory principles and it will meet its objectives much more effectively. By making trustees more accountable, those who do not have the skill to serve members appropriately, notwithstanding their background, will be found out and higher standards will automatically develop because a powerful incentive of transparency has finally been put in place. Myners already recommended this in 2003 via Principle 4 on performance measurement;

"To arrange for the formal measurement of performance of the investment advisors, and to periodically make a formal assessment of their own effectiveness as a decision-making body and report on this to scheme members"

But it was never implemented, or has been rendered ineffective by self-assessment which will typically not be based on actual outcomes produced.

We think that the 21st century trustee should be someone who is willing to be accountable, open to scrutiny and who will willingly let a 3rd party report on the impact of his/her decisions on member benefits. We think this is a common sense principle if you want to be the guardian of other people's money in today's world. If trustees do not want to be transparent they should not be a 21st century trustee at all.

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[12] Keith Ambachtsheer. "Fixing the Pension Governance Deficit: Taking the Next Step" – July 2014.

We are delighted to introduce with our response the early concept of the *21st century guide to good governance* which we believe should go hand in hand with the 21st century trustee. In it, we aim to provide a simple framework which:

- Enables the measuring and reporting on trustee activities
- Aligns the regulatory burden with the nature of activities carried out by the trustees
- Incentivises trustees to focus on value-added activities

The overall purpose of the 'good governance' framework is:

1. To protect members, tax payers and shareholders from the behavioural biases of the decision-makers that are meant to represent their interests
2. To help decision-makers by providing a framework around which they can transparently manage and report on the outcome of their activities as well as assessing the input of their advisors
3. To help decision-makers better understand and manage the explicit and implicit cost of influencers in the value chain
4. To incentivise decision-makers to act transparently and to ensure that investment outcomes and value for money is optimised. We envisage that all 21st century decision-makers will sign up to a 'contractual' and common sense code of conduct to make them accountable to members before carrying out their fiduciary duties

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Maximising TPR's Return on Investment

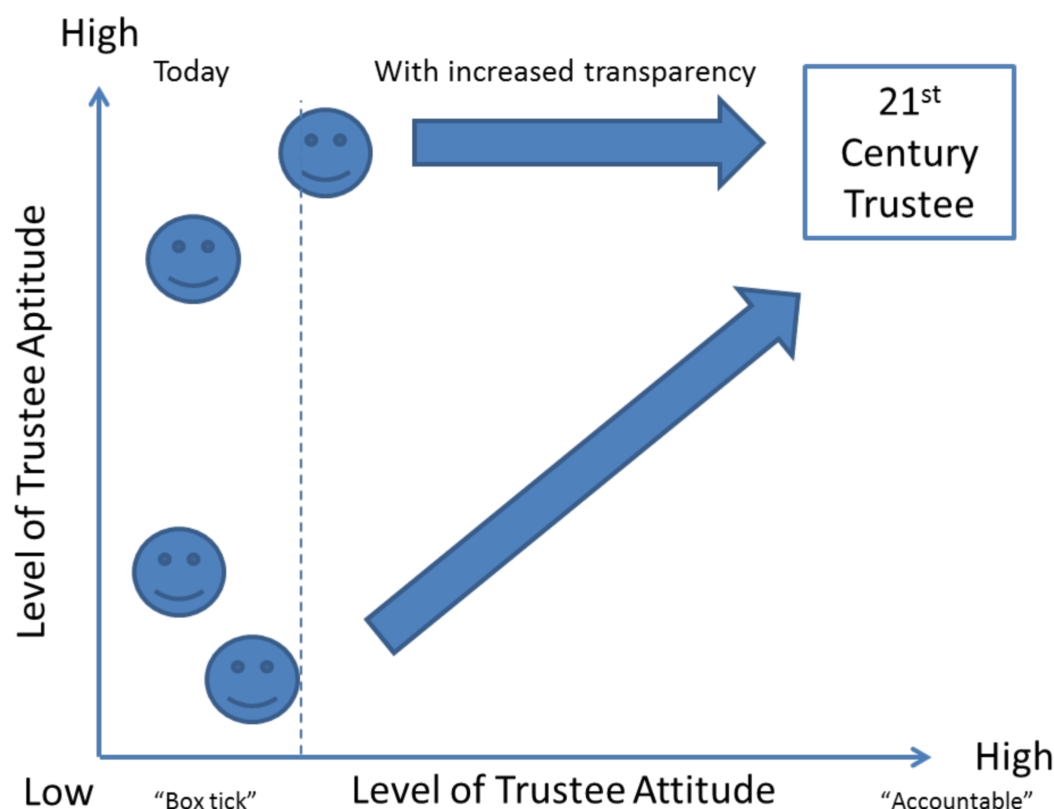
TPR has invested heavily and successfully in driving up the levels of competence amongst trustees through development of the trustee toolkit and so on. However, the extent to which trustees have truly acquired the knowledge and applied it 'in the real world' is questionable and we suspect that many have 'gone through the motions' as far as improving competence is concerned.

