The investment case for better asset owner governance

"If you could wave a magic wand and get rid of all the barriers that stand between you/your fund and better organisation performance, how much do you think your fund performance would improve?"

– Keith Ambactsheer, 1994

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Introduction and overview

Institutional funds have a mission of building wealth for their stakeholders by generating risk-adjusted excess returns. **Governance** comprises the arrangements put in place to ensure that this outcome is defined and achieved.[1]

There is now general acknowledgement that effective governance plays an important role in the success of organisations. In this paper we set out to answer the question: how much is better governance worth to institutional funds?

We start by highlighting some of the theoretical thinking on the value of governance and point to some of the best, albeit thin, empirical data. We also explore some of the research evidence from behavioural economics as to the human biases that lead to sub-optimal decision making that poor governance is unable to overcome.

We then advance a general proposition – better governance leads to better risk-adjusted returns – without specifying how great the extra returns are. We argue that an organisation's expectations about the return to better governance will be based on its strength of belief in the general proposition and an impartial assessment of where it currently sits on the governance spectrum.

Taking these starting points, we go on to develop various plausible scenarios for the governance payoff and calculate the expected return to each. We illustrate that almost any plausible, well-directed investment in better governance has a very attractive payoff. To further emphasise that attractiveness, we compare investment in better governance with investment in traditional active management.

Finally, we conclude with brief case studies of four funds regarded as having top-class, fit-for-purpose governance arrangements.

Some history, data and theory

If you could wave a magic wand and get rid of all the barriers that stand between you/your fund and better organisation performance, how much do you think your fund performance would improve? That was a question that Keith Ambachtsheer and colleagues posed to 50 pension fund executives at a symposium in 1994.[2] The median response was 66 bps per annum (p.a.)

In 1997 Ambachtsheer and co-authors went on to conduct a deeper study of the relationship between performance and organisational design,[3] and in 2007 he suggested the return difference between a poorly governed and well-governed fund was likely in the range of 100 – 200 bps, but perhaps as much as 300 bps p.a.[4] Separate studies looking at Australian and Swiss pension funds[5,6] found positive empirical relationships between certain aspects of governance and performance.

Looking beyond the governance of investment funds, a number of studies have looked at the impact of governance on firm value for listed companies. The weight of academic research in this area suggests that quality of governance matters.[7] There seems little reason to doubt that the same would apply to institutional funds.

CEM Benchmarking[8] has measured the performance of pension funds for over 20 years. Importantly, because different funds have differing risk tolerances and therefore asset allocation, CEM focuses on measuring net value added relative to a fund's policy portfolio rather than absolute return. For the 10 years to the end of 2014, CEM has data on 127 funds who have been in their survey the full 10 years. The data show a gap between median and third quartile net value add of 31 bps (p.a.), while the gap between first and third quartiles was 58 bps, and between 10th and 90th centile was 142 bps. Over 20 years (sample size 47 funds) the respective gaps are 35 bps, 68 bps and 134 bps.

CEM does not measure the governance quality of funds that contribute to its survey, so we can't be definitive that a fund with long-term third quartile performance had better governance than one with first quartile performance. However, we might reasonably postulate that governance differences account for at least part of the gap.

So, how does better governance enhance returns? To start to address this question, we first turn it around: why does poor governance harm returns? Research has shown that humans are subject to a number of behavioural biases affecting how they invest. In aggregate these biases can significantly detract from value creation.

'Representativeness' is a form of behavioural bias that results in funds labelling investments (commonly investment managers) as good or bad based on their recent past performance. Consequently, funds invest more in those investments that have performed well, expecting them to continue to do so, and, conversely, divest from those that have done poorly.

Illustrating the significance of this bias, one study looking at stock market investors' historical returns found investors in the US equity market had underperformed the market average by 130 bps p.a. over the period 1926-2002. The study found a similar underperformance (150 bps) over 19 international markets for the period 1973-2004.[9] A follow-up study found an even more alarming result with respect to hedge funds[10]. There the research showed an underperformance of between 300 and 700 bps p.a. depending on specification and the time period used.

