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Canterbury Christ Church University

# Governance duties of agents in outsourced funds management of UK pensions

by

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Canterbury Christ Church University

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Degree of Doctor of Philosophy

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## Author's declaration

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# Abstract

# Governance duties of agents in outsourced funds management of UK pensions

The aim of the thesis is to investigate whether the corporate governance of professional pension fund managers supports outsourced funds management for the UK pensions industry; significant as the largest client of the UK financial services industry with over £2 trillion in assets under management (Godfrey, 2014). The study examines fund manager corporate governance from the perspective of agency theory. The thesis proposes that pension fund managers, some of the largest corporate entities globally, exhibit the same corporate governance induced behaviour as corporate entities in the real economy. Where governed in fiduciary for shareholder wealth maximisation, this may conflict with the agency duty of best interests to a pension client. The post-positivist methodology examined two aspects of pension asset management: 1) relationships between the size of pension assets per member and the corporate governance characteristics of the fund manager appointed; and 2) the perceptions of whether this governance concerns pension trustees, including the perception of whether a fiduciary duty was owed to the client, under the trajectory of regulatory and case law reviewing pension trusts' fiduciary relationship with fund managers. These analyses found a statistically significant relationship between the corporate entity of the fund manager and the size of the assets of the pension scheme assets they manage. It also revealed a convoluted and contradictory expression of the fiduciary duties owed to pension clients by pension trustees, law courts, and regulators. With the Financial Conduct Authority's imminent review of the asset management industry, the study contributes a comprehensive assessment of this potentially fiduciary agency relationship, being both timely and relevant to the financial industry reform agenda in academia, policy and regulation.

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# Terms

Adapted from The Pensions Regulator (2016)[1]

**Absolute return**

An investment policy/strategy that aims to give the same return regardless of market conditions. The return should not rise or fall in line with UK equities, but will often offer a fixed percentage above bank rates, inflation or other objective measure. See also: targeted return.

**Active fund management**

The management of assets (eg equities, gilts) in which the skill of the fund manager is used to select particular stocks at particular times, with the aim of achieving higher than average growth for the assets in question.

See also: passive fund management.

**Active member**

A member of an occupational pension scheme who is at present accruing benefits under that scheme in respect of current service.

**Alpha**

Returns on a portfolio which exceed those indicated by movements in the index for the asset class in question.

Usually alpha is achieved by appointing fund managers with specific skills in selecting the asset in question which will allow for these excess returns.

See also: beta.

[1] http://www.thepensionsregulator.gov.uk/glossary.aspx

**Benchmark**

A measure against which fund management performance is to be judged. A series of appropriate indices is chosen which reflects the requirements of the trustees. Usually a target is set which requires an agreed percentage better performance from the fund manager than the benchmark.

**Beneficiary**

A member of a pension scheme who is entitled to a benefit from the scheme or a dependant who will become entitled on the death of the member.

**Beta**

Returns on a portfolio which can be attributed to movements in the market as a whole, rather than the skills of a particular fund manager. Usually achieved by holding a portfolio which exactly mirrors a particular index, eg the FTSE 350.

**Breach of trust**

Any act or omission on the part of the trustee that is inconsistent with the terms of the trust agreement or the law of trusts.

**Capital markets**

The markets in which capital is raised initially through the issue of shares (equities) and loans (bonds) and then subsequently traded. The stock market (dealing with the trading of equities) forms a significant, but by no means only, part of the capital market.

**Closed scheme**

A pension scheme which does not admit new members. Contributions may or may not continue and benefits may or may not be provided for future service.

**Conflicts of interest**

A conflict, for example, between:

- a trustee's interest as an employee, eg financial director, and his or her duty as a trustee
- the duty of a professional to the employer as well as to the trustees, where they are acting for both

**DB scheme: Defined benefit scheme.**

A scheme in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring, and the length of pensionable service.

Also known as 'final salary' or 'salary-related' scheme.

**DC scheme: Defined contribution scheme.**

A scheme in which a member's benefits are determined by the value of the pension fund at retirement. The fund, in turn, is determined by the contributions paid into it in respect of that member, and any investment returns.

Also known as 'money purchase' scheme.

**Deferred member**

A member entitled to a deferred pension (sometimes known as 'preserved benefits').

**Deferred pension**

A benefit relating to the past service of members of an occupational pension scheme who are no longer active members but have not yet retired. The benefits are payable at retirement or earlier death.

**Deficit**

The amount by which a scheme's liabilities exceed its assets.

**Engagement letters**

Used by accountants, investment banks and other advisers to set out the terms under which they are giving advice, they are now used by a wide range of advisers and suppliers. The precise form of the document will vary greatly depending on which type of adviser you are appointing. There are statutory requirements prescribing how scheme actuaries and scheme auditors must be appointed, and also the professional bodies that regulate your advisers will have their own requirements.

Usually drawn up by the adviser in question, the document should reflect everything you have agreed with your adviser including their liability limit, agreed fees and charges, their conflict of interest policy and arrangements for terminating their appointment.

Also known as: terms of appointment, letter of engagement, letter of appointment, signed agreement, contract.

**Financial Conduct Authority (FCA)**

On 1 April 2013 the Financial Services Authority (FSA) split into two regulatory bodies - the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

The FCA is responsible for regulating the standards of conduct in retail and wholesale, financial markets and for supervising the infrastructure that supports those markets. The FCA also has responsibility for the prudential regulation of firms that are not regulated by the PRA.

**Fixed interest**

A generic term covering all investments which pay interest at a pre-agreed rate for a fixed term, including corporate bonds, gilts and index-linked gilts.

**FSA: Financial Services Act**

This act, passed in 2012, sets out the framework under which the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) operate[2].

**Fund manager**

An individual (or company) to whom the trustees delegate the management of all or part of the scheme's assets.

Also known as investment manager or asset manager.

**Independent trustee**

An individual or company which performs the duties of the trustee but has no other direct or indirect involvement with the pension scheme or its advisers, the sponsoring employer or the members.

[2] Differentiated from the Financial Services and Markets Act 2000 (Available at: http://www.legislation.gov.uk/ukpga/2000/8/introduction). According to the Pension Regulator, the Financial Services and Markets Act was "passed in 2000, sets out the framework under which the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) operate." (Available at: http://www.thepensionsregulator.gov.uk/glossary.aspx (accessed 24 April 2017)).

The regulator may appoint an independent trustee to an occupational pension scheme, where an insolvency practitioner has been appointed to the employer.

**Investment management agreement**

The document agreed between a fund manager and the trustees of a scheme setting out the basis upon which the fund manager will manage a portfolio of investments for the trustees

**Mandate**

That part of the investment management agreement which stipulates the target return and covers such matters as the proportion of the assets in question which may be invested in different sectors/geographical areas/fixed interest/equities/property (a constrained mandate). Alternatively, it may go so far as to offer the manager total discretion about how to achieve the target (an unconstrained mandate).

**Member**

A person who has been admitted to membership of a pension scheme and is entitled to benefit under that scheme.

Sometimes narrowly used to refer only to an active member.

See also: active member; deferred member; pensioner.

**Passive fund management**

The management of assets, eg equities, gilts, by holding an exact replica of a given index, eg FTSE100, FTSE350, with the result that the assets in question move exactly in line with the chosen index.

See also: active fund management.

**Pension Protection Fund (PPF)**

Established to pay compensation to members of eligible defined benefit pension schemes, whose sponsoring employers become insolvent. The PPF is funded by a levy on all eligible DB schemes.

The PPF became operational on 6 April 2005.

**Pensioner**

A person who is currently receiving a pension from a pension scheme.

**Preserved benefits**

Benefits arising on an individual ceasing to be an active member of an occupational pension scheme, payable at a later date (eg a member who leaves that employment before retirement date).

**Prudential Regulation Authority (PRA)**

On 1 April 2013 the Financial Services Authority (FSA) split into two regulatory bodies - the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

The PRA is responsible for the authorisation, in conjunction with the FCA, and prudential supervision of individual deposit takers (including banks, building societies and credit unions), insurers (including friendly societies) and certain designated investment firms[3].