We believe that moving forward TPR will achieve a bigger 'bang for buck' on the investment in TKU already made by now focusing on the application of the knowledge that has supposedly already been acquired; and an excellent way to do that is through increasing transparency/accountability/scrutiny.

In simplistic terms we can think of a chart with the vertical axis being aptitude (knowledge/ability) and a horizontal axis being attitude (motivation to perform the task with the sole interest of members' interest at hand).The ideal 21st century trustee would be in the top-right corner of that chart i.e. high aptitude and high attitude.

In general terms we believe that most trustees are either in the top left corner of the chart at the moment (high aptitude/low attitude) or the bottom left hand corner (low aptitude/low attitude). On that basis the challenge and the priority now is to move them as far to the right as possible and increasing transparency/accountability/scrutiny will do that more efficiently than anything else.

Furthermore, individuals that are high attitude will self-seek the knowledge and ability they need; they do not need to be spoon-fed; they will get good at what they do because they want to do it well; they are incentivised; they do not want to be SEEN to be doing a mediocre or poor job; that's the power of transparency.



So, for TPR to utilise its limited resource as efficiently as possible it should now apply as much of it as possible in creating greater transparency/accountability/scrutiny for trustees.

Q 1: There are currently no barriers to entry for professional trustees. Should there be? For example, should all professional trustees be required to be qualified or registered by a professional body?

We think that every trustee should be asked to sign a code of conduct which makes them accountable to members and open to scrutiny as a pre-requisite to enter. This would be an important step forward in order for members and sponsors to be able to identify those trustees who add value and those who do not, whether they are 'professional' or not.

To answer the question on qualification, we would need to know exactly the kind of qualification intended and what impact it would have on the trustees' ability to reject changes proposed by advisors and to protect members from excess fees as an example. Registration/qualification in itself may not have any impact other than creating an extra layer of cost. Many of the existing pension bodies survive on sponsorship from industry. It would be important to understand who would control the barriers to entry as this could be used to keep more qualified people out as the current stable of professional trustees could use this to limit competition. Most of the professional trustees employed today can probably find a way to become qualified or registered anyway.

That said, the combination of greater transparency/accountability/scrutiny plus relevant qualifications and membership of a relevant professional body could be a potent combination for the positive change that is needed. Certainly it could be more effective than the CPD process.

Q 2: Do you think it is the role of the chair of trustees to support trustees and use their leadership skills to improve the likelihood of appropriate scheme processes being put in place? Given the crucial role played by chairs, do you think more needs to be done to raise the standards of trustee chairmanship? For instance, do you think that chairs should be required to meet a minimum standard through having minimum qualifications or experience or belonging to a professional body?

As per question 1, we think that every trustee should be asked to sign a code of conduct which makes them accountable to members and open to scrutiny. This would be an important step forward in order for members and sponsors to be able to identify those trustees who add value and those who do not.

The standards of a trustee board would automatically improve if they were open to scrutiny. It is not clear if certain qualifications, experience or belonging to a professional body on its own would increase standards without a simultaneous requirement of transparency.