Besides representativeness, other common behavioural biases, which can be broadly divided into cognitive processing biases and emotional biases, include the following:[11]

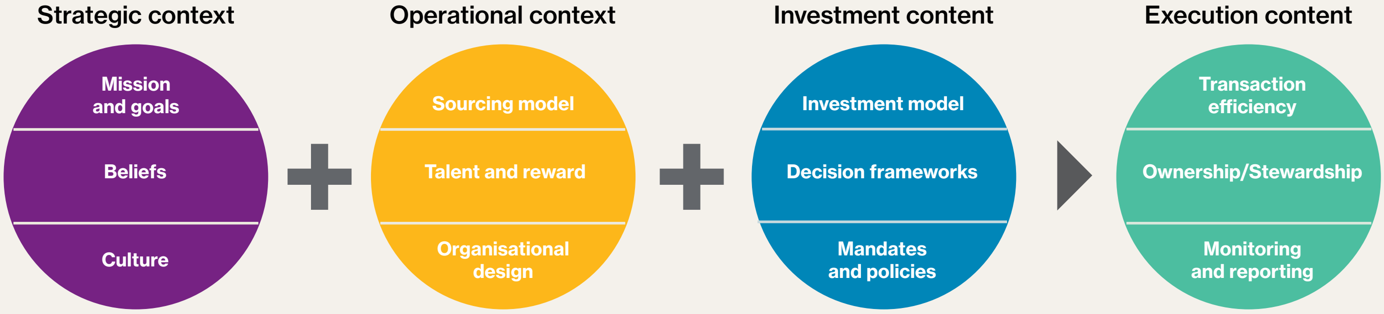
Investment decision making is largely undertaken in a context of uncertainty, probabilities, best estimates and complexity. In order to extract the fullest value out of these scenarios, a consistent structured approach is required.

- *Regret (loss) aversion*, which leads investors to not sell poor investments because to do so would confirm they have made a poor decision.
- *Familiarity,* which causes investors to have a preference for familiar investments despite obvious gains from diversification. Local and home biases are familiarity biases.
- *Anchoring,* which is the tendency to hold on to a belief or event and then apply it as a reference point for future decisions. So, for example, those who suffered financial damage during the financial crisis might view that period as more like the norm than the outlier event it was.
- *Trend-chasing,* which manifests in the mistaken belief that historical returns predict future returns.
- *Over-confidence,* by which people tend to over-estimate their skills, abilities and predictions for success. As Nobel Laureate Daniel Kahneman observed: "Overconfident professionals sincerely believe they have expertise, act as experts and look like experts. You will have to struggle to remind yourself that they may be in the grip of an illusion."[12]

Good governance, through the provision of consistent frameworks, processes and structures to decision making, is well set to counter both these forms of biases. Investment decision making is largely undertaken in a context of uncertainty, probabilities, best estimates and complexity. In order to extract the fullest value out of these scenarios, a consistent structured approach is required. Good governance can facilitate objective, logical analysis to mitigate human processing errors, and the policies and frameworks it puts in place can systematically limit the possibility of emotionally-interfered decision processes. As well as mitigating the downside effects of behavioural biases, good governance provides the foundational underpinning for investment strategies that allow successful investors to add value.

How is value created or destroyed?

We think assets owners create value in four broad areas:



Context	Value creation	Value destruction
Strategic	▪ Coherently mapping investment actions to goals and beliefs ▪ Staying the course ▪ Having a learning culture	▪ Goals that keep shifting ▪ Decisions that are inconsistent with beliefs ▪ Losing nerve ▪ Playing the 'blame game'
Operational	▪ Exploiting competitive advantages ▪ Having motivated staff aligned to maximise fund performance	▪ Mismatched skills and capabilities ▪ Lack of alignment and 'ownership' ▪ Inconsistency of approach
Investment	▪ Rigorous application of decision frameworks ▪ Diversification across multiple factors ▪ Effective delegation of responsibilities	▪ Sub-optimal asset allocation ▪ Poorly specified decision rules ▪ Unduly restrictive policies ▪ Missed opportunities
Execution	▪ A focus on execution ▪ Identifying new opportunities through positive feedback loops	▪ Chasing past returns ▪ Transactional inefficiency ▪ Missing warning signals

A general proposition and a matter of belief

So what is better governance worth? The truth is that it is hard to be definitive about the answer. Measurement is very difficult. If we had an objective score for governance recorded over many years then we might, in conjunction with data like CEM's, be able to answer the question definitively. But we don't. In a technical sense, we can't measure the precise value of improving governance because we can't run the same organisation in parallel over the same time period with differing levels of governance. In other terms, we lack a 'no change to governance' benchmark to measure against. Governance is an integrated component of how an investment fund functions and, therefore, isolating its effects entirely is impossible. However, we should try to measure its impact as best as we can.

Many leading funds have clearly articulated investment beliefs, and a number of those have an explicit belief about the importance of good governance...