[3] See definition of FSA 2012, there is conflicting information published by the Pensions Regulator regarding their role and supervision under the FSMA Act 2002 and the FSA Act 2012. According to the Parliamentary Legislator, the prior Act was considerably amended by the FSA Act 2012 by the Bank of England to outline the objectives of the newly formed FCA (Financial Conduct Authority) and PRA (Prudential Regulation Authority) http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted (Accessed 24 April 2017)

**Real returns**

The difference between the rate of return of an investment and a selected measure of inflation (eg. RPI) over the same period.

**Returns**

The amount by which an investor benefits from owning an asset (interest, dividends and any change in value less any charges levied).

See also: real returns, wealth capture

**Risk premium**

The extra yield of an investment (over the gilt yield) demanded by investors to compensate them for the higher risk. Sometimes used in the calculation of expected investment returns on equities, when selecting an assumption for the discount rate.

**Sponsoring employer**

The employer with responsibility for meeting the liabilities of a DB pension scheme.

In DC schemes, typically the employer who sets up and/or assumes responsibility for the running of the scheme, and meets the expenses.

**SRI: Socially responsible investment.**

Investments that comply with any social, environmental and ethical principles which may be adopted by the trustees.

Occupational pension schemes are required to disclose the extent to which, if at all, social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.

**Statutory funding objective**

The requirement for an ongoing scheme to have sufficient and appropriate assets to cover its technical provisions, or a recovery plan to reach that position.

**Statutory objectives**

The three specific objectives set for The Pensions Regulator in the Pensions Act 2004:

1. to protect the benefits of members of work-based pension schemes
2. to promote good administration of work-based pension schemes
3. to reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund

**Strategic investment**

Carried out by trustees as part of the preparation of their SIP, it is the practice of making long term decisions on asset allocation so that they are able to pay pension benefits as they fall due.

Also called Liability Driven Investing

**Targeted return**

A particular absolute return agreed between the trustees and the fund manager.

Also called relative return.  See also: absolute return.

**Traffic light principle**

The Pensions Regulator's principle to help trustees decide whether a breach of the law is serious enough to report ('of material significance').

A breach is in the red category when:

1. it is caused by dishonesty, deliberate contravention of the law, poor advice, or poor scheme governance;
2. it is significant;
3. steps are not being taken to put it right; and
4. it has wider implications.

'Amber' breaches are harder to define as they fall in between red and green. They might consist of several failures of administration that, although not significant in themselves, have a cumulative significance because steps are not taken to put things right.

'Green' breaches are those that are not caused deliberately or dishonestly, or by poor governance or poor advice; they are not significant, steps are being taken to put them right, and they don't have wider implications.

**Trust corporation**

A company empowered under trust law to act as a custodian for scheme assets and which is expected to provide professional expertise in managing trusts.

**Trustee**

An individual or company appointed to carry out the purposes of a trust in accordance with the provisions of the trust instrument and general principles of trust law.

**Wealth capture**

The amount of targeted, or relative return withheld by the manager of assets for services provided that detach the targeted return from the risk premium paid by the owner of assets.

See the statutory objectives for contemplation of a conflict of interest in the instance that wealth capture is too great.

# Chapter 1
# Introduction

## 1.1 Context of the thesis

> *"*The maintenance of old age has hitherto been a private, not a public charge. The proposal to alter this is more than an amendment to the Poor Law. It is a proposal to alter a fundamental principle of society*."*
> (Hon. Sec. T. Mackay 1892; cited in Harris, 2006; p51)

This research thesis examines the governance of the fund managers stewarding contributed pension funds in the United Kingdom (UK). Altering the fundamental principle (above) of the universal right to retirement security in 1948 handed a very real problem to modern day government; delivering a retirement pension as a non-optional, vastly expensive commitment to an aging population (Blackburn, 2006). Throughout the European Union the conflict between recognition of the sanctity of this social protection and its fiscal consequences has led to substantial legislative reform (Dale, 2012). In light of the magnitude of the modern retirement problem, this thesis explores the outsourcing implications of the UK's subsequent statutory shift (back) to private sector apparatus for a retirement solution. It examines whether there is evidence that this apparatus of outsourced suppliers provide corporate governance systems that protect the contributed assets of both working and retired members; one its constituents consider an economically efficient and socially justifiable return on contributed assets at a fair price as a fiduciary duty, were it to be found existing, would imply.

### 1.1.1 Why the pension industry is socially vital

The synopsis of the pension problem is rudimentary. In the mid-twentieth century, with life expectancy less than 60 years of age, few people drew the state pension at age 65, and only on average for a short period of time (Barr, 2006). By 1970 men spent an average of 10 years in retirement, rising to approximately 20 years in 2004 (Barr, 2006). The UK population aged over 65 is already 15% of total population, and projected to rise to 24% by 2032 (Blackburn, 2006). Simultaneously there are fewer young people, the pension pool's future contributors, and the population of those aged 20-64 is projected to continue its steep decline (Barr, 2006). Economist Paul Krugman describes the pension crisis as "an immense problem that requires changing everything" (Krugman, 2005; p11), and the World Bank concurs calling it unsustainable (Petraki, 2012).

At inception in the mid twentieth century the projected impact of state pensions on the public purse did not anticipate these seismic demographic shifts, and Anglo-American governments have reacted with various reforms such as increasing the statutory retirement age, reducing entitlements and decreasing tax incentives (Dale, 2012; Hannah, 2002). However, the most significant reform came in the 1980s when the Thatcher government scaled back the state pension, intending that the workforce should utilise private sector financial products to secure anything above a subsistence retirement income (Orenstein, 2011). Responsibility for pension delivery was firmly shifted from the public sphere to individual savings managed by the finance industry.

Employer or industry sponsored pension trusts were established from this time to support the financial objectives of their employees.  Pension scholar Robert Monks (2002b; p116) observes that these trusts have:

> *…*a simple obligation to collateralise the pension promise by maximising the long-term value of trust assets.  The importance of appropriate fiduciary management of these contributions cannot be overstated.  The beneficiaries of pension funds are not rich people.  Fluctuations in market values are no longer primarily a question as to whether rich people are a bit richer or poorer, they are a question as to whether pensions will be paid to the roughly half of the population of the OECD world who have interests in employee benefit plans.  This makes investment a matter of social and political concern.

In order to fulfil this fiduciary obligation, the majority of pension schemes outsource their contributed assets to institutional investors in the finance sector with the expertise to maximise the long-term value of pension assets and match forecast liabilities (Ingley and van der Walt, 2004).  The rise of institutional investors (such as fund managers) servicing the pension industry is a contemporary phenomenon as incorporated entities have taken charge of pension asset management in an outsourced capacity (O'Brien, 2004).  These fund managers comprise some of the largest listed corporations in the world (Ingley and van der Walt, 2004).  Now pension funds represent 36% of the total assets managed by the finance industry, making them the largest client of the industry, well ahead of second placed client, the insurance industry (accounting for 20% of assets) (Godfrey, 2014). There are approximately £2 trillion in UK workforce assets currently managed by fund management firms (Godfrey, 2014). This immense pool of wealth is reliant on the finance industry to fulfil a stewardship role. In a short period of time the promise of a pension has transformed workforce protection from a government commitment to the largest client of the finance industry.

### 1.1.2 Corporate governance in the finance industry is significant to the pension solution

In the collapse of the New York Stock Exchange in 1929 many family investors were bankrupted by exposure to corporate risk through financial illiteracy (White, 1990). Consequently, listed corporations have received increased scrutiny and corporate governance has become entrenched in economic, accounting and corporate legal research, policy and practice (Ramirez, 2012; Reich-Graefe, 2011a). The codified Anglo-American understanding of corporate governance is that corporations should be managed by an agent (management) in the fiduciary best interest of their principal (shareholder owners, although this ownership concept is debated), widely interpreted as the maximisation of returns on the shareholders' invested assets (Purnell and Freeman, 2012; Arcot and Bruno, 2006; Waring, 2006; Bratton, 2001). This code applies equally to any publicly listed institutional investor managing pension funds. The thesis explores whether in contrast with their codified fiduciary shareholder duties, the fiduciary obligations institutional investors owe to protect pension assets seem currently disjointed and ambiguous in legal, practice and academic fields. Two economic systems (corporate governance codification and pension privatisation) that were formed separately for decades have quickly and contemporarily become inextricably linked. Waring (2006) describes institutional investors as guardians of the investing public with fiduciary duties to these beneficiaries. This social dependence raises the question over whether the finance industry and managers of financial firms have a different role or special obligations not owed by managers of firms in other industries (Ryan et al., 2010). With the deregulation of the pensions industry and demutualisation of the savings industry great power to control society's wealth shifted to the finance industry (Sparkes, 2010). Workforce pensions are exposed to fund manager governance compliance towards their shareholders. The Law Commission Review (LCR, 2013) exhorts that pension investments are in important need of fiduciary clarification. The Financial Conduct Authority is currently examining whether fund management fees are justifiable (FCA, 2015). This thesis concentrates on the fiduciary management of pension savings, specifically their access to fiduciary agency from institutional fund managers to comment on its adequacy for purpose.

