Trustee Leadership Forum for Retirement Security

Inaugural Meeting Summary

On May 17-18, 2011, the Initiative for Responsible Investment hosted a meeting of labor-affiliated public and Taft-Hartley pension plan trustees and related service providers to explore the challenges of trustee leadership on responsible investment issues. This brief paper provides an overview of the discussion and an outline of potential steps to address the role of trustee leadership in the context of the financial crisis and the recession it engendered, as well as the political debates over the role of pension plans in providing retirement security for US workers.

The meeting was designed to provide an overview of the trustee's role by drawing on attendees' own experiences of the challenges they face in fulfilling their fiduciary duty toward the participants in their funds, especially given the effects of the current investment and political environment. The idea was to explore the views of trustees on the nature of pension fund stewardship in the current crisis, the ways in which trustees develop investment beliefs and strategies and oversee investment decisions, and how the ecosystem of fund staff, legal counsel, investment consultants, fund managers, fund beneficiaries, and related stakeholders shape and at times constrain the decision-making process.

In addition, a purpose of the meeting was to aid in the construction of a research agenda for the IRI in its construction of a Trustee Leadership Forum to engage and aid trustees on the issues they face. Thus, the meeting helped identify both theoretical and practical research that addresses the trustees' core challenge: responsible stewardship of investment funds for the retirement security of past, current, and future beneficiaries.

We focused on three key themes:

- the context in which trustees find themselves reviewing, and for many rethinking, investment strategies in light of the crisis and the economic dislocation it caused;
- the power map of stakeholders that shapes how trustees make decisions; and
- the tools that trustees need to better inform decisions for the long-term benefits of their funds and their ultimate beneficiaries.

Trustees often feel disempowered individually and collectively. **Trustee leadership itself might be defined as the ability to direct the many stakeholders involved in fund investments towards the ultimate goal of serving beneficiaries' interests**. In the current environment, this can mean challenging conventional theories, confronting agency issues, and holding stakeholders to account. Perhaps the key point of consensus for the group was that trustees need the capacity, and support, to ask hard questions and to properly evaluate the responses to those questions.

The Current Political and Economic Context

The discussion began by reviewing the current political and economic context in which funds work. A number of service providers were invited to the initial session in order to access their potential contributions. Attendees agreed that this is a particularly challenging moment to be a pension fund trustee. (It was recognized that a number of kinds of benefits funds exist that face similar issues, include training and health funds. Given that the bulk of assets relevant to this discussion are in pension funds, their issues were center stage.) Funds lost substantial capital in the financial crisis, and aside from the obvious actuarial problems these losses may

have caused, they also have forced a rethinking of investment strategies and risk management systems which may have seemed appropriate when markets were going up. Pressure to make up losses quickly is itself part of the story of the pension plans' turn to riskier strategies that contributed in part to the build up to the financial crisis of 2008.

But perhaps more important than the near term financial losses - which funds with long-term time horizons are built to manage - are the political challenges to the very nature of defined benefit plans. The cyclical nature of political attention, as one participant put it - in bull markets, fund investments receive little attention, while in bad times, public and corporate contributions are called into question - can lead to attacks on pension funds' financial health while they weather a down market. And fund beneficiaries themselves will suffer personal economic setbacks that reduce their own contributions.

The result has been a perfect storm of financial, economic, and political challenges. Debates over the relative practicability of defined benefit plans put pension plan advocates on the defensive, and they complicate discussions over appropriate funding levels, discount rates, and benefit levels. Broader debates over the nature of retirement security, and the commitment that funds themselves represent to retirement security, have become a fundamental part of their work of financial stewardship.

Several attendees pointed to the need for fund advocates to build a narrative that explains the role of defined benefit plans in maintaining a broader social contract with fund beneficiaries. Given the nature of political discourse today, as well as the financial interests of the financial service sector, an alternative narrative that stresses the needs of fund beneficiaries is crucial. One suggestion was to focus on the ties between the performance of pension funds and the health of the real economy. In recent years the focus on financial savvy and investment outperformance may have engendered a belief in "alpha," based more on short-term benchmarks and unsustainable speculation rather than long-term wealth creation. If funds were to develop a narrative that tied long-term financial performance to identifiable support for real economic activity, they would address their own role in supporting a stable economy through productive investment activity -- a rethinking of investment strategy that would also contribute to the broader debate on the role that pension plans can play in supporting their beneficiaries.