We might, as a reasonable starting point, agree on a general proposition: better governance should lead to better risk-adjusted performance – at worst, it does not harm performance. In other words, it has a positive expected payoff. As to the size of that payoff: the conclusions of the various academics cited, together with CEM's long run data series, might give us some reasonable expected range.

Because the link between governance and performance is not conclusive, the degree to which better governance leads to better performance is best expressed as a matter of belief. We have previously written about the importance of investment beliefs:[13] indeed, we cite the existence of investment beliefs as one of the markers of best-practice governance. Many leading funds have clearly articulated investment beliefs, and a number of those have an explicit belief about the importance of good governance, for example:

CalPERS	CalPERS will be best positioned for success if it has strong governance
NZ Super Fund	Clear governance and decision-making structures that promote decisiveness, efficiency and accountability are effective and add value to the Fund
Railpen	Effective governance, leadership and strong culture are essential for a world-class investor
USS	High-quality governance and decision making are critical to success
OTPP	Good governance is good business and contributes to sustainable value
ABP	Good governance and corporate social responsibility are important
Cbus	Sound investment governance practices lead to better investment outcomes
AIMCO	Good governance has a return

Willis Towers Watson articulates its governance belief as follows: *Strong governance is critical, particularly given the fact that all investors delegate part of their arrangements to third parties.*

Importantly, belief that good governance has a positive payoff does not require precision as to the amount of that payoff. The amount of expected payoff will depend on: a) how strongly the belief is held by a particular organization, and b) an assessment of that organization's current state of governance.

This proposition and our subsequent analysis is founded on two sub-beliefs, namely:

1. Governance can be changed (although it often has significant inelasticity that needs to be snapped).
2. Attempting to improve governance won't make it worse. A target of what good or leading governance looks like provides a sufficient direction-of-travel to achieve a positive outcome.

Starting to measure: beliefs and governance

How strongly an organisation holds a belief about the value of governance will be a matter of some introspection. Different members of the board and the staff are likely to have different levels of acceptance of this proposition. As with other beliefs, the best way to arrive at an organisational belief about governance is through well-structured, deep debate about the merits of the belief – a process best referred to as 'settlement', because we should not expect perfect alignment on beliefs.

Organisations will also have their own inherent view of the quality of their governance. The danger with self-assessment in this area is the human tendency to be over-confident in one's own abilities.[14] Few funds will be willing to admit that they have below average governance, even though, definitionally, half must. Having said that, governance is context specific – a small fund with a simple passive portfolio will have considerably less sophisticated governance arrangements than a large one with complex private market investments.

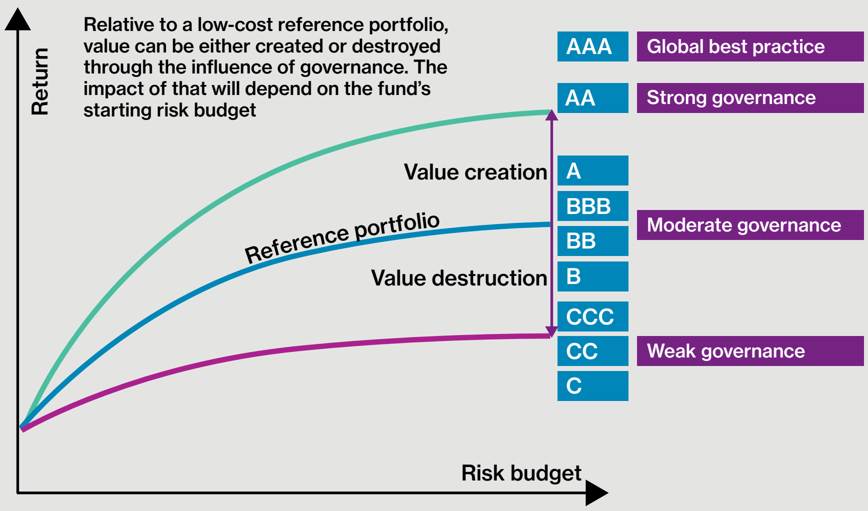
A dispassionate assessment of an organisation's current state of governance might draw on the landmark work of Oxford University's Professor Gordon Clark and Willis Towers Watson's Roger Urwin, who together looked at the governance attributes of best practice funds. Clark and Urwin identified 12 factors relevant to best-practice governance:

Relevant factor	A best-practice fund:
Mission clarity	Has clarity of its mission and the commitment of its stakeholders to the mission
Effective focusing of time	Resources each element in its investment process with an appropriate budget considering impact and required capabilities
Leadership	Shows leadership, particularly at the board/investment committee (IC) level, with the key roles being the board/IC Chair and the CEO/CIO (where present)
Strong beliefs	Has strong investment beliefs, commanding fund-wide support, that align with operational goals and inform all investment decision making
Risk budget framework	Frames its investment process by reference to a risk budget aligned to its goals and incorporates an accurate view of the sources of risk and return
Fit-for-purpose manager line-up	Makes effective use of its investment managers, is governed by clear mandates, aligned to goals and selected on fit-for-purpose criteria
Investment executive	Has a highly competent investment function tasked with clearly specified responsibilities, with clear accountabilities to the investment committee
Required competencies	Guides selection to its board and senior staff by: numeric skills, capacity for logical thinking and ability to think about risk in the probability domain
Effective compensation	Employs effective compensation practices to build bench strength and align actions to the mission, with different strategies working according to fund context
Competitive positioning	Frames its investment philosophy and process by reference to its comparative advantages and disadvantages
Real-time decisions	Uses decision-making systems that function in real-time not calendar-time
Learning organisation	Works as a learning culture, which deliberately encourages change and challenges the commonplace assumptions of the industry

Earlier we talked about inherent human biases that damage investment returns. A common feature of better governed funds is that they have organised themselves to counter these biases. They start by being very clear about their mission, their organisational strengths and their beliefs about what drives investment markets and returns. They have a highly competent board and executive; the latter builds very clear frameworks to guide their investment decision making and applies them under very clearly delegated authorities. They make decisions in real-time, able to respond to opportunities as they arise. Finally, they never assume they have investing fully worked out: they are always learning. In short, they score well across most of the factors in the Clark Urwin framework.

A governance ratings framework, developed at Willis Towers Watson, allows us to rank organisations' governance from C (very weak) to AAA (global best practice). Using this framework, we can help funds make a realistic assessment of how much improvement in their governance is within their grasp.

Figure 1. **Willis Towers Watson's governance rating framework**



With an assessment of how strongly the belief that governance adds value is held, an assessment of the current quality of governance and a target state for governance, we can begin to make some projections about the value to be added through governance enhancement.

The organisational rating system explained

Global best practice (AAA): This is best practice relative to an international peer group of successful institutional investors. Within this band, the fund has considered all of the 12 factors needed to have a successful governance structure within the fund. This attainment is extremely unusual.

Strong governance (AA): Strong governance indicates that the fund has implemented best practice or displayed successful governance across the majority of the 12 factors; however, there may be areas for improvement in one or two areas. This attainment is unusual.

Moderate governance (A-B): This is a moderate range of governance – the fund has considered most of the factors but hasn't implemented best practice across many of them. Within this level of governance there are areas of improvement, despite perhaps how different organisational areas will affect management of the fund, successful implementation is still lacking. There is an opportunity cost to this and even though it may not detrimentally affect fund performance, it will not enhance it. This attainment is relatively common.

Weak governance (CCC-C): This is a weak level of governance – the fund has considered some of the factors when implementing a governance structure, however, it is lacking in effectiveness or has not covered the primary/important areas which are needed for the management of the fund. Within this range, funds will find it harder over the long term to reach their objectives due to a lack of clear direction or oversight. Fund behaviours destroy value relative to a simple, low-cost alternative. This attainment is relatively common.

Given a belief that better governance will add value, and a clear sense for the direction of travel required, almost any effort to improve governance would be worthwhile.

Going from average to strong

Given a belief that better governance will add value, and a clear sense for the direction of travel required, almost any effort to improve governance would be worthwhile. Investment practitioners, though, like to quantify the expected return on any investment – and that is exactly how we should think of efforts to improve governance: as an investment.

As a starting scenario, we assume that governance is improved from Moderate (A/BBB) to Strong (AA) and that the net gain is 0.35% (35 bps) p.a.[15] That magnitude of gain is within the reach of most funds – think of it as aiming for a shift from median to top quartile performance. Of course, 0.35% is an arbitrary choice, but it is broadly (although somewhat conservatively) consistent with Ambachtsheer's conclusions and the CEM evidence.

For readers inclined to forecast a somewhat lesser or greater gain given their circumstances, we also provide (in brackets) outcomes at 10 bps and 70 bps.