It is wholly accepted that the Chair has a particularly important role and therefore the transparency/accountability/scrutiny applied to Chairs should be as high as possible.

Q 3: Should DB schemes be required to appoint a chair and report on compliance with governance standards?

Governance standards must first be expressed so that they are simple and measurable. Reporting should be aligned with the level of activities carried out. For example if we are talking about a small scheme, invested in two or three passive trackers, who do not change investment strategy (i.e. is a long-term investor) and generally focus on cost-control, then they should only have limited reporting requirements. On the other hand a scheme who is actively gambling the markets with opaque investment strategies should probably have a chair and very steep reporting requirements in particular relating to whether their investment activities were adding value over and above the passive alternative. This would enable the sponsor/members to ask them to stop detracting value from the fund.

The reporting requirements for DC schemes should also be applied to DB schemes.

Q 4: How can we help trustees to be aware of, understand and apply the TKU framework?

If trustees are required to be transparent around their investment activities and the due diligence they carry out on investment advisors recommendations, this will provide the strongest incentive for them to be aware of, understand and apply the TKU framework in a meaningful and measureable way. Individual voting on each investment proposal should be made transparent as this will allow members to establish if the TKU framework is being applied by those meant to represent their interests. Members should be able to remove trustees who do not apply the framework, overpay for services and do not carry out proper due diligence.

NB: due diligence goes over and above asking questions and then agreeing to the proposition being promoted anyway.

Q 5: Do you have any views as to how we can help new trustees bring their knowledge and skills up to the required standard within the statutory period? For instance would it be useful to make completion of the Trustee toolkit or other equivalent learning tool within six months mandatory? Or would the introduction of a six-month probationary period for new trustees help to meet standards of TKU? What are the difficulties associated with these options and how could these be solved?

Knowledge and skill are very different concepts. Knowledge refers to theory whereas skill refers to successfully applying that theory in practice and getting expected results. Skill requires practical exposure and has measurable results. Skill cannot be obtained by doing a toolkit. Not everyone can become a footballer, or a doctor no matter how much they train.

If trustees are required to be transparent around the impact of their investment activities (i.e .the value-add of their activity = the skill) and the due diligence they carry out on investment advisors recommendations, this will provide the strongest incentive for them to be aware of, understand and apply the TKU framework in a meaningful and measureable way. Members should be able to remove trustees who take decisions without applying the framework, who are unwilling to be measured, or who do not carry out proper due diligence to reject investment propositions that are not evidence based.

Currently there is no transparency or scrutiny on the performance of a trustee; his/her input and decision-making takes place in a closed environment. The process is opaque to stakeholders. As a consequence, the impact and quality of trustee decision-making cannot be independently assessed. There is therefore no incentive to perform well or to reject investment propositions with low probability of success. Reporting ought to be far more thorough. Accountability should be extended to individuals as well as the board as a whole.

Relevant questions for TPR to explore further are:

- What was the impact of the decisions of the individual trustees / trustee board?
- Were decisions evidence-based and/or rational in a long-term context
- If not, what prohibited rational decision-making?
- Did a lack of intelligible information play a part in the decision-making process?
- If so, what was the consequence?
- What can be done about the asymmetry of information issue that is endemic throughout pension scheme stewardship and governance in the UK? (i.e .the fact that investment managers often provide complex and opaque information that is not easily understood by trustee boards).

As a general rule we would suggest a **"If I can't get the info or don't 100% understand / I don't invest"** governance criteria ala Warren Buffet! Greater transparency will lead to better scrutiny, which will lead to better decisions being made and therefore better outcomes being achieved.

In short, greater transparency on the performance of the trustee will lead to better trustee performance. More work needs to be done to put in place a robust framework for reporting, assessing and scrutinising trustee behavior.

One particular area worth exploring by TPR is the irrational over-use of active fund management. It is scary how the bad habits of DB plans have entered DC default options where solid low cost tracker funds are being replaced with expensive active funds despite empirical evidence that they are not value-for-money[13]. **One easy solution is to ban active management from default options**, and let those who want active funds individually self-select. Another is provided in the TTF framework where the difference in performance from the original passive fund to the new active fund must be reported to members so that they have redress on the decision-makers and the company.

