Some perspectives for pension fund managers

Reviewing the benefits that have accrued to institutional investors from Big Bang, Mr D A Walker, an Executive Director of the Bank, reflects[1] on the role and responsibilities of pension fund managers in sustaining a free and competitive environment in the future. He stresses in particular that 'those with most muscle on the institutional side of the securities market place should use their bargaining power judiciously, having regard to the future structure of the market that they want to be able to operate in as well as the minimisation of their costs now'; and underlines also the advantages of encouraging the development of more free-standing research capacity, separately remunerated.

He suggests that if the liberal market environment in which pension fund managers operate is to be upheld, it is essential that the privilege this represents be exercised with commensurate responsibility, and suggests, as possible areas of specific initiative towards this end:

- *a fresh examination of the responsibilities of trustees, their role in the formulation of pension investment strategies, and the legal framework in which all this is set;*
- *early progress in the promulgation of a code of best practice for listed companies which could commend a minimum proportion of independent directors and the introduction of audit committees;*
- *early progress, by the Accounting Standards Committee and others, towards a code of best or recommended practice and, eventually, a standard on disclosure of spending on R and D and innovation.*

The last three years have been a phase of great excitement, opportunity and achievement for institutional investors. The market environment has been benign, with a long continuation of bull market conditions and with UK equities up by more than 100% between the end of 1983 and late-February 1987, despite the absorption by the market of the very large privatisation issues in this period. Big Bang itself, preceded by substantial regroupings in and recapitalisation of the securities industry, and accompanied by a reduction in stamp duty to $\frac{1}{2}$%, has yielded large savings in transactions costs; and it provides a market that is more liquid and accessible than ever before. The general sense of well-being is particularly great for pension funds where, in contrast with the early 1980s, the problem is now how to cope with actuarial surpluses rather than deficiencies, and favourable fiscal treatment has been maintained for this form of saving despite its withdrawal from life assurance.

But a time of plenty is also a time to think ahead and to prepare for the future. Bull markets will not last for ever and, starting in the market place itself, there is a major question how robustly present securities firms will be able to cope when market conditions generally are less favourable. This is undoubtedly partly a matter of containing and reducing overheads, but it will also be crucially relevant whether the initial post-Big Bang squeeze on transactions margins is relaxed over the next 6–12 months. It is hardly surprising that the move away from fixed to negotiated commissions or to dealing on a net price basis should have yielded such large savings to the institutional investor. This was indeed one of the objects of the whole process. I cannot forbear from observing that your enthusiasm to move away from fixed commissions that you pay has been matched only by your enthusiasm to maintain cartelised fixing of the fees that you yourselves receive for sub-underwriting. But an individual fund manager might reasonably ask why the pressure should not be kept on securities houses to keep transactions costs down even if this means squeezing their margins to the bone.

The answer to this question depends on one's perspective, but I want to mention three factors to be taken into account in any event.

First, fund managers are benefiting greatly now from a market place in which there is unprecedentedly keen competition among market makers and substantially enhanced capacity for block trades. Continuance of this

(1) In a speech to the National Association of Pension Funds Investment Conference at Eastbourne, on 27 February.

environment, once the first flush of competitive energy release has passed, will depend largely on the ability of a sufficient number of securities firms to cut costs and generate revenues that enable them to stay in business. This does not mean that there is not fat to be squeezed out, nor additional business to be done. But it does place a particular responsibility on those with most muscle on the institutional side of the market place to use their bargaining power judiciously, having regard to the future structure of the market that they want to be able to operate in as well as the minimisation of their costs now. A market in which a significantly reduced number of market makers were in effect oligopolists would be a good deal less accommodating for most investors. The larger institutions would no doubt be able to look after themselves, but, with fewer market makers and a less competitive market, even they could suffer.