Given our central assumption (35 bps), we can look at the cumulative value add from improved governance over time. To start, we take a fund whose projected net capital outflows exactly equal its existing investment income – ie, it will not grow over time. With an incremental return boost from improved governance the fund will grow by the expected return to governance, and this growth will compound through time.

A 35 bps improvement from governance translates to a little over $72m incremental value add per $1bn fund size over 20 years ($20m at 10 bps; $150m at 70 bps).

Of course, a dollar 20 years from now is not the same as one today. To adjust for this we can discount the cumulative values back to today's dollars. For illustration we use a discount rate of 5% p.a.

Even in today's terms a $1bn fund will be just over $27m better off if it institutes governance reforms worth 35 bps ($7.5m at 10 bps; $56m at 70 bps). A $25bn fund will of course be just over $680m better off. That is an extraordinary amount of value to be gained. Even if the $25bn fund is sceptical about the amount to be gained from better governance and assumed only a net gain of 10 bps p.a., it would be $190m better off in present value terms.

Now, if, rather than being stable, the fund is growing, the effects of compounding make the payoff to better governance even more compelling. If we assume that the same $25bn fund has no net capital inflows (or outflows) but grows at the rate of its investment earnings (let's assume 5% p.a. – the same as the discount rate) then it would be worth $1.7bn more in present value terms assuming 35 bps of incremental performance improvement ($480m at 10 bps; $3.5bn at 70 bps). To summarise:

Net present value of cumulative gains over 20 years

	Net gain from improved governance		
	10 bps p.a.	35 bps p.a.	70 bps p.a.
$1bn fund (no growth)	$7.6m	$27.3m	$56.4m
$1bn fund (5% p.a. growth)	$19.2m	$68.8m	$142.1m
$25bn fund (no growth)	$190.2m	$682.0m	$1,410.6m
$25bn fund (5% p.a. growth)	$480.5m	$1,720.5m	$3,553.1m

The investment payoff

The really attractive aspect of focusing on better governance is that it is a relatively inexpensive exercise to go through – at least in dollar terms (we explore some of the non-financial costs below). Our assumed $25bn fund aiming for a lift from Average to Strong (to achieve 35 bps p.a.) might spend in the range of 2-4 bps upfront to reconfigure its governance structure. The single-year expected payoff alone would be somewhere in the order of nine to 17 times the upfront investment. Looking at the present value of 20 years' worth of cumulative benefit, the expected payoff would be in the order of 68 to 136 times the upfront investment required. If we assume a growing fund, the payoffs are significantly higher.

Faced with this outcome – there is some (small) probability that you will not get your money but an upside potential in the range of 20-140 times your money back – most investors would jump at the chance.

Improving governance though is not a one-shot exercise. While a lot of work might be required upfront to reconfigure and deepen capabilities, and to align investment practices with organisational beliefs (and even to articulate those) and competitive edge, a best-practice organisation will work at constantly enhancing its governance through reference to emerging best-practice. A 2005 paper by Ambachtsheer et al., deduced (from CEM data) that top-performing funds were spending approximately 4 bps more on governance and oversight than bottom-performing funds.[16] In the examples above we talked about net gains to improved governance. The ongoing costs to better governance are, therefore, embedded within these net gains.

For argument's sake, though, we might assume that the worst case scenario is that there is no payoff to better governance, in which case the 2-4 bps spent on it is a lost investment. The range of expected payoff to governance for hypothetical fund is therefore somewhere between (say) -4 bps and +35 bps p.a. (or more, if belief in the value of governance is stronger or the organisation is in even worse shape).

If we accept, however, that the annual maintenance investment in better governance will at least be recovered and the expected return is net of those costs (ie, there is no downside), then the payoff on the upfront investment is truly staggering. Measuring 20 years of forward benefit, the costs of our organisation positioning itself to reap an expected 35 bps p.a. of benefits will be repaid nearly 70-fold. Even if only 10 bps improvement is achieved, the payoff is nearly 20 times the initial investment. And of course at 70 bps the payoff is more like 140 times.

Faced with this outcome – there is some (small) probability that the fund will not get its money back, but an upside potential in the range of 20-140 times its money back – most investors would jump at the chance.