Q 6: How can trustees demonstrate they have the minimum level of competence required to fulfill their role? For instance, do you think holding relevant qualifications is the right way to demonstrate competence? What are the difficulties associated with this option and how could these be solved? Are there other options?

The only objective way to demonstrate competence is to measure and report on the value-add by a trustee. This is similar to what is expected from an investment manager, or a portfolio manager, who also take decisions with other people's money. It is simple and perfectly reasonable requirement if you want to be a fiduciary. Activity based measurement is well-established and relatively simple to carry out. We have provided a template.

Sample Performance Measurement Report for XYZ Pension Fund

Description	Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Full Period	Per Annum
Original Benchmark		-11.8%	-11.9%	18.2%	10.0%	6.1%	9.6%	3.6%	-31.0%	15.0%	8.3%	-0.8%	10.4%	11.4%	37.1%	2.87%
Actual Benchmark		-11.8%	-11.9%	17.7%	9.6%	5.6%	9.8%	3.7%	-32.0%	15.4%	9.5%	-1.0%	10.5%	11.8%	37.1%	2.87%
Actual Performance		**-11.8%**	**-11.9%**	**17.7%**	**9.6%**	**5.6%**	**10.0%**	**3.7%**	**-32.0%**	**14.7%**	**9.0%**	**-1.1%**	**9.7%**	**11.3%**	**34.5%**	**2.67%**
Target Performance		-10.8%	-10.9%	18.7%	10.6%	6.6%	10.8%	4.7%	-31.0%	16.4%	10.5%	0.0%	11.5%	12.8%	50.1%	3.88%

Performance Attribution Summary:

Description	Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Full Period	Per Annum
Asset Allocation Changes		0.0%	0.0%	-0.5%	-0.3%	-0.4%	0.2%	0.1%	-1.0%	0.4%	1.2%	-0.2%	0.2%	0.4%	0.0%	0.00%
Manager Selection vs. 'Market'		0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.0%	0.0%	-0.7%	-0.5%	-0.1%	-0.8%	-0.5%	-2.6%	-0.20%
Total Performance:		**0.0%**	**0.0%**	**-0.5%**	**-0.3%**	**-0.5%**	**0.3%**	**0.1%**	**-1.0%**	**-0.4%**	**0.6%**	**-0.3%**	**-0.6%**	**-0.1%**	**-2.6%**	**-0.20%**

Performance Attribution in Detail:

Description	Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Full Period	Per Annum
Asset Allocation Changes:	Date	**0.0%**	**0.0%**	**-0.5%**	**-0.3%**	**-0.4%**	**0.2%**	**0.1%**	**-1.0%**	**0.4%**	**1.2%**	**-0.2%**	**0.2%**	**0.4%**	**0.0%**	**0.00%**
1) Increase allocation to US equities from UK equities	May-03	0.0%	0.0%	-0.5%	-0.3%	-0.4%	-0.4%	-0.3%	0.6%	-0.3%	0.3%	0.8%	0.0%	0.4%	-0.2%	-0.01%
2) Increase allocation to High Yield Credit from Government Bonds	Jul-06	0.0%	0.0%	0.0%	0.0%	0.0%	0.6%	0.4%	-1.6%	1.8%	1.4%	-0.6%	1.0%	1.4%	4.4%	0.34%
3) Allocate 10%to Hedge Fund / Abs.Return from equity allocation	Jun-09	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	-1.2%	-0.5%	-0.4%	-0.9%	-1.4%	-4.3%	-0.33%
Manager Selection vs. 'Market':	Date	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.2%**	**0.0%**	**0.0%**	**-0.7%**	**-0.5%**	**-0.1%**	**-0.8%**	**-0.5%**	**-2.6%**	-0.20%
1) Replace Fixed income manager A with Fixed income manager B	Oct-05	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.01%
2) Replace Equity manager X with Equity manager Y	Jan-09	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	-0.7%	-0.5%	-0.1%	-0.8%	-0.5%	-2.7%	-0.21%

Notes: Asset Allocation changes measure the performance impact of becnmark changes since the start of the measurement period
Manager Selection vs. Benchmark measure the benchmark relative performance from haven choosen active managers versus being invested passively in the benchmark

Trustees with a strong track-record of value-add in a given area has demonstrated competence. Building skill (competence) requires practical exposure, but results are measurable. Of course there are other activities that trustees are involved with such as negotiating with employers and making sure the trust deed is adhered to. These kinds of activities are more likely to benefit members.