## 1.2 The aim of the thesis: Contributing to pension governance research, policy and practice

The aim of the thesis is to investigate whether the corporate governance of professional fund managers with pension clients share a relationship with asset management outcomes for the UK pensions industry. It proposes to achieve this aim through a set of four research objectives.

### 1.2.1 Research objectives

The research is designed to achieve its aim through the following objectives:

1) To describe the various corporate governance structures of the professional fund managers with UK pension clients;

2) To investigate whether different corporate governance characteristics of professional fund managers relate with characteristics of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations;

3) To investigate whether pension clients perceive that the corporate governance of the fund manager matters to the governance of asset management for their beneficiaries; and

4) To determine whether pension clients believe the fiduciary duties of professional fund managers conflict with the delivery of outsourced asset management.

The objectives were developed through the literature explored in Chapters 2 and 3. The research design adopts a post-positivist research methodology (described in Chapter 5) that acknowledges reality cannot be measured with certainty and all theories are revisable (Ryan, 2006) particularly in the social sciences where the falsifiability of more traditional science is more challenging (Popper,1934). In order to describe the agency of fund management in the UK meeting the requirements of post-positivist theory testing, the thesis analyses two aspects of the fiduciary agency relationship. The first examines results of the 2013 pension scheme assets under management correlated with corporate governance characteristics of the fund manager appointed. The second surveys the fund manager selection techniques of pension trustees, including the perception of the fiduciary duty, if any, the fund manager owes the client. This is accomplished in the context of examining the regulatory and case law assessment of fiduciary agency owed by fund managers to the pension industry. Combining these sets of analysis provides a comprehensive view of this agency relationship from an empirical and stakeholder perspective. This thesis contributes to the current conception of the need for urgent financial industry reform in academia, policy and regulation. From the practical perspective it contributes to efforts to optimise fund manager selection frameworks.

## 1.3 Research rationale

To illustrate the timeliness of the thesis, the convergence of an aging population and pension deregulation are reiterated. Alongside the increase in longevity, the combined effect of a post-war baby boom and subsequent collapse in fecundity in recent decades will see the population aged over 65 rise by 20% in the Anglo-American economies over the next twenty years (Blackburn, 2006). Retirees are more numerous and living longer, with fewer young people entering the workforce to perpetuate pension contributions. This demographic shift prompted one of the most profound changes to the finance industry in modern times.

In October 1986 the Thatcher government deregulated the finance industry in the UK (Davies et al., 2010). It marked several important changes in the industry, among them the deregulation of state based pension plans. Tony Greenham observed:

> "It marked a sudden and significant increase in capital alongside an industry shift from a client-based to a transaction-based business model, potentially rife with short-termism and conflict of interest implications."[4]

This presented a challenge to the newly conceived finance industry in establishing their responsibility for pension management. Should it be that the industry: 1) use their new inter-temporal role as pension custodians to deliver adequate returns on investment to achieve retirement for members today while protecting the savings contributions of future generations (Monks, 2002a); 2) use their new role as institutional investors with vast capital at their disposal to influence the long term sustainable value creation activity of the entities in which they are invested (Sparkes and Cowton, 2004); or 3) fulfil their traditional role as institutions with shareholders of their own, to protect and serve the interests of their shareholders as fiduciaries with duties to the commonly understood owners of the corporation (Bebchuk and Weisbach, 2010)?

The Law Commission (2013) defines duties as they apply to employer control over intermediaries as "…the ultimate decision makers in appointing contract-

[4] Tony Greenham, Founder of the New Economics Think Tank, (Stewart and Goodley, 2011; p1).

based workplace pension schemes providers, employers have a responsibility to put in place pension arrangements that offer value for money and act in the scheme members' best interests." (Simpson, 2014; p1). With no clear regulatory guidance on their new role forthcoming, the investment industry has been left to create its own narrative, one that some commentators have characterised as avaricious and opportunistic (Graafland, 2012; Salter, 2010; Augur, 2009). In 1992 the United Nations Environment Programme Finance Initiative was established, working with the global finance industry to understand their responsibility to consider environmental, social and governance (ESG) factors when directing capital (UNEP FI, 2015). In 2005, law firm Freshfields Bruckhaus and Deringer comprehensively reported to the UNEP FI that it is within the fiduciary remit of pension trustees to apply ESG considerations to asset selection, rather than the previously held doctrine of returns maximisation alone.[5] (Freshfields et al., 2005).

As the Freshfields et al. (2005) review highlighted, pension trusts have legal and court appointed fiduciary duties (Richardson, 2011; Freshfields et al., 2005). Berle and Means (1932; p336) described the essence of these duties:

> Taking this doctrine back into the womb of equity, whence it sprang, the foundation becomes plain. Wherever one man or a group of men entrusted another man or group with the management of property, the second group became fiduciaries. As such they were obliged to act

[5] Landmark case Cowen v. Scargill is discussed in chapter 3.

> conscionably, which meant in fidelity to the interests of the persons whose wealth they had undertaken to handle.

The fiduciary obligation demands pension trusts undertake to invest member contributions with attention, expertise and care (Pacces, 2000). To fulfil this duty, the majority believe it best to outsource their assets to corporate intermediary experts of the finance sector. These contractual relationships exhibit typical principal-agent characteristics, where the principal lacks the expertise to carry out a task and enlists the agent with relevant expertise to act on their behalf (Eisenhardt, 1989). The law of agency confers strong commitments on the agent to protect the principal and avoid using their advantageous position to the principal's detriment (Lan and Heracleous, 2010).

Yet the fiduciary duty Berle and Means described was that to external shareholders. Fund managers are a heterogeneous group of investors, from small partnerships to the largest listed organisations globally (Ingley and van der Walt, 2004). Juntunen (2007) believes the landscape is shifting: "…the ownership structure of many consultancies changed from partnerships to corporates where the goal is to boost shareholder assets". This confronts the issue of conflicts of interest, and whether corporates are appropriately neutral to be financial intermediaries.

In the behavioural analysis of capital channelling Franklin Allen (2001, p1165) asks "do financial institutions matter?" Financial intermediation theory assumes investors enter the market directly, incurring market-induced transaction costs for channelling pooled savings through the banking industry as borrowing and lending, or through the stock and commodities markets as investment in assets (Levine, 2002). The finance industry is theoretically an agora for buyers and sellers to come together. Allen (2001, p1166) argues "how can it be that when you give your money to a financial institution there is no agency problem, but when you give it to a firm there is?" The narrow focus of corporate governance theory remains on traditional corporations, and financial intermediation theory assumes an institution-free finance industry, so these phenomena have not been analysed together (Bogle, 2009). Pension investors are dependent on financial institutions for information and transactions execution, dependent on their fiduciary obligations of disclosure, honesty and promise keeping (Dunfee and Gunter, 1999). These are the functional outcomes of the corporate governance mechanism for shareholders.

Whether there is a fiduciary conflict between the exclusive best interest of fund management shareholders and the pension principal is the question addressed by the thesis and essential to optimising pension trust fund management selection practices.[6]

[6] Through the extraction of returns rightly owing to the pension principal.