[redacted]

[redacted] [redacted]

Comparing investment choices

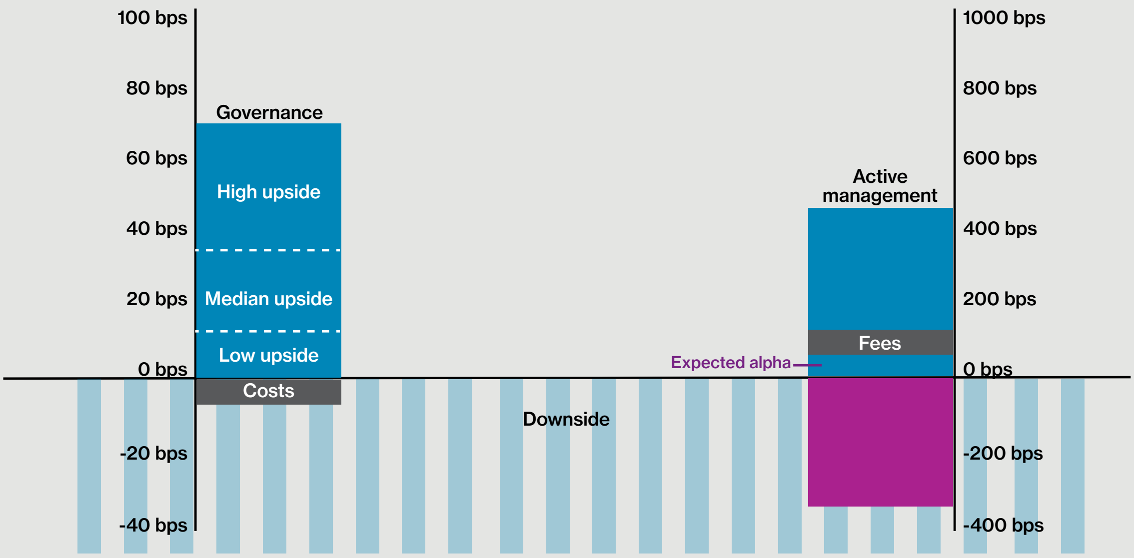
We can compare the expected cost/benefit outcome from improving governance with another activity common to investors. Many funds routinely spend a significant amount of time and money in the pursuit of active management. Consider this scenario for a typical fund investing in listed equity markets: it hires a portfolio of managers of varying geographies and styles, and has a portfolio with total active risk of 200 bps. For this it pays 40 bps p.a.

Mathematically, active management of listed equities is a zero sum game before fees.[17] It may be that active institutional managers make up a special subset of active managers who can, at the expense of fellow active investors, beat the market, but the evidence for this is thin. Nevertheless investors persist.

If our typical fund's managers could in aggregate produce a long-term gross information ratio of 0.50 (ie, one unit of return for every two units of active risk); this would not only be extremely impressive but would produce an annual gross alpha of 100 bps. Subtracting the 40 bps management fee would mean a net alpha of 60 bps p.a.[18] Active risk of 200 bps implies that the annual distribution of returns falls with a range of +/- 400 bps of this 95% of the time.[19] In other words, in any given year the outcome could be spectacularly good (+460 bps) – or spectacularly bad (-340 bps).

Figure 2 shows, in a rather stylised way, the respective payoffs for governance versus active management. Even taking a conservative view of the payoff to governance, the return for unit of governance expenditure is likely greater than the expected alpha under a relatively optimistic active management scenario. The likely payoff to governance grows depending on belief about its value and the current state of governance. While there is potential for significant upside under active management, it is matched by potential for downside – unlike governance where the downside potential is likely limited to the cost of its implementation.

Figure 2. **Governance vs active management (scaled for comparison)**



So why doesn't everyone do it?

If the investment case for better governance is so strong, why doesn't everyone do it? It's surely not a cost issue – as we have seen, financial costs to transform governance are relatively small in the context of other decisions that funds routinely make. The reasons are diverse: some funds are constrained by legislatively enshrined poor institutional structures or are burdened by competing multiple objectives; some lack the awareness to recognise that there are better governance models available, and some who are aware might simply not know where to start.

In many cases, the impediment is one or more of the human biases we identified earlier. Boards and executive staff may be overconfident in their assessment of their governance capabilities. They might regard themselves as above average and any evidence to the contrary dismissed as not fitting with their perception of reality. It is also tough for anyone to admit that they have not been doing as well as they thought they were. It's a brave incumbent CEO or CIO who volunteers to their board that better performance might actually lie in their (the CEO's) hands. The natural response might be: why haven't you been doing this all along? Similarly, boards find it difficult to be this self-critical (and it's difficult for executives to be too critical of the board).

...discomfort represents a necessary, albeit not sufficient, condition of success.