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[13] So much evidence has been produced by academics and other institutions in this area that providing an exhaustive list would be impractical. Here is a recent analysis and link: "Active vs. Passive: Performance Comparisons" *IPE*, 2 August 2016

Q 7: Do you have a view as to whether a CPD framework would assist trustees to meet the challenges of scheme governance? What are the difficulties associated with this option and how could they be solved?

The use of CPD frameworks is widespread but there is limited evidence that it meets its objective without a simultaneous requirement of transparency.

CPD points can be gained already today by a trustee going to a sell-side conference. In fact a majority of CPD certified trustee training is provided for free by service providers in order to build sales relationships or push product. Having trustees go to more sales meetings labeled as educational are unlikely to help them meet the challenges of better scheme governance. The benefit would therefore depend on the type of training they would receive and by whom. Paid-for options by truly independent experts who could help are unlikely to be attractive as they compete with the free sales-driven options. One solution could be to provide restrictions on the type of institutions who could provide the training, but it would be difficult to police and is open to gaming.

The only incentive-linked guarantee that trustees take the appropriate unbiased training that will help them meet the challenges of scheme governance is to require trustees to be transparent around the impact of their investment activities and the due diligence they carry out on investment advisors recommendations. This will provide the strongest incentive for them to seek the training required for them to optimize outcomes for members.

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Q 8: What further education tools and products would you find useful to receive from us?

The ideas for better education suggested in the paper are all worth further consideration, but as already mentioned we believe the motivation for trustees to perform to a high standard is best established through greater transparency, accountability, scrutiny and so on.

Once the reason for performing well at an individual level is established the individual trustee will either drive up improvements to his/her approach or decide to discontinue being a trustee.

Both are good outcomes; trustees that are not able and/or not willing to carry out their duties properly should not be entrusted to look after other people's money.

Q 9: What do you think is the best way of managing conflicts of interests? How could the system be improved to reduce the likelihood of conflicts arising in the first place?

Greater transparency has a big part to play in managing conflicts. Conflicts are allowed to exist due to systemic opacity and a general lack of reporting/assessment/scrutiny. This means that the influencers interest' are more likely to be served than the intended beneficiaries.

Fundamental to the conflicts of interests in the current system arise from the requirement to take advice. However there is no evidence that the so-called 'experts' know more than anyone else, and more or less anyone can claim to be an 'expert' in investment matters. Empirical evidence show that

"demand for investment advice is being transformed into demand for underperforming actively managed funds" (They are more expensive and perform worse due to advisor incentives and lack of competition and cost the client 0.87% per annum in underperformance)[14].

Because there is a requirement to take advice there is no competition and no incentive for trustees to pick and choose advisors carefully based on merit. Rather a poor practice has been established with the current 'one shop advisory approach' where the same consultants: i) recommend managers; ii) set benchmarks; iii) monitor performance; and iv) manage relations which investment managers. This is poor governance because it reduces transparency and increases conflict of interest. It also disassociates decision makers from control and impact over essential parts of the investment process, to agents not being held properly to account. Most trustees are aware of these conflicts and the negative impact but there is no incentive for them to do anything about it.

The Chair's Statement/equivalent should have a highly detailed assessment of all actual and potential conflicts relating to all participants in the scheme – sponsor, trustee, advisers and so on.

The Professional Indemnity underwriters should have much greater visibility on actual and potential conflicts and their pricing should reflect the risk of malpractice driven by (potential) conflicts. Do undeclared (potential) conflicts jeopardize the validity of PI cover? Should they?