### 1.4 The contribution of the thesis

The thesis contributes to the conception of pension wealth management and the development of a fund manager selection framework. It posits that the almost ubiquitous deployment of finance theory in the study of institutional investor performance is insufficient in supporting the conception of fiduciary asset management. In the modern finance industry principal-agent theory is the appropriate theory for examining the relationship between the pension scheme and the institutional fund manager they engage, and the thesis makes a contribution to its development as a theory capable of multi-principal considerations.

The research contributes to the academic understanding of structural conflicts fund managers may experience when their primary corporate governance compliance objective and their primary asset provider for the funds they manage are different principals. It contributes to the young, yet growing body of literature surrounding the governance of pension contributions. It further contributes to policy making in the pensions and institutional investment industries by investigating whether the corporate governance norm of shareholder primacy is creating perverse outcomes for pension contributors through an inflated cost of financial intermediation. It would be expected that either fund managers owed significant fiduciary responsibilities to the pension assets they are mentoring, protecting the long term value of assets in a significantly long-tail industry, or pension clients are empowered to negotiate contracts benefiting contributing members. Evidence of this conflict (or lack thereof), either empirical or perceived, is the chief contribution of the thesis, supported by the findings of the Kay Review (2012) and Law Commission Review (2013).

### 1.4.1 The research relationship to the literature: Contributions to the academy

Agency theory is founded on the agency cost of information asymmetry (Dittmar and Thakor, 2007). Information asymmetry (specifically moral hazard) the pension principal experiences suggests they may not understand or be capable of informed consent (Clark, 2013). Whether the fund manager's motivations are aimed at the pension scheme's long term wealth preservation, or to short term investment results favouring the fund managers themselves is argued in the literature (Clark, 2013; Erkens et al., 2012; Holland, 2011; Ryan et al., 2010). Holland (2011) believes there is only anecdotal evidence examining this potential conflict. The thesis will contribute empirically to this literature.

In the corporate governance literature, corporate management is characterised as trying to wield unrestrained power, and increasing shareholder power has been advocated as the means of curbing this potential opportunism (Bebchuck, 2007; Monks and Sykes, 2002; Hay, 1972). Legislatively increasing shareholder powers in a bid to combat the management excess has received wide support (Dunning, 2012; Bebchuk and Weisbach, 2010; Becht et al., 2009). What is not known, and may be exacerbated by increasing shareholder power, is the increased incentive to encourage management risk-taking and short-termism by shareholders themselves (Dunning, 2012). Shareholders of fund managers might easily replace corporate managers in the ruthless acquisition of firm's managed assets for their own benefit (Becht et al., 2009). Despite this, minority shareholders are not seen as holding responsibilities and can attempt to influence the corporation as they see fit, including in self-serving ways (Anabtawi and Stout, 2008), their only informal duty being the exercise of their ownership rights (Waring, 2006). With the deregulation of the pensions industry great power to control society's wealth shifted to the finance industry (Sparkes, 2010). The thesis contributes empirically to the exploration of whether listed entities are appropriate financial intermediaries when their interests are conflicted. It both explores whether listed entities contribute lower returns to pension beneficiaries in revealed data, then questions trustees specifically on whether they believe this is the case. In asking these questions it seeks to understand what duties are contractually passed to the agent by the pension principal.

Literature on the fiduciary duties of directors and officers to the firm and shareholders proliferates (Johnson, 2016; Anabtawi and Stout, 2008; Gillan, 2006; Boatright, 1994). However, there is little formal guidance and few principles aimed at investment professionals (Johnston and Morrow, 2016; Jennings, 2014). John C. Bogle (2009, p15), Founder of American investment management company The Vanguard Group, described a fiduciary principle: cautioning that no man can serve two masters:

> "No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that *principle… Financial institutions … consider only last, if at all, the*

> interests of those whose funds they command, suggesting how far we have ignored the necessary implications of t*hat [the fiduciary] principle."*

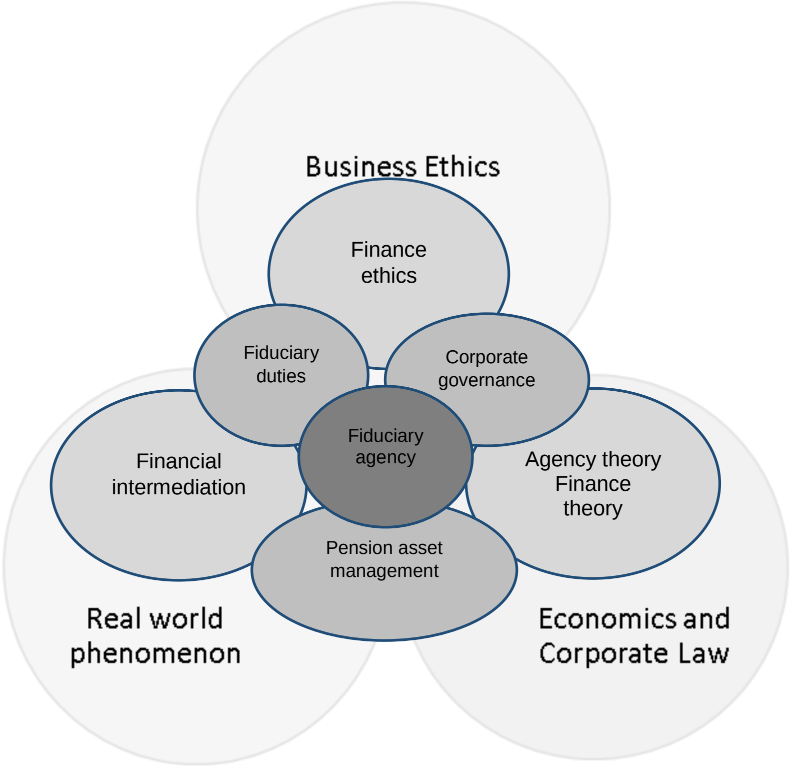
Bogle (2009) believes the fiduciary principal is absent from the fund manager-pension scheme relationship. He criticises the paucity of academic scrutiny into funds management conflicts of interest in modern research. Alongside shareholder pressure on fund management institutions Bogle sees the lack of clarity regarding the fiduciary nature of funds management as a further glaring gap in the literature in need of academic attention.

Many commentators hold that fund managers have not yet been handed special duties to pension clients (LCR, 2013; Clark, 2013; Kay, 2012; O'Brien, 2004). Monks (2002a) insists that if fund managers have a conflict of interest between pension clients and shareholders, they must step aside. The institutional investment literature concurs with Ingley and van der Walt (2004) who believe the implications of this conflict for the investment industry are profound, encouraging exploitation of the pension funds to capture wealth for a tightly held group of shareholders in the finance industry, rather than facilitating its efficient flow between corporate investment and pension beneficiaries.

The investment performance of fund managers has been widely researched through the traditional literature of finance, portfolio construction and financial intermediation theory (Whitehall, 2014). This literature rests on the assumption that funds management is agency cost-free. Yet the little work available on pension agency, where the fund manager is conflicted, in the business ethics and corporate governance literature is being treated in a conceptual sense only as deeply flawed with systemic conflicts of interest (Dunning, 2012; Boatright, 2011; Kangis and Kareklis, 2001). The business ethics and corporate governance literature agrees that increasing shareholder power may inevitably invite unintended consequences not yet capable of observation in academia or practice, and the solution requires a fundamental overhaul of the corporate governance architecture (see Ryan et al., 2010; Blair and Stout, 2006).

Figure 1.1 illustrates the literature considered in the agency of pension funds management for evaluating the asset management function addressed by the thesis. The background literature examined the large bodies of work addressing economics and corporate law (the theory of the firm), business ethics (how firm agents should behave) and the real world phenomenon (the function of the finance industry). Through an agency theory lens, two principals considered in isolation in the literature are the shareholders of the financial intermediary firm and the asset owners of the funds they intermediate. The mediating literature is the fiduciary duty of asset management. The contribution of the thesis is the concept of multi-fiduciary agency.

Figure 1.1 The thesis in the context of the existing literature


Business Ethics
Finance ethics
Fiduciary duties
Corporate governance
Fiduciary agency
Financial intermediation
Agency theory Finance theory
Pension asset management
Real world phenomenon
Economics and Corporate Law

- Background literature (three large bodies of relevant literature);
- Framing literature (four bodies of finance industry and agency theory focused literature sitting within the background literature);
- Focal literature (three bodies of literature describing agency in the pension asset investment supply chain);
- Fiduciary agency: The conflicted fiduciary agency of the pension funds manager (the thesis contribution to the literature).