Often then, some catalyst is required: an extended period of poor performance; change in senior management; or change within the board, particularly the chair. These catalysts provide an opportunity for a full and frank assessment of the state of governance and a rigorous evaluation of the gaps between existing governance and best practice together with a roadmap of how to bridge the gaps.

It's not an easy process though. The financial cost of better governance might be relatively low but the mental costs are not necessarily so. Boards and executives have to commit to a structured, continuous programme of improvement. This will bring in new, challenging ways of doing things. It's not as exciting as investing and it may require significant culture change in how decisions are made. As David Swenson, long-time CIO of Yale's Investment Office, has said: "discomfort represents a necessary, albeit not sufficient, condition of success."[20]

In our view, the case for continually improving how funds are managed holds through any environment. At a time when investors are faced with historically low expected returns, the case seems overwhelming.

Four case studies

To illustrate the positive payoffs to good governance, we outline below four best-practice funds. All, in one way or another, are poster children for how to effectively run a long-term fund. They represent a mixture of purposes (pensions, endowments and sovereign wealth), a mixture of operating models (largely outsourced to largely insourced, very active to relatively passive) and a mixture of size (USD20bn to USD130bn).

There is, of course, selection bias in our choice of the four but they all have the benefit of at least 10 years published performance history and are clear about their objectives, beliefs and operating model.

Ontario Teachers' Pension Plan (OTPP)

OTPP, responsible for investing and administering the plan assets for over 300,000 current and retired teachers and their survivors, manages assets in excess of CAD170bn. It is acknowledged as the pioneer of the Canadian Model, the principle attributes of which include:

- Strong governance and executive functions
- Investment practices based on sound principles
- In-house professional teams that achieve economies of scale for investing and the administration of benefits
- Responsibility to deliver superior returns to members
- The ability to attract and retain top investment professionals

The fund has a well-diversified portfolio of assets including significant investments in natural resources, infrastructure, real estate and private equity. Since its inception as an independent entity in 1990, OTPP has generated a net (of fees) return of 10.3% p.a., well above its benchmark return of 8.1%. That difference amounts to a staggering CAD35.6bn of value added.[21]

Yale Endowment (Yale)

Totalling over USD25bn, the Yale Endowment contains thousands of funds with various purposes and restrictions. The vast bulk of these are gifts by donors to provide long-term funding for designated purposes. The individual funds are commingled together and tracked with unit pricing much like a mutual fund.

Led for over 25 years by David Swenson, Yale has been a pioneer in multi-asset class investing – indeed Swenson authored one of the seminal books on institutional investing: *Pioneering Portfolio Management - An Unconventional Approach to Institutional Investment*. Yale's portfolio has very significant exposures to private equity (32.5%), real estate (14.0%), absolute return (20.5%) and natural resources (6.7%), with only modest exposures to traditional listed equity and bond asset classes.

In the 2000s particularly, it was fashionable for many funds to attempt to replicate the Yale model with a significant shift towards alternative assets. The power of the Yale model, though, lies in much more than its asset allocation. All but Yale's bond exposures are managed through an extensive array of external managers. Yale's relatively small internal investment team focuses on asset allocation and manager selection for which it conducts extensive and deep due diligence drawing on its unparalleled industry contacts. It does all this according to a deeply held, and consistently applied, set of beliefs as to how to manage money.

In the 10 years to June 2015, Yale earned an annualised net of fee return of 10%. Relative to its passive benchmark, that return generated an additional USD6.8bn for the university. Relative to the broad universe of college and university endowments, Yale generated USD8.0bn of additional value.[22]

New Zealand Superannuation Fund (NZ Super)

NZ Super was established in 2002 to help smooth out the forecast rise in fiscal costs of New Zealand's universal pension system. A single purpose entity was established to manage the fund on a prudent and commercial basis in a manner consistent with best-practice portfolio management, maximising return without undue risk to the fund as a whole – and avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

NZ Super has a board of between five to seven members appointed for their expertise in the management of financial assets who serve for total terms of up to 10 years. The fund's board has always taken the statutory best-practice requirement very seriously and, consequently, NZ Super puts a lot of effort into benchmarking its practice against those of leading peers through frequent and in-depth dialogue.

NZ Super uses a reference portfolio approach and all prospective investments are judged on the contribution they will make to the fund as a whole – if they add to the prospective risk-adjusted return of the fund they are eligible to be included. The fund does not have fixed allocations to asset classes and prefers to work with risk, rather than capital, allocation decisions. NZ Super articulates a clear operating model, which favours getting as close as possible to the investments it makes. They also have a clearly stated set of beliefs that anchor all investment decisions.

Since it started investing in late 2003, the now NZD30bn fund has generated an annualised net of fees return of 9.6%, well in excess of its reference portfolio benchmark of 8.3% and its long-run performance expectation of 6.9%. The excess return relative to the reference portfolio is estimated to have added NZD4.4bn to the fund.[23]

Arbejdsmarkedets Tillægspension (ATP)

Established in 1964, Denmark's ATP now ranks as one of the best pension providers in Europe. As well as investing assets on behalf of the ATP Lifelong Pension, ATP also administers a number of labour market, social security and welfare schemes.

ATP is widely acknowledged as an industry innovator. Having been an early, and enthusiastic, proponent of alpha and beta separation, ATP has now come to the view that most alpha is a form of smart beta. Accordingly, where it previously organised itself into separate alpha and beta teams, it now has combined those back into one.

Over the past decade, ATP's investment strategy has been to allocate on the basis of risk rather than capital. Each investment was allocated to one of five risk classes (commodities, inflation, credit, equities, interest rates). The advantage of this is that risk diversification and management are improved. Starting in 2016, ATP has modified its approach. Now all assets are decomposed into one of four risk factors (interest rates, inflation, equity, other). A single asset might include all four factors.

Organisationally, ATP's Pensions & Investments division consolidates asset management, actuarial tasks and risk management. Their view is that this achieves a better perspective, synergy, and added dynamics and efficiency across the various business areas while providing a common platform for managing both assets and liabilities.

Over the past 10 years ATP's returns (before taxes and costs) have averaged just over 11.5% p.a. The NOK705bn fund's annual investment expenses were just 0.19% in 2015, reflecting both the degree to which it manages assets in-house and its concentration on harvesting systematic risk premia rather than alpha.[24]

Conclusion

We believe the investment case for improving governance is, for most funds, overwhelming. By integrating how strongly they believe in the proposition that improved governance adds value with an objective assessment of where they currently sit in terms of best governance practices, funds can develop a strong business case to undertake a governance strengthening exercise.

Willis Towers Watson works with leading asset owners around the world to help them identify the strengths and weaknesses of their governance arrangements and to implement change programs to enhance them.

Further information

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Endnotes

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4 *Pension revolution: A solution to the pensions crisis,* (Chapter 19), Ambachtsheer, 2007
5 *Governance and Performance of Private Pension Funds*: Australian Evidence, Liu, 2014
6 *Performance and Governance of Swiss Pension Funds*, Ammann and Zingg, 2008
7 *See The Value of Governance*, Anand, 2013, for a summary
8 http://www.cembenchmarking.com/
9 *What are stock investors' actual historical returns?* Dichev, 2004
10 *Higher risk, lower returns: What hedge fund investors really earn*, Dichev & Yu, 2010
11 For a good summary, see *How Biases Affect Investor Behaviour*, Baker & Ricciardi, 2014
12 *Don't Blink! The Hazards of Confidence*, Kahneman, *The New York Times,* 2011
13 *Towers Watson Perspectives: The Importance of Beliefs*, 2011
14 See, for example, Ricciardi, 2008. The overconfidence bias was effectively popularised up by Garrison Keiller in his Prairie Home Companion radio show when he talked about Lake Wobegon, '*where all the women are strong, all the men are good-looking, and all the children are above average*.'
15 Note that this is consistent with the median to top quartile gap in the 20-year CEM data
16 See *The Pension Governance Deficit: Still With Us*, Ambachtsheer et al., 2005, in which the authors deduced (from CEM data) that top-performing funds were spending approximately 4 bps more on governance and oversight than bottom performing funds.
17 If in doubt about this, see *The Arithmetic of Active Management,* by Nobel Laureate Bill Sharpe, https://web.stanford.edu/~wfsharpe/art/active/active.htm
18 For an indication of how challenging this is, consider that upper quartile net performance amongst the 10-year funds in CEM's database is 45 bps. Over 20-years, it is 51 bps
19 Assuming a normal distribution of expected alpha
20 *Pioneering Portfolio Management: An Unconventional Approach to Institution Investment*
21 All data as at 31 Dec 2015 and sourced from *Teachers' at a Glance*, www.otpp.com
22 http://investments.yale.edu/images/documents/Yale_Endowment_15.pdf
23 All data as at 31 May 2016 from www.nzsuperfund.co.nz
24 All data as at 31 December 2015 from https://www.atp.dk/

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