Q 10: What do you think are the key challenges faced by trustees in engaging effectively with administration and investment governance and third party providers and advisers? What could we do to help them in addition to what we outline above?

The Value for Money element of the new DC Code ought to be applied wholeheartedly. Doing so will lead to far better assessment of all services being supplied to the scheme.

However, a challenge exists for trustees being able to access all the information they need to determine the full costs of the services being provided.

Much work needs to be done to drive up the levels of transparency on costs and charges of all kinds in relation to all types of services being provided; but particularly in relation to asset management services. The announcement by the FCA on 5th October relating to the consultation on transaction costs is a very significant and welcomed step forward in the quest for full costs and charges disclosure.

Q 11: What should be done with those schemes that are unwilling or unable to deliver good governance and member outcomes? In particular, should small schemes be encouraged or forced to exit the market or to consolidate into larger scale provision? Is regulatory intervention required to facilitate this or can it be achieved through existing market forces?

To answer this question we must first define what is good governance and good member outcomes.

[14] Del Guercio D and Reuter J, "Mutual Fund Performance and the Incentive to generate Alpha", *The Journal of Finance*, July 2014, pp. 28-29.

This must be done in monetary and measurable format. Governance is only good if it delivers the expected or desired outcomes. Defining what good governance really is will be a big challenge because no-one wants to be accountable and report on poor-performance unless they are required to do so by law. Who should decide what good governance looks like? Vanguard has published a simple set of principles for investing success including Goals, Balance, Cost and Discipline[15] that could form a basis for a measurable framework and we could add, keeping it simple and measurable.

Society has taken an evidence based approach to limiting the use of tobacco, because the cost to the UK Government in lost GDP and increased health-bill is higher than the taxes levied on each packet of cigarettes sold. For the same reason the regulator should do something similar for short-term investment activities and high fee investments; they are not good for your long-term wealth.

Just like we do not outlaw smoking, we do not need to be prescriptive on how trustees invest, but simply provide the basis on which trustees could govern in the best interest of members. This would be to produce investment returns provided by the market at the lowest possible cost (i.e. a passive investment) for a given level of risk the fund is willing to run consistently in the long run. If they decide to become active investors then they must report on their performance.

For most trustees good governance would be to understand their own limitation and not make any changes to their investment strategy other than the rebalancing of simple passive mandates.

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Unfortunately as described previously the current market equilibrium is unsustainable for society in the long run as the profits of advisers and investment managers are inversely correlated to scheme efficiencies, so market forces will not drive the consolidation/ aggregation that is required. This is what explains the snail's pace trend in the UK to scheme consolidation and the appallingly small size (and therefore low efficiency) of UK pensions schemes when compared to other countries.

On that basis, regulatory intervention is clearly necessary.

Q 12: Would you find it useful to see overarching guidance covering issues common to all schemes, with more specific issues being covered in separate guidance?

The regulation of pension schemes is highly fragmented; a more joined-up approach would be beneficial in terms of consistency and understanding so affirmative to all points in the question. We suggest that the overarching guidance is reframed so as to incentivize long-term cost-effective steward-ship. Hopefully the TTF Framework for the 21st Century guide to good governance will provide some fresh and unbiased inspiration. We believe that guidance should be aimed at protecting members as well as trustees from undue behavioral biases. It is not beneficial to pretend they do not exist. **Everyone behaves rationally within their own sphere of influence.**

[15] Vanguard's principles for investing success – Four timeless principles to help you reach your investment objectives

Q 13: Do you have any other thoughts on the issues raised in this paper or on how standards of trusteeship and the quality of governance can be improved?

A recurring theme in our response has been the importance of greater transparency/accountability/assessment and scrutiny of trustees. We are genuinely concerned that without trustees being properly incentivised to perform to a high standard any deficiencies in their performance will remain unnoticed and unchallenged. This is a key element of our response and therefore our response to Q 13 is taken as an opportunity to expand on our thinking:

How might better transparency/accountability/assessment and scrutiny of the performance of trustees be achieved in practical terms?