Source: Author

Chapters 2 and 3 present the literature of principal 1 (the fund management shareholder) and principal 2 (the pension asset client) respectively. Chapter 4 then situates this literature of two principals with one agent into a conceptual framework grounded in the literature of business ethics generally, and specifically the finance ethics of fiduciary duty and the agency theory of corporate governance to summarise the intentions of the research design (Chapter 5) for capturing and empirically analysing the fiduciary nature of the pension problem.

The analysis Chapters aim to further understand the agency-costs of pension savings intermediation. The finance theory of returns on investment does not capture the agency theory of corporate institutional behaviour. The proposition that information asymmetry and moral hazard may affect the statutorily protected shareholder of the fund manager more than the pension contributor is common to the analysis chapters.

### 1.4.2 Using economic agency theory to analyse pension asset management: Theoretical contributions

While the thesis evaluates the relevant theories for post-positivist testing (stakeholder, agency and finance theory) agency theory is still the dominant theory in empirical studies of corporate governance and alleviating some of its parsimony is a useful contribution. The research proposes that the majority of agency theory contributions are to the study of the relationship between corporate management and their shareholders. It questions whether shareholders are theoretically the owners of corporations and contributes to a multi-agency view that there are other principals more significant to the agent and deserving of priority. In this case it is the pension client to the fund manager, whose supply of finance dwarfs that of equity holders. The two-fold theoretical contributions are an analysis of the current academic status of the theory of the firm and the introduction of more than one principal to agency theory to challenge its currently dyadic perspective.

The contribution assists the gap in the literature fails to connect economic agency theory to either business ethics and finance theory. The agency problem manifests at the moment shareholders believe management have deviated from their interests. Economist Milton Friedman (1970, p1) assigned managers the foundational duty of attending to the business of profit increases "while conforming to the basic rules of society, both those embodied in the law and those embodied in ethical customs". The formalisation of economic agency theory was proposed by Ross (1973) in a seminal treatise on both the moral hazard and allocation inefficiencies created by the information asymmetry benefiting the manager. In 1976 Jensen and Meckling (1976; p35) wrote of the prevalence of firms with widely dispersed ownership, "[h]ow does it happen that millions of individuals are willing to turn over a significant fraction of their wealth to organisations run by managers who have so little interest in their welfare?" before outlining the practice for binding management motives to shareholder gain specifically. This article placed agency theory at the core of management theory and practice. The firm behaved like all agents in the markets, principals will contract with the agent until the cost is too high and substitution is available, with shareholder principals being the rightful claimants of the agent's value creation process (Bainbridge, 2006; Jones, 1995; Jensen and Meckling, 1976). A body of economic literature has developed around the concept of the rationally self-interested agent who requires controlling through market oriented mechanisms (Stieb, 2009; Jensen, 2001; Williamson, 1979). These mechanisms include aligning agent desires with those of principals through performance based contracting, and shareholder principals have the board of directors who act as monitors of management on their behalf and the market for corporate control to penalise transgressions (Lan and Heracleous, 2010; Donaldson and Davis, 1991). Pension principals are left vulnerable to information asymmetry problems with no market mechanisms to incentivise or censure the agent outside the fund management contract and the ability to exit (Boatright 2011). This absence of acknowledgement in current agency theory can be conceptualised by the thesis as the contribution to multi-principal environments where principals are not equally equipped.

Notions of trustworthiness, duty or professionalism have been undermined by agency theory, acknowledging only self-serving motivations of the agent that may encourage a self-fulfilling prophecy (Ghoshal, 2005; Stout, 2003a). Blair and Stout (2006, p722) speculate on agency theory under Kuhn's shifting paradigm; "intellectual progress sometimes must await the arrival of new tools and technologies". Agency theory became the primary intellectual tool available to scholars in economics and corporate law yet in the corporate governance literature it fails to predict fundamental elements in the agent's reality that they have a multiple principal universe by simplifying the firm's economic problem down to getting management to act as shareholders require of them.

Empirical contributions include a bespoke database, survey data and content analysis of the fiduciary developments in pension asset management. This research will add the UK pension wealth management industry to the growing body of empirical agency work in the business and management literature in the search for a predictive theory.

### 1.4.3 Contribution to practice

Fund manager selection is influenced by the real world agency problems threatening moral hazard and adverse selection.  The research is aiming to provide pension trustees with insight into the governance characteristics of fund managers that are most likely to align with one of these perverse outcomes.  It also studies the characteristics of pension funds that are most able to resist them, such as collective bargaining or multiple fund manager engagement, as a decision making aid.  It is grounded in the current practice of Environmental, Social and Governance (ESG) screening fund managers conduct on portfolio assets, suggesting these screening practices could easily be modified to screen the fund managers themselves for socially responsible attributes.  The intended result is to encourage a more efficient investment returns distribution system to the providers of capital and owners of the long-term liability underwriting the managed assets.

### 1.4.4 Contribution to policy

The current Law Commission Review analysis of fiduciary duties was mandated to provide an opinion on “how fiduciary duties currently apply to investment intermediaries,” (LCR, 2013; p4).  This review marks a significant step forward in clarifying current understanding of trustee powers to command best interest from the investment supply chain.  It may signal room for regulators to grant the trustees power to instruct fund managers to consider the interests of their beneficiaries as the primary fiduciary duty owed by the fund manager. This active passing of fiduciary duties to the agent may provide the means of achieving efficient intermediaries in pension fund management in light of the fact that fund managers are increasingly listed corporate entities (Juntunen, 2007). It also hopes to illuminate for regulators whether or not these corporations with limitations imposed by shares are an appropriate vehicle to manage compulsory retirement savings. This is the subject of the discussion in Chapter 8 (particularly Section 8.5).

## 1.5 Structure of the research

The thesis is presented in a series of chapters that establish the relevant literature for the industry and the theories used for its analysis. These culminate in the conceptual framework that supports the research design and methodology. The methodology is then deployed through three analysis chapters and the results are triangulated for discussion. The logic and epistemology of chapters are represented in Figure 1.2, describing their contribution to the research design as a progression from theory to empirical observation. They are then described briefly in the following subsections.

Figure 1.2 The design of the research to achieve the aim of the thesis

| | |
|---|---|
| REAL WORLD<br>PROBLEM | Introduction and Rationale<br>Chapter 1 |
| | ↓ |
| THEORETICAL PERSPECTIVE | Chapter 2 literature review: Literature review of the theory of the firm and its philosophical and pragmatic development over time |
| | Chapter 3 literature review: Literature review of the governance of pension funds management |
| | Chapter 4 Conceptual framework: Grounding the methodology in the literature |
| EMPIRICAL PERSPECTIVE | ↓ |
| | Chapter 5 Research design and methodology |
| | Chapter 6 Analysis Stage 1: Empirical examination of the relationship between fund manager corporate governance and pension assets |
| | Chapter 7 Analysis Stage 2: Survey examination of the perceptions pension trustees hold |
| | ↓ |
| CONTRIB<br>UTIONS | Chapter 8 Discussion and conclusion: The state of fiduciary agency in pension asset management |

### 1.5.1 Chapter 2: Literature review: The theory of the firm and its philosophical and pragmatic development over time

This chapter presents a critical review of the theory and practice of corporate governance in light of its role in the three crises of the early twenty first century that Ryan et al. (2010; p673) labelled the “Decade from Hell”. The decade began with the failure to protect investors during the turn of the century dot.com boom and bust, saw the crisis of managerial fraud blamed for the 2003 collapse of numerous giants including Enron and WorldCom, and culminated with the 2007-2008 financial crisis. Corporate governance is in a state of turmoil that has left economists (see Aglietta and Reberioux, 2005), business ethicists (see Rodin, 2005), corporate law theorists (see Hutchison, 2011) and firm theorists (see Karns, 2011) criticising current theory as incapable of guiding or explaining the ethics of modern business practices of the large, complex organisations dominating the capital market system. The chapter proposes that contrary to common belief shareholders are not the owners of firms, and not entitled to demand fiduciary advantage from the firm (Boatright, 1994).