Second, it is important not to underestimate the force of the macho instinct within securities firms in present market conditions. No firm will want to be the first to withdraw from any important market function because it cannot make ends meet, in part because the very fact of its withdrawal will strengthen the prospects of the competitors that remain. I am sure that many brave faces are being put on by securities houses in negotiations with fund managers on the basis of forecasts that their positioning profits will increase to enable them to withstand narrower margins, or that total turnover will rise, or that they will gain market share, partly because they hope or expect that competitors will fall out first. We have no confident basis for gauging the extent of excess capacity or the likely rise in turnover, but there may be some tendency for firms to try to conceal problems for as long as possible, and this means that any adjustment, if or when it comes, could be quite severe. The capital adequacy requirements that are or are being put in place will minimise the risk that firms will go out of business in a disorderly or abrupt fashion, causing loss for others. But there could well be further mergers and decisions to concentrate on particular areas of business, involving withdrawal from some markets.

Third, despite the increase in research output from analysts in the last few years, the development of new, more efficient and liquid markets calls for more rather than less high quality research if fund managers are to be able to take best advantage of the opportunities available to them. Yet present circumstances are such that, because of the squeeze on their margins, some firms may be having to think of retrenchment in their client research budgets. One respect in which the recent securities market revolution has departed from what I had expected is that we have not as yet seen much unbundling of client research capacity. I acknowledge that there was little unbundling in Wall Street after 1975, but it seems to me that there is much to be said from the standpoint of the fund manager, and also more widely, for reducing the dependence of the budgets of research teams on the buoyancy of transactions revenues of securities firms. I know that bundling has its attractions because it enables the fund manager to reward the firms that produce the best research without need for securing the endorsement of trustees for a separate budget to meet the cost of research requirements. But retention of flexibility here may mean that fund managers are not able to move as fully onto a net price basis of dealing as might otherwise be appropriate, and I wonder whether, given the pressure now being put on margins generally, this approach does not leave some good research capability needlessly at risk. It is for this reason that I would hope that we might see the development of more free-standing research capability, separately remunerated.

You will not I think deny that the actual or prospective improvement in your performance attributable to significantly lower transactions costs has been fairly easily achieved. You have been the beneficiaries of systemic and structural change generated, so to speak, from outside and, in any event, these savings in transactions costs represent a step-change improvement that is unlikely to be repeated. The interesting questions now are how far, and over what timescale, your performance can be maintained or improved in future. In this context, it is important that trustees should give fund managers realistic performance objectives. It is just not reasonable to expect consistent above-average performance, and I submit that trustees should not press or expect their fund managers consistently to achieve the top quartile.

You operate in a very liberal market environment and the predicate of the remarks that follow is that it is desirable that this should continue. But if this is to be achieved, great sensitivity will be needed to the wider socio-economic environment. One aspect is the enormous growth in the significance of pension funds, which now probably hold about a third of listed UK equities. The switching of some funds from in-house management to the hands of large-scale discretionary managers has greatly increased the importance of some of those firms as well, some of whom are now responsible for stakes in British listed companies comparable in size with those held directly by the larger life assurance companies.

This accumulation of investor power in the hands of fund managers and the continued enjoyment of relatively free market conditions represents substantial privilege. In a complex society such as ours, no such privilege will long be endured either by those who do not have it or by those who find that they are at the wrong end of its exercise unless such privilege is exercised with commensurate responsibility. The trouble is that what constitutes responsibility is unavoidably complex, and those who seek an easy answer and easy guidance will be disappointed. Yet the quest for panaceas is extraordinarily strong, and spoils much of the contemporary debate in this area. Two examples come immediately to mind.

The first is the nature of the responsibility of the pension fund trustee. I recently heard a senior and distinguished financial figure say that, as a trustee, his sole responsibility is to the beneficiaries, and that no other consideration should be allowed to obtrude. This attitude is no doubt widely held, and plainly deserves considerable respect. It has protected pensioners from excesses of self-investment or prejudiced interference that would undoubtedly have damaged portfolio performance in many situations. Yet it cannot possibly be the whole story, for the trustees are aware that, in the event that their fund goes into actuarial deficiency, the ultimate obligor is the company just as, in circumstances of actuarial surplus, the company may be the beneficiary through reduced contributions.