We can look at the progress that has been made in the commercial world for pragmatic solutions to this type of problem. Much greater transparency/accountability/assessment and scrutiny of the performance of directors of commercial organisations is provided to shareholders now than has been the case in the past.

We believe that trustees of pension schemes should be dealt with in a similar way. How? Through detailed reporting that provides for:

- Full transparency on how the pension fund is invested i.e. into which organisations
- Full transparency on how the pension fund is exercising shareholder rights on behalf of members
- Full transparency on how the fund has implemented its investment policy over the previous year; and how it intends to carry out that responsibility in the coming year
- Full transparency on how the fund has identified and managed risks over the previous year and how it intends to carry out that responsibility in the coming year
- Full transparency on key decisions that have been made about the stewardship and governance of the scheme and what processes have been put in place to monitor the impact of those decisions (including transparency on voting)

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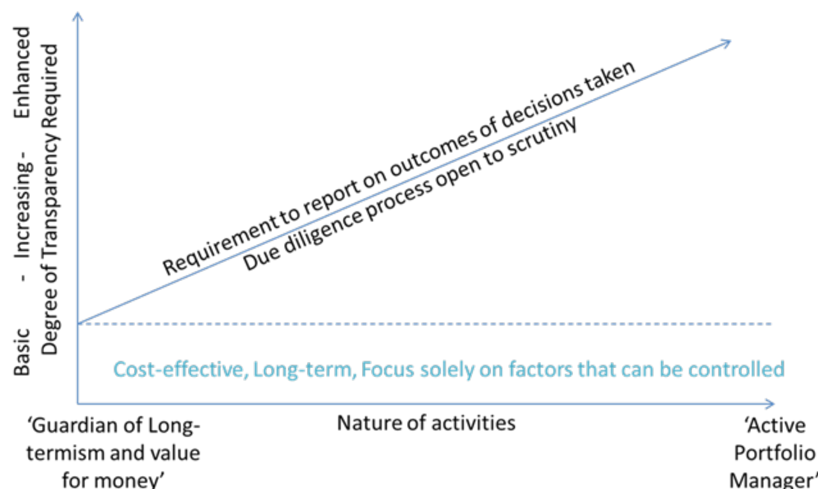
The reporting can be provided for inexpensively through a scheme website; no requirement to print materials. It must be possible for members to assess if the activities undertaken on their behalf have added value to them or not, in particular in DC default plans when they are effectively being 'opted-in'. For DB schemes the shareholders should also have a right to understand how much extra they must contribute into the pension plan because trustees follow a systematic buy high/sell low investment manager or allocation strategy driven by their advisor.

Yes - a good governance framework is meant to incentivise a stable and long-term approach to investment. Yes - it is meant to reduce behavioral biases that drive value-detracting activities.

Why? - because it is other people's money, and because empirical evidence shows that change and churn has negative expected return for members; there must be a high hurdle to demonstrate value-add.

We have sought to illustrate this basic concept of a good governance framework that maximizes

expected outcomes by minimizing the investment activities that drain on performance in the diagram below. A good governance framework for the 21st century trustee could have a huge impact by protecting stakeholders against the behavioral biases that prevent progress to take hold.



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We recognize there are differences between DC and DB schemes and that some of the more recent regulatory initiatives such as the reporting on cost and IGC seek to improve outcomes by focusing attention on key areas, however without transparency on the 21st century trustee, nothing will change and the money extraction game will go on.

For DC we are mainly concerned with the default option. We know most members do not read statement or letters and are increasingly being opted in to expensive solutions. The most effective governance measure here is cost per unit of investment risk. The Benchmark for good governance is a passive investment. There is no room for active managers in default DC. If members want to gamble they should be allowed. However like with smoking, they should not be open to advertising and if they seek to opt out they should receive several warnings.

Today, many of the bad habits from DB are moving into DC. Why? Consultants need to earn fees from manager selection and making changes to default options. Investment managers want to convert millions of captive passive savers into high margin active savers. We have seen some DC plans being benchmarked against cash even if they hold equities and bonds. This development to transfer wealth from members to service providers was also predicted by the 'game' we described initially. To stop this trend a strong incentive needs to be provided as described. It would allow members to seek redress should expensive active solutions they did not ask for underperform.