### 1.5.2 Chapter 3: Literature review: The governance of pension funds management

This chapter outlines the development of the occupational pensions industry alongside the development of the finance industry into an era dubbed “financialisation”, where financial markets dominate traditional industrial and agricultural economics (Aglietta and Reberioux, 2006). The chapter then describes how this transformation has changed the conceptualisation of fiduciary duties borne by the administrators of pension funds that academia believes have not been formally reflected in the pension’s supply chain. Fiduciary duties are examined from a finance ethics perspective and described as the development of the concept and practice of these duties. The chapter explores a framework for how the fund manager have been assessed as delivering a fiduciary relationship in practical terms from both industry and legal perspectives. It concludes that finance theory and financial intermediation theory assume the intermediary has no agency conflicts. Yet the fact that intermediaries are profit oriented commercial vehicles negates this premise. There is ambiguity over the principal of chief benefit in industry, yet almost ubiquitous understanding that it is the shareholder by law makers.

### 1.5.3 Chapter 4: Conceptual framework: The theories employed to examine pension fiduciary agency

This chapter unites the two preceding literature reviews into a conceptual framework based on an adaptation of John Holland's (2011; p159), "A conceptual framework for changes in Fund Management and Accountability relative to ESG issues." It then proposes that the agent's (fund manager) two principals (the dispersed shareholder where they exist, and the pension client) may be in conflict for the agent's fiduciary attention. This conception of the multi-agency problem is based on the principle of founder of The Vanguard Group, John C. Bogle (2009; p15): "The Fiduciary Principle: No Man Can Serve Two Masters." The chapter establishes the proposition that the conflict between the principals is the business ethics conundrum proposed by Arya and Sun (2004, p297) that "real ethical dilemmas arise when people must choose between right and right where both choices can be justified, yet one must be chosen over the other." The fund manager is ethically justified in promoting the fiduciary best interests of either principal over the other. The chapter concludes that pension fund management presents this ethical dilemma, one that must be addressed by academia and the regulatory regime rather than reliance on voluntary self-regulation.

### 1.5.4 Chapter 5: Research design, methodology and methods

This chapter commences with a description of the philosophy, epistemology and ontological understanding the researcher holds on the nature of the research problem. It then situates the research in the existing ontology of finance and pensions research to guide the design of the methodology. It proposes a sequential research design that commences with a portrait of the relationship between fund managers and their UK pension clients in 2013 (Wilmington, 2013) to identify any pattern between the corporate governance characteristics of particular fund managers and the asset allocation per member of the pension schemes they manage to determine if any dual principal relationships can be identified. It proceeds to describe a survey of pension scheme trustees on whether they identify corporate governance traits during fund manager selection and/or perceive a fiduciary conflict. It concludes with a description of the content analysis method determining where legislation, regulation and case law narratives on fiduciary responsibility are reflected in industry perceptions via the industry media. The following three chapters explore the sequential analysis.

### 1.5.5 Chapter 6: Analysis Part 1: Empirical examination of the relationship between fund manager corporate governance and pension assets

The chapter commences describing the creation of a proprietary database that makes an important contribution to industry research. The database combines the size of assets per single member of a pension scheme with the independently researched corporate governance characteristics of the fund manager in control of their funds. The analysis provides the context that maps the pension industry asset spread onto the corporate governance characteristics of the fund managers controlling their wealth creation. It explores whether fund managers with dispersed shareholders are attached to pension clients with fewer assets per member. It goes onto consider whether the traits of the scheme itself mitigate any wealth capture or share trends in the type of pension scheme and the type of fund manager they select. The chapter concludes, after examining the limitations of the data, that there is a relationship between ownership structure and size of pension assets, however the direction of the relationship cannot be ascertained.

### 1.5.6 Chapter 7: Analysis Part 2: Survey examination of the perceptions of pension trustees

This chapter analyses the findings of an attitudinal survey of pension scheme trustees. The survey addresses their attitudes to fund management selection, and the characteristics they assess when selecting fund managers. Specifically, it asks whether corporate governance attributes are considered during screening, and their perception of the fiduciary duty the fund manager applies to their role. The chapter builds on the findings from the previous analysis to develop a picture of whether trustee perceptions reflect the previous chapter results. Further, it is the vital link between the corporate governance results and the perception of the fiduciary relationship to determine if it changes as the fund manager shareholding disperses. The challenge of the fund manager demands for non-disclosure agreements over fees erupting during the deployment of the survey are discussed as emblematic of the secrecy of the relationship. The chapter concludes that there is genuine confusion over the state of duties agents owe to pension trusts. Corporate governance characteristics are not noteworthy to trustees as traditional financial measures such as past performance. Agency theory does not appear to predict fund manager selection choices, however externally owned fund managers in.

### 1.5.7 Chapter 8: Discussion and conclusions

This chapter draws on the previous three analysis chapters to determine whether there is an appropriately functioning fiduciary obligation in the UK finance industry. It takes independent observations, trustee perceptions and the developments in supporting legal infrastructure to form an opinion on whether pension funds are protected when managed externally. By determining the existence of a functioning and universally acknowledged fiduciary obligation to the assets of the members of a pension scheme and, in keeping with the Berle and Means (1932) definition of one man's fiduciary obligation to another when managing their assets, it discusses financial intermediation institutions and the state of fiduciary protection of modern day pension assets.

The summary of this collation of knowledge of fiduciary duty in pension governance is an important analysis of what the concept of the universal right to retirement security means in reality. The workforce has salary-sacrificed for this right and the finance industry needs to function according to its intended purpose. It must funnel capital into investment returning assets, where those returns are enjoyed by appropriate owner. The confusion found in the results implies that the appropriate owner needs identification at regulatory level. Currently the fiduciary duty to maximise profit is for the exclusive benefit of shareholders in dispersed ownership entities, the occupiers of the finance industry itself. However, the largest supply of finance by orders of magnitude is the contributing workforce that accounts for half of the OECD population (Monks, 2002b). If the returns on these assets are not 'returned' to their originating owners through an efficient cost of intermediation, and instead reside with Clark's (1976; p6) "elite suppliers of capital" pension trustees are failing in their duty to demand fiduciary agency from a finance industry that currently retains 40% of the UK's corporate profits (Crotty, 2009).

## 1.6 Conclusion

Given the pension trust responsibility for intergenerational retirement returns and an asymmetrical information reliance placed on outsourced experts, the governance of these experts (fund managers) becomes critical to any examination of pension asset management. Agency theory rests on the economic assumption of self-interested management and the mechanisms shareholder owners must employ to ensure management acts in the best interest of their investment (Hasnas, 1998). Corporate law reinforces this assumption with fiduciary duties assigned to management to act in the best interests of the company and its shareholders (Waring, 2006). Over 75% of fund management firms specialised in catering to pension wealth management are owned, broadly equally, by investment banks and insurance companies (Bogle, 2009; Monks and Sykes, 2002). The duties owed to shareholders by fund managers may incentivise them to enter into inefficient contracts with their pension clients, ones that over-reward and under-monitor their effort and expertise for the benefit of the theory's self-interested shareholders.

Fund managers with shareholder governance structures must navigate a conflict of interest that sets the fiduciary duties held to shareholders against the agency duties held to a client vulnerable to information asymmetry and imperfect monitoring opportunities. This vulnerability, and agency to act on the principal's behalf would feasibly trigger a fiduciary obligation in the agent. Following the significant losses suffered by pension schemes through the 2007-2008 financial crisis the government commissioned Kay Review noted:

> *“*The long term public goal for equity markets is in securing the public purposes of high performing companies and strong returns to savers through an effective asset management industry, and in ensuring that the profits earned by companies are as far as possible **translated into returns to beneficiaries by minimising the costs of intermediation***…* It would seem fair to say that equity markets today serve the needs of the players in these markets better than they serve either those who put up the money or the businesses wanting finance to support growth.*”* (Kay Review, 2012; p6) [Emphasis added]

This agency problem of the incorrect fiduciary beneficiary of the agent’s efforts in a multi-principal environment has been described by Blackburn (2006) as inviting the systematic failure of modern day pension provision.  The thesis seeks to contribute understanding of the empirical manifestation of this pension challenge.