It seems unavoidable, therefore, that trustees, in proper exercise of their responsibilities, should take into account in determining the appropriate acceptance of risk not only the interests of current and future pensioners but also the implications for the company that has to pick up the tab if things go wrong and, incidentally, whose financial strength will be relevant to its capacity to do so. As a further complication, the trustees also need to have regard to the maturity of the fund, in principle being justified in entertaining a higher risk investment strategy the less mature the fund. My purpose in spelling this out is to emphasise that the judgement to be exercised by a trustee in determining investment strategy is complex, and I question how any trustee who does not recognise this—for example one who cleaves in all situations to a simple principle of 'safety first at any price'—can claim to be playing his role wholly responsibly.

I acknowledge that the responsibilities placed on trustees may on occasion seem to call for reconciliation of an unrealistically wide spread of interests. This may lead to the plausible enough view that trust law may no longer be able to cope with strains placed upon it by the weight and importance of the modern pension fund, and that new pensions legislation may be required, among other reasons, to set out more clearly where the responsibilities of trustees lie. I am myself uncertain about this, but those who would wish to direct the investment of pension funds in some way will no doubt have increasingly clear views of the legislation that they have in mind for this purpose. I suggest that those who value and wish to maintain the freedom of the present environment, and to avoid such direction, might well undertake a fresh examination of the responsibilities of trustees, their role in the formulation of pension investment strategies, and the legal framework within which all this is set. It seems to me that this is a task that could very well be undertaken under the auspices of the NAPF.

The second area of oversimplification in current debate relates to so-called 'short-termism'. I observe a polarisation between, on the one hand, those who regard financial markets as comprehensively and excessively myopic and, on the other, those who claim that financial markets are efficient and that the shocks that they may on occasion impart to company boardrooms are deserved and overdue. I regret this oversimplification because it distracts attention away from points at which leverage could be exerted in a way that would ensure real improvement in performance.

There are no doubt many situations in which financial markets may be held to have taken unduly short-term views. Equally, there are no doubt many board situations where there is no real strategy, and such forward thinking as takes place involves waiting for something to turn up, with no real assurance about where the next process or product is coming from. 'Short-termism' among financial institutions has become descriptive of what is perceived as a disease, with the implication that the condition 'long-termism' signifies robust health. But if 'long-termism' among institutional investors means that they neither reduce their holdings nor indicate in any other way to its board their concerns about a company of which they are members, it is not clear how such 'long-termism' differs from inertia. With the benefit of hindsight, it is not difficult to call to mind situations in the last few years where a shorter-term approach, equivalent to less patience, not to say less passivity, on the part of institutional shareholders, might with advantage have been adopted at a much earlier stage.

The short-term/long-term debate involves focus on something of a bogus dilemma for the fund manager and can turn into a trivialisation of the issues that helps no one. The more pertinent and difficult question is how risk-averse a particular fund would be. Palpably, this is a cross-grained affair, with some short-term instruments involving high risk and some long-term instruments involving low risk. In this situation, I am inclined to think that the short-termism debate has now cast as much light as it is capable of doing and that the debate on relationships between financial institutions and industry needs to be developed in a more down-to-earth and pragmatic way. I suggest that we should move on to specific areas for initiative where fund managers have opportunities to exert influence and improve performance and, I submit, responsibility for seeking to do so.

At risk of breaching my own stricture against oversimplification, I would say that too much attention has been concentrated at the short and long-term ends of the behavioural spectrum and that there has not been enough attention to the area in between. I want to divide this middle ground into two parts: one relates to your responses as fund managers in particular investment situations; the other relates to disclosure and the standard-setting process for financial reporting by listed companies.