For DB it is mainly the company shareholder and/or tax payer who pays the bill and who should be entitled to transparency of how their contributions are being managed, but of course, members are also at increased risk if investment activities are loss-making and put additional loss-making strain on the sponsor and should be able to scrutinize too, so should the regulator. Again for DB a simple investment strategy implemented via low-cost trackers in traditional investments should be the base

case. We have illustrated how activity can be measured. Again, the incentive should be to reduce value-attracting activities that do not benefit the members, including, but not excluding the search for fool's gold which is still going strong today.

Another important governance factor is the correct use of investment benchmarks. Without correct benchmarks value for money cannot be assessed. Asset managers and fund selectors have a vested interest to provide benchmarks that make their performance look attractive in order to justify higher fees, hide the impact of poor performance or excessive transaction costs. Even trustees have incentive to accept lower benchmarks as it reduces their personal liability and makes their decisions look better than they are. The response to past underperformance has been to lower the bar against which performance is being assessed.

According to a recent report from the CFA UK[16] a significant proportion of benchmarks used by investment managers and consultants are 'inappropriate' and 'fall short of the criteria required for a valid benchmark'. Areas of particular concern relate to the use of aspirational or so called 'target return' benchmarks used within fiduciary mandates, implemented consulting, absolute return, private equity, hedge funds, multi strategy or asset and private markets including infrastructure.

Liability hedging can be part of such a simple investment strategy. Having a hedge policy in itself does not need to be defined as a trustee activity as often this decision is forced on them by the TPR or the sponsor. At today's interest rate level it would probably make more sense for a sponsor to pay 1% per annum extra into the fund compared to paying 1% per annum in negative real yield to hedge 20 year interest rate exposure close to the zero boundary. A suitable liability hedging strategy can be included in base investment strategy or asset allocation from which future activities are measured against. Still there is nothing lost in measuring and reporting the impact of all decisions to those who contribute and are meant to benefit as would be done in all other areas of business in the UK or elsewhere.

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Furthermore, to enhance transparency further, at least once a year, scheme members should have the opportunity to attend meetings where the trustee board can provide responses to questions put to them by members; a 'Pension Scheme AGM' as it were.

It follows that these measures bring more into line the way a pension scheme is run with the governance structures applied to companies. The better transparency/accountability/assessment and scrutiny of the performance of trustees that they provide will substantially improve the performance of trustees; that would truly bring pension scheme trusteeship into the 21st Century.

It must always be remembered that pension scheme trustees have agreed to be responsible for the welfare of other people's money; if they are willing to have that responsibility and are willing to take their responsibility seriously they should be completely comfortable with high levels of transparency and scrutiny.

Why would they not, if they fully understand their responsibility and take their responsibility seriously?

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[16] CFA UK "Benchmarks and Indices" January 2016 – the full report is found here

4. Conclusion

The Transparency Task Force is highly appreciative of the excellent work that TPR has been doing with its 21st Century Trustee initiative and we can see how it will continue to raise the standards of scheme governance and member outcomes.

However, we believe that existing standards are generally poor; we are 'starting at a low base'.

Furthermore, we believe that the lack of transparency/accountability/assessment and scrutiny of trustee's performance has been a barrier to progress and unless remedied the enormous investment being made in driving up standards will only achieve a fraction of their potential.

If trustees are free to continue to operate in a state of opacity their development will be hindered, because they will continue to have the option to perform in a mediocre way without there being any real visibility of the reality.

Trustees need to operate in a state of transparency to sharpen their behavior and therefore drive up the standards of stewardship they can achieve.

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Transparency will alter the mindset of trustees running pension schemes on behalf of their members, just as it has helped to alter the mindset of directors running companies on behalf of their shareholders.

We are happy to meet and discuss our input further; and would welcome TPR becoming more aware of the work of our Stewardship and Decision-Making Team, as it aligns very closely with TPR's aims and objectives in this space.

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