# Chapter 2
# Literature review:  The theory of the firm and its philosophical and pragmatic development over time

Solvitur Ambiando – *"It is solved by walking" (Saint Augustine)*

## 2.1 Introduction

This chapter presents a critical review of the theory and practice of the corporate governance[7] of UK fund managers. It is the exploration of the first principal of the fund management agent; their shareholders (for later comparison with the second agency principal, the pension client). The objective of the Chapter is to explore the origin and development of fiduciary obligations to shareholders in fund management firms through the literature of economic and legal corporate governance.

The governance crises of the start of the twenty first century (the dot.com bust 2001, Enron collapse 2003, and the financial crisis of 2007-2008) were successively decried in the media and academia as the worst since the Great Depression of the 1930s (Ryan et al., 2010). In 2001, $USD7 trillion in market value was wiped from global markets (Zukin, 2012). Enron, WorldCom and Tyco financial scandals created widespread job losses and destroyed tens of thousands of retirement plans (Christofi et al., 2010). The financial crisis' Troubled Asset Relief Program (TARP) saw the US government pour $700 billion into bailing out corporations that free market theorists would dictate failed in what Verret (2010; p283) described as "a unique historical event; not merely because of its size, but also because of a resulting ripple through corporate scholarship and practice." Corporations, according to Zukin (2012) caused such "egregious"

[7] "The way that a… company… is controlled by the people who run it" at www.merriam-webster.com/dictionary/governance (accessed 25 March 2016)

money loss without board intervention that it robbed shareholders of their entire investment.  Ramirez (2007; p345) quotes mutual fund founder John C. Bogle as accusing corporate governance practice of contracting a “pathological mutation” that has transformed “traditional owners’ capitalism” to “new managers’ capitalism”.  Atherton et al. (2011; p1) condemned “[t]he lack of trust in American corporations and corporate management over the recent scandals and financial crises has increased public and legislative outcry for accountability in business decisions.”  However, before Atherton et al.’s public and legislative outcry can be given appropriate and cautious determination, an important set of questions needs clarification: what is a business corporation and what purpose should it serve?  Leading corporate law scholars Margaret Blair and Lynn Stout (Blair and Stout, 2008; p720) expand, “[t]hese questions have been raised repeatedly by legal scholars, practitioners and policy makers for at least the last 150 years. Each generation has struggled to find acceptable answers.”  Previously Stout (Stout, 2003a) outlined the puzzle facing corporate theorists; investors place their own hard won capital into the overwhelming control of the firm and its management.  They thereby relinquish any control over the efficient or ethical running of the firm, or even whether corporate earnings will be distributed back as dividends and used instead, for instance, to raise salaries, build empires or fund unspecified charitable works.  Kenneth Goodpaster (1994) described this conundrum as the underlying foundation of the corporate governance problem. The relationship between managers and shareholders is “ethically different” precisely because of this vulnerability.  While corporations must at a minimum act legally towards all stakeholders (Spurgin, 2001), they owe special or fiduciary duties to shareholders to control the corporation in the best interest of their assets. In Lynn Stout's (2007; p2) later opinion this has developed as a "common but misleading" representation of shareholders as owners of firms. So dominant is this perception that Sundaram and Inkman (2004) believe finance textbooks assert its logic, rather than argue for it. Popularly coined "shareholder primacy", Fisch (2006) believes there are no longer attempts at justification in the finance literature; it is incorporated without consideration of the implications. It is written into the UK governance codes (Armour et al., 2003) and explicit in the accounting body of literature (Christofi et al., 2010; Stein, 2008; Waring, 2006; Pitts, 2002). Yet whether the firm's responsibilities to the shareholder is the only fiduciary duty held by fund management firms is the contemplation of this and the following literature chapter addressing the two principals purportedly vulnerable to the agent's control of their assets.

Whether agreeing that shareholders are owners of firms or not, La Porta et al. (2000) argue that investor protections are essential for preventing exploitation in any investment. When external investors finance firms they need certainty (or at least risks mitigated) that there will be a return on investment and management or controlling shareholders will not exploit their advantageous position (Boatright, 2009). McSweeney (2008) agrees; external monitoring to protect finance is a positive role played by stock markets and investors would be in short supply without it. However, he continues, this is not an argument to place shareholders' short-term interests above those of the long-term health of the corporation or society in the absence of stock market protections. Blair (2003; p889) catalogues Enron, WorldCom and many other firms where shareholder primacy rhetoric was used to artificially inflate share prices and manipulate accounting positions. She concluded that “the Anglo-American insistence that share value is the only right way to measure corporate performance and only acceptable goal for corporate executives and directors rings suddenly, pathetically, hollow.” While canonical theorists, Berle and Means (1932) believed in the efficacy of the judicial system to alleviate distributive injustices, shareholder hegemony supported by business theory has been criticised by Merino et al. (2010) as having a long history of dangerous outcomes when economic markets dictate social norms. This has profound implications for funds management firms managing client funds as well as those of their own powerful shareholders, one that O’Brien (2004) worries leads to the danger of unmanageable conflicts of interest.

Central to the chapter is an investigation of the development and current state of firm governance. This establishes the governance characteristics for later empirical interrogation to determine whether they predict or prescribe the mechanisms of financial intermediary behaviour in the pensions industry. Section 2.2 of the chapter briefly examines the relationship business shares, or should share, with society and where contemporary corporate governance theory has brought tension to this relationship. Section 2.3 investigates the formation of academic theories and what characteristics a theory needs to sustain legitimacy. Section 2.4 builds on the creation of academic theories over time, outlining the historical progress of the theory of the firm and the events that have shaped contemporary views on the very nature of the modern firm. Section 2.5 takes these heterogeneous views and applies them to corporate governance changes over time and into the contemporary controversies over which stakeholders should be the responsibility of the firm. Section 2.6 concludes that until the purpose of the firm is agreed, tensions in corporate governance theory will continue to plague academic development and an undisputed dominant paradigm to guide fiduciary business governance will remain elusive.

## 2.2 The duties and obligations of firms in society

Letza et al. (2004) explain that the exploration of who should control the firm and how they should control it is unresolved in the business ethics literature. Carroll (1996; p13) paints a society distrusting of business "because society's expectations of its behaviour have outpaced business's ability to meet these growing expectations". Business in the modern era undoubtedly wields a great deal of power but whether it necessarily abuses that power requires careful examination. Democratic society decides the laws for business so where compliance is in evidence, many scholars argue that the firm cannot be held to be abusing power simply by not redistributing resources further than that specified by law (Stieb, 2009; Jensen, 2001; Davis, 1973; Friedman, 1970). While ethical conduct is often mistaken as not breaking the law, others argue it goes beyond the letter and to the spirit of the law society intended, and the consideration of what is right and good (Augur, 2009; Arcot and Bruno, 2006; Freshfields, 2005, Freeman, 1984). Certainly, ethics scholarship is the study of theories in the right and wrong of human behaviour and the conduct of business is simply an outcome of human behaviour (Stieb, 2009). How the firm is governed shapes the nature of its interactions with society, and the study of business ethics explores the normative principles for governing business in order to meet any obligations society demands (Craft, 2012; Crane and Matten, 2007; Phillips et al., 2003; Hasnas, 1998). The theory of business ethics is discussed in Chapter 4 as the foundation literature supporting the conceptual framework of the theories of fiduciary agency in financial management when two principals share a common agent. Supporting this, the objective of this section is to establish how the modern corporation came to conceptualise shareholders as firm owners. The shareholder principal has come to possess strong economic and legal influence over their agent managers. While the theories of agency and fiduciary duty are explicitly described in Chapter 4, this chapter seeks to clarify the historical and current role of the shareholder in the modern firm as the principal of fiduciary concern for corporate managers, including fund management firms stewarding the £5 trillion in UK pension funds on behalf of non-shareholder principals with contestable fiduciary protection (Godfrey, 2014).