One of the major arguments for privatisation has been the difficulty of establishing satisfactory working relationships between successive governments and the boards of the nationalised industries of which, until recently, they have been sole shareholders. The counterpart to this observation is that institutional shareholders of newly privatised businesses are expected to be able to establish better relationships with their boards. But there is plainly a question how confident we can be about this. One difficulty is cultural. Whereas boards are accountable to shareholders, this accountability has until recently and in many cases tended to be a formality, with not much disposition on either side to give it substance. Yet the reciprocal of the accountability of the board to the shareholders is the duty of the shareholder to satisfy himself as to the quality and composition of the board. This becomes a more than ever important responsibility with the growing concentration of equity holdings, especially given the growing influence of the major discretionary managers. The proposition is not of course that fund managers should interfere in the running of the business. They have no competence to do so. But they should stand ready to exert the influence which it is their right and responsibility to do to promote better boards.

Let us consider the alternatives. For an individual fund manager with a small holding in a company where the board seems deficient, disposal of the shares may be the best course. Although a large holder can reduce the weight of his holding, he is unlikely to be able to go far without moving the price against himself. All that remains for him is thus either to sit tight for the time being, taking no action but hoping that bidders will come along, or to take some initiative designed to strengthen the board. Such initiative is of course much easier to prescribe than to achieve, and I do not belittle the effort needed and difficulties involved in bringing effective influence to bear on a chairman who is not keen to respond to what he may regard as unwelcome outside interference. But how can it be regarded as 'outside' interference?—for, after all, you are the members of the company, and the board is accountable to you.

In any event, whatever the difficulties, let us reflect for a moment on the potential cost of shareholder inertia, which means either no signal to the board or, in effect, an implicit signal that the shareholder is content with what is going on. This is relevant to the question whether institutional shareholders should exercise their voting rights save in special situations such as on a share option resolution where they may have a strong view. It seems that, in general, even the larger fund managers do not exercise their votes as a matter of course. While it plainly takes time and effort to exercise voting rights, forgoing their use on a regular basis does involve the loss of a potentially useful influence on boards. I do not want to exaggerate the significance of voting, and it will be of little value as against abstaining if votes are always cast in favour of the management. But not to vote risks being interpreted as a signal either of disinterest or of approbation, neither of which may be the intended or most appropriate message.

One major reason for the recent spate of merger and acquisition activity is that, as a result of board and shareholder inertia, assets become undermanaged and thus lowly valued in the market place. Takeover is apt to correct the position, but it may come late in the day, so that needed adjustment is long delayed, and the process may be a very disruptive one. Mergers and acquisitions can play a significant role in the working of the market mechanism, but the question nags insistently whether we have not become too dependent on them as means of securing improvement in underperforming companies. The temptation is plainly there for a hard-pressed fund manager with an underperforming holding that is too big to unload to hope that a bidder will come along. From his standpoint, waiting may reasonably enough seem the most cost-effective course, especially given that a contested takeover may well drive up the price of the offeree company by as much as 50% to judge from experience in 1986. But it would be a sorry indictment if this were the attitude of funds generally, and it cannot be a logical proposition that a failure of management necessarily requires a change of ownership. Even though, in a particular situation, there may be no practicable alternative to takeover, this will not always have been the situation and much might have been achieved, at less cost in social terms, had action been taken earlier.

In a general way, I think it would be a justifiable criticism that institutional shareholders have not been active enough in this respect and that, far from failing to support the companies of which they are major shareholders, they have if anything been insufficiently critical and insufficiently ready to exert their influence in a timely manner, so that drift in performance has tended to continue. Welcome as the relatively low gearing of British companies is in other respects, it does place on shareholders a bigger responsibility for oversight and influence than in situations where debt plays a larger role and bankers are thus more closely involved.

I think that the answer lies in building up critical mass in terms of a wider understanding and expectation in both industry and investing institutions that it is responsible behaviour for institutional shareholders to take a closer interest in the boards of their companies than has generally been the case in the past. I hope that the Task Force that has been set up under the president of the CBI will help to achieve something of a breakthrough in this respect.