The Internal Context

From the external context in which trustees are evaluating their funds' purpose and strategy, we turned to the practical realities of how they perform their role overseeing fund management. In particular, attendees focused on the ways in which trustees view the institutional constraints that shape how they do their work.

In the first place, attendees highlighted the fact that trustees themselves are crucially situated to fulfill the mission of their position, as they come from the population that has the most at stake. Thus, their interests are precisely aligned with the beneficiaries. However, they are not necessarily trained in investment decision-making. As they often have full time jobs apart from their trustee work their role as overseers is mediated through a broad array of stakeholders who shape the information they receive and the options they consider when making decisions. Though in theory trustees make fundamental decisions about organizational policy and strategy, in practice they are substantially constrained in their role.

Trustee training and skill development remains a long-standing challenge. Given the lack of a coherent alternative to the problems of modern portfolio theory, training itself can either empower new trustees or encourage them to adopt conventional views that may discourage

active stewardship. Fund investment decisions take place within the framework of the information shaped in large part by staff and external service providers and involve important power questions. The conventional framework can lead to agency issues, that is, when the long-term interests of funds come into conflict with stakeholders' other objectives. And, more generally, self-interested conventional investment culture can resist trustees' efforts to interrogate, and on occasion reformulate, investment practice.

Staff and service providers, for instance, are often evaluated on their relative performance in meeting benchmarks set by the performance of their peers. At a systemic level, this can encourage herding behavior, an especially important concern when the benchmarks themselves encourage short-term performance that may create long-term systemic risk.

But, because trustees do not necessarily come from the investment community, they may encounter skepticism (justified or not) when they question investment strategies and beliefs, even though their role, attendees frequently pointed out, is precisely to ask hard questions of staff and service providers. The discussion turned more than once to the idea of a "cult of expertise" that tended to marginalize trustees who asked hard questions. One example that surfaced repeatedly was that of conventional understandings of fiduciary duty restricting trustees' ability to question strategic allocation or fund manager selection decisions. From the attendees' point of view, invocations of "fiduciary duty" can be used by stakeholders to cut off debate, regardless of the merits of their understanding of that vital concept.

Discussion around the "cult of expertise" focused not on the importance of technical investment expertise - a point generally agreed to - but rather the assumption that investment expertise was more important than careful alignment of fund objectives and investment strategies. When combined with agency issues with service providers - when, for instance, the goal of maximizing their own financial interests - or cynicism towards alternative views of the importance and applicability of principles of long term investment may rub against the goal of best serving the long-term interests of their pension fund clients - the idea of expertise may disfavor productive dialogue and engagement. Some noted that investment complexity has been used to disguise high fees or excessive risk taking.

In sum, fund governance, as it relates to identifying the skills trustees need, the tools for trustee education, and the management of strategic oversight and stakeholder relationships, can be brought together into a map of the issues and agents that shape how trustees make decisions. Important issues about pension fund best practices - from ethics policies governing gifts to trustees; to methods for using Requests for Proposals (RFPs) to build in long-term time horizons and responsible investment practices into manager relationships; to asset allocation decisions that tie strategic decisions to their implications for sustainable long-term wealth creation - can all be seen as responses to the investment culture that shapes how decisions are made today, and might be reshaped into a more effective system for meeting fund objectives in the future.

Engaging the Financial System

Discussion around the power map of stakeholder relationships and investment structures that shape pension fund behavior inevitably turned to the relationship between funds and the wider financial community. Attendees noted that their own money managers occasionally engage in advocacy efforts that destabilize the very funds they are serving. Recent months have seen public and Taft-Hartley funds, in particular, engage their fund managers on agency issues such as securities lending, foreign exchange transaction, Congressional reports and media attention to the packaging of securities which put funds at risk, and a wider

discussion -- building on financial reform efforts, and intensified by concerns in Europe -- on the systemic problems that remain in the financial community.

Efforts to engage the financial community are intimately tied to questions raised by the financial crisis. One attendee told of his group's practice of bringing in their fund managers to ask them how they had responded to the crisis and how they expected to respond in light of changed circumstances. These conversations were tied to the group's general practice of engaging fund managers on questions such as how they were positioned vis-à-vis the green economy, or how their work did or did not relate to the crisis of job creation in the US.

Fund trustees see opportunities for funds to be more active and engaged, to lead in response to these sorts of issues and challenges. Conventional practice has funds acting alone, making investment decisions as if their own investments have little to no impact on the markets themselves. But trustees concerned about short-termism in the markets, agency issues, and so on, also feel that they are not using their potential influence to shape investment markets towards the sort of long-term sustainable wealth generation on which their own fund performance and, more importantly, their beneficiaries, depend.