### 2.3 The theory of the firm

This section examines the development of a theory of the firm from the time of Adam Smith (1723-1790) to the post Reagan-Thatcher era of economic rethinking to contextualise developments in corporate governance in the geo-political legislative regimes where UK pension money is managed. Coase (1937; p386) influentially wanted a clear definition of the firm in economic theory, and if it differed from the "plain man's" understanding it should be made clear how. This, argued Jensen (2000), would enable us to better engineer organisational and management practices that help firms create value, thereby theoretically increasing human living standards. Firms are simple to describe, as Coelho et al. (2002; p2) demonstrate; “corporations are legal fictions created by the State to engage in enterprises that the State allows.” The modern corporation is characterised by limited liability and the ability to lock in capital regardless of the wishes of owners and creditors (Ramirez, 2012). However, since the invention of the joint stock company economic theory has struggled to explain the conditions where gains from specialisation and cooperative production are better achieved in a firm than across efficient markets. Alchian and Demsetz (1972) point to the delusion that firms have any powers of fiat, authority or discipline different to two parties contracting in the market. Reich-Graefe (2011a; p343) goes further, the firm “is the principal legal vehicle utilized in order to remove large areas of economic activity from free market forces and to internalize and concentrate such activity in planned economies under absolutist, hierarchical command-and-control structures such that the orthodox view would classify them as socialist or non-market economies”. He concludes that they displace pricing signals used to guide markets, rule by fiat, hold assets and returns on these collectively and so should not be embraced by economists as an efficient mode of organisation. Green (1993) holds that legalese such as “fiduciary obligations” and “principal-agent” have unwittingly created popular myths of the firm’s nature. However, at the heart of firm theory confusion is the separation of the decision and risk bearing functions outlined by Fama and Jensen (1983), where decision makers bear no adverse wealth effects regardless of their decisions. This functional separation departs from the traditional finance theory relationship between risk and reward in asset management, and is more accurately described by the agency theory conception that agents require incentivising to fully deliver the principal's appropriate risk/reward relationship. The thesis posits that this holds true for both of the fund managers' principals.

In 1932 Adolf Berle, a law scholar, and Gardiner Means, an economist, famously documented the contradiction in the modern firm; the transaction cost to the dispersed owner-shareholder of monitoring the management of the company (and the risk of other shareholders freeriding at their expense) had delivered all realistic power to the firm's non-owner managers (described variously in Bebchuck and Weisbach, 2010; Cheffins and Bank, 2006; Bratton, 2001; Katz, 1960). Their monograph, The Modern Corporation and Private Property has been described as "the last major work of original scholarship" (Reich-Graefe, 2011b; p346). Its publication led to the iconic Berle-Dodd debate, where Merrick Dodd argued that by unshackling managers from the relentless pursuit of profit to satisfy shareholder avarice, they would be free to act responsibly on behalf of the firm (Stout, 2007). Berle eventually also backed this decoupling from the traditional view of ownership; even while concerned there was no clear alternative steward for management, but assuming they would rise to "business statesmanship" challenge (Hay, 1972). Corporations were, according to Berle and Means, more than investment vehicles for shareholders, they had an impact on "whole districts, bring[ing] ruin to one community and prosperity to another... giving rise to new responsibilities towards the owners, the workers, the consumers, and the State [that] thus rest upon the shoulders of those in control" (Winkler, 2004; p113). Shareholders, on the other hand, had simply become passive property owners. In Berle's corporate legal opinion they were the owners of shares, not the owners of the corporation. Ingley and van der Walt (2004;

p537) are more direct, "…there are few owners, most being punters rather than proprietors" possessing little loyalty and easy exit options. In 1960 Katz observed that modern investors viewed themselves as speculative stock market participants rather than company owners because ownership implies taking on risk and active management. Shareholders had departed from the traditional model of corporate owner management earlier in the century. Reich-Graefe (2011a; p345) illustrates the shareholders' removal from the firm operational reality with a case study:

> *"As the world's largest, fully*-integrated retailing business Wal-Mart accumulates to nothing more than a fiction in the legal realm - a corporation organized under the laws of the State of Delaware. Its almost four billion outstanding shares of common stock are principally traded on the New York Stock Exchange, but its almost 300,000 shareholders will never be able to touch what they own - in most cases, not even in the form of a physical share certificate. What makes this legal fiction tangible, however, and indeed a vast economic reality is that Wal-Mart owns, controls and operates an enormous empire of productive resources which generates superlatives in the global marketplace on an Olympian scale: net sales of $401.2 billion in its 2008 fiscal year; a market capitalization of close to $220 billion at the end of 2008 (ranking Wal-Mart, at the time, the third-largest publicly listed enterprise by market capitalization in the world).*"*

It is unrealistic heurism to view this firm as operating for the benefit of 300,000 anonymous and constantly shifting shareholders alone when its societal impact is global and immense. However, according to Stout (2007) it is a commonly received wisdom that shareholders are the owners of the corporation, alongside strong sense that someone must be empowered to command obedience following a wake of management scandals. Supporting this is the core concept of traditional corporate governance as the responsibility to assure minority investors that their powerlessness will not be improperly exploited, thus encouraging that investment in the first place (Clarke, 2010). This still does not address the fundamental issue of traditional private property ownership or whether the theory of shareholder primacy is predicting or explaining the phenomenon of the firm behaviour. Siebecker (2010) sees the nature of the phenomenon as evolving rapidly. Reich-Graefe (2011b) calls the theory "unfinished business". In order to unpick this fundamental corporate governance knowledge gap, the next section explores the development of the joint-stock corporation over time to ascertain where the "owner" was determined.

### 2.3.1 The firm and capital markets from Adam Smith to the turn of the twentieth century

According to prominent business ethicist, Ronald Duska, "Adam Smith may be, perhaps, the most misunderstood academic frequently taught in the academy today" (Duska and Ragatz, 2008; p158). Adam Smith was a Scottish economist, philosopher and academic in the eighteenth century, and author of An Inquiry into the Nature and Causes of the Wealth of Nations (1776). This treatise, according to biographer Robert Falkner (2008) continues to influence economic and political liberal theory and the conception of the free markets. Smith was concerned with the nature of joint-stock companies on the basis of a perceived separation of ownership and control (Stephen and Backhaus, 2003; Jensen and Meckling, 1983):

> *“*[Shareholders] seldom pretend to understand anything of the business of the company, and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half-yearly or yearly dividend as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private *copartnery.”* Adam Smith (2005; 1776; p606).

This sentiment alludes not only to the passivity of shareholders, but also to the attractiveness of limited risk. However, contemporary firm theory development cannot be considered absent the operation of private property rights of the firm’s host market, and in the context of Smith’s most quoted contribution to classical economic thinking; the concept of the “invisible hand”:

> *“By preferring the support of d*omestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain; and he is in this, as in many other cases, led by an invisible

> *hand to promote an end which was no part of his intention"* (Smith, 2005; 1776; p363).

This introduced the construct and legitimisation of self-interest to the vocabulary of economic and firm theory (Dunning, 2012). The pursuit of self-interest results in efficient resource allocation and social wealth maximisation; a misinterpretation of Smith's intention, Karns (2011) believes. On the Social Science Research Network[8] 199 papers endorsing the egoism of the 'invisible hand' have been posted since 1997. However, this quote is the only reference Smith makes to the concept in the 786 pages of The Wealth of Nations (Smith, 2005: 1776; compared with 36 references to the moral duties of man, 2 to ethical duties and 3 to the injustices of the Poor Law). His earlier book, The Theory of Moral Sentiments 1759, which Falkner (2008) credits as Smith's preferred work, shapes his own theory on the development of moral behaviour and judgement arising from social relationships, and was written while a theologian and moral philosopher at Glasgow University. Smith clearly evidenced the importance of the moral duty in economic theory (the fellow-sympathy theory, see Mele, 2008) and this would extend to the duty to manage another man's property with fiduciary care. However, it is also important to contextualise Smith's writing to the business environment at the time.

Smith's ire was directed at the injustices of mercantilism and government nepotism focused on filling the treasury rather than allowing free and competitive

[8] http://papers.ssrn.com/sol3/Results.cfm (accessed 7 February 2014)

participation in the market place to the greater social good (Dunning, 2012). At the start of the twentieth century business ownership in the UK was changing rapidly following the passing of the Limited Liability Act 1855 (Jeffreys, 1946). In the US in 1929 Owen D Young (future president