As one specific initiative in this direction, a good deal of attention is being given to the possibility of introducing a code of best practice for listed companies which would commend a minimum proportion of independent directors on such boards and the introduction of audit committees. The code would not be mandatory, and I believe that more experience is needed, together with respect for entirely reasonable differences of view, before such provisions are introduced either as a condition of listing or as a statutory requirement in new companies legislation. But the introduction of a code of best practice would enable fund managers to pay particular attention to companies that did not comply with it—companies that would, so to speak, select themselves for attention and questioning. I hope that early progress will be made in the promulgation of such a code, and that fund managers will increasingly be able to use it as a means of exerting the right sort of leverage on their boards.

A second main area for initiative relates to disclosure and standards of financial accounting. The argument is now increasingly familiar that it is unsatisfactory for boards to complain about the perceived lack of institutional support for their future strategy when little or no indication of what this comprises is given to investors. Yet although there has been some progress in the last year or two, few directors' reports even now say much about what is being spent on innovation, whether in processes or products and through R and D or bought-in technology. I hope that early progress might be made by the Accounting Standards Committee and others toward a code of best or recommended practice and, eventually, a standard in this area, and that their efforts will have strong encouragement and support from institutional shareholders.

I choose my terms advisedly because I am concerned at the apparent lack of effective shareholder interest in improved disclosure and accounting standards more widely. The Bank was often told during the long debate on accounting for inflation that fund managers were only interested in historic cost accounts and would pay little attention to inflation adjustments, irrespective of precisely how these were done. Yet quite apart from disclosure in respect of innovation and inflation accounting (a debate that you will be relieved to know I do not seek to reopen here), there are several other major areas where it is much in the interest of shareholders that higher standards of reporting are achieved.

An important topical example is off-balance-sheet financing. The proliferation of sophisticated off-balance-sheet financing schemes calls into question the adequacy of the true and fair view shown in financial accounts where the view that is given is based on the form rather than the substance of a transaction. Although there is an important debate to be had whether the development of such financing is desirable or otherwise, my concern now is not to address this, any more than to argue for a particular level of expenditure on innovation. It is rather to urge that it is very unsatisfactory for proprietors not to be aware of the nature and extent of off-balance-sheet commitments or exposures that may be materially relevant to the valuation of their companies. Specifically, it is important that better disclosure be achieved and, in this context, it matters little whether a transaction is recorded on or off balance sheet provided that sufficient information is clearly disclosed in the notes to the accounts to enable the intelligent analyst to form a full appreciation of the extent of the company's financial position and obligations.

There are other areas for improved disclosure or standard setting where what is done, or not done, is of key relevance to the ability of analysts and fund managers to appraise listed companies. Merger accounting is a significant example where there are grounds for supposing that present conventions may make it possible for a company that has concluded a merger to give an unduly favourable impression of its subsequent progress in terms of earnings per share. To the extent that this is the case, it helps to explain the familiar phenomenon that companies that have achieved success through mergers have a strong inducement to undertake further mergers if they are to keep up their growth in terms of earnings per share. Any distortion of this kind would be mitigated if companies were called upon to account for the full value of the consideration, including goodwill, in a merger transaction.

Yet it is hard for those responsible for the establishment of standards on such matters to determine and allot priorities to this work without a clear indication of interest from major users of accounts. Institutional shareholders are most prominent among them but, on most such issues, you appear to be responsive rather than proactive. I believe accordingly that there is a case for much closer and more regular involvement between the investment committees and the Accounting Standards Committee. This would be a means of acquainting the ASC more fully with your concerns and their priority, and I believe that the encouragement that your declared interest and support would bring could significantly reinforce and accelerate the standard-setting process.

I have suggested areas for specific initiative by the investment committee and by fund managers and I believe that progress with these would be far more productive than any yield from continuing an oversimplified debate about short-termism. I also believe that determination on the part of fund managers to achieve progress on these fronts makes it more likely that the freedom of the environment in which you have the good fortune to operate will be upheld.