More than once, trustees worried that current fund behavior disfavored collaborative action and efforts to build more effective investment markets. One participant noted that the very idea of benchmarking relative performance meant that funds' might focus on outstripping their peers at the expense of systemic reforms necessary to build a system that delivers retirement security for all beneficiaries and, by implication, all of society. That systemic risk has proven to be substantially more important than was previously acknowledged by conventional investment professionals reaffirms the importance of increased attention to this area.

One important effort at collaborative action, the development of the Council of Institutional Investors, was seen as an attempt to empower asset owners like pension funds with the means to engage their fund managers and others on important issues of corporate governance. A variety of platforms have enabled pension funds to engage in shareholder activism, promoting efforts to improve corporate governance in publicly traded companies, and also on issues ranging from climate change, to executive pay, to human rights risks in corporate supply chains. These efforts have seen both successes and failures; they have modeled the potential for collective action and also revealed where funds have yet to take advantage of its potential. Research evidence makes clear that such attention is crucial for successful long-term performance.

Another avenue for collective action is fund collaboration on building demand for investment products that are explicitly tied to long-term objectives and impact on the real economy. Already there are products with track record in the market that target market rate returns with specific collateral measurement of jobs created, for instance. The production of jobs is especially important for those funds which rely on contributions form local governmental employers who raise such money from their local taxpayers. Many funds have successfully implemented responsible contracting policies that support quality job creation, and communicate those policies, via RFPs, to potential service providers. But there are also opportunities for funds to shape products - across asset classes - that might better suit their needs.

One interesting field to explore is that of infrastructure - an asset class with tangible impact on job creation and sustainable development where funds might pool asset at scale. Discussion revealed that funds are skeptical that many infrastructure products currently in the marketplace are best designed to meet pension fund obligations. This discussion about

infrastructure represents, in microcosm, the broader discussion about how funds can work together to make their voices heard, and their interests valued, in the financial system as a whole. It is also a field in which funds can build a vision of what it means to invest in economic growth rather than financial speculation.

What Can Be Done to Develop Trustee Leadership

We concluded the meeting with a roundtable discussion about what can be done to enhance trustee leadership and fund performance on issues of long-term sustainable wealth creation. Below is a select list of ideas that emerged as part of a larger conversation about how to identify issues to research and build collaborative platforms from which trustees can draw resources, share best practices, and build knowledge for the field.

- **Explore the concept of investment beliefs**. Various attendees pointed to the idea of investment beliefs as a core concept that can help trustees frame issues of long-term performance. For instance, funds have used portfolio theory as a way to avoid dealing with vital issues such as systemic financial problems, wealth polarization, or climate change that inevitably create risk for fund performance. All approaches contain investment beliefs, transparency, and attention to the content of the beliefs can better enable funds to address hard questions.

- **Collaborate on product development, embedded fees, and best practices**. Funds can explore platforms for coordinating prospective strategies, as a way to bring scale and demonstrate to fund managers demand for particular kinds of products. The issue of investment fees itself has potential for collaborative action - how can funds come together to better determine what constitute reasonable fees, and how can they use their influence to limit the fees they pay to what they consider appropriate? What are best practices in these areas?

- **Build tools for trustees to integrate responsible investment issues into their strategic oversight**. The idea of a toolkit for trustees that deals with issues surrounding long-term sustainable wealth creation came up repeatedly. The toolkit, which can be fleshed out by a robust research agenda, will synthesize current research and best practices into distributable materials that open up issues for hard questions. The toolkit could address core issues, such as fiduciary duty, asset allocation, RFP-writing, and benchmarking. Trustees may benefit from being able to call on additional research on issue areas such as infrastructure, topics such as investment beliefs, and the relationship of funds to the macroeconomic context.

- **As part of the toolkit, we should design a set of hard questions for trustees and a way to evaluate responses.** A research project could be designed that engages trustees on where they think hard questions need to be asked across the spectrum of investment activity. This project could provide a framework for research on trustee leadership, and serve as a practical tool for trustee education and discussion. With discussions of how to evaluate responses, this could also be a practical tool to assist trustees in engaging service providers and staff in a way that recognizes the ultimate responsibility of the trustee for the long-term well-being of the fund and its beneficiaries.

- **Build peer network of trustees to identify key topics for consideration**. Such a peer network could facilitate discussions about what issues need more research and best practices for reducing isolation and building capacity as a group. A national peer network may be built with regional hubs that allow for regular meetings of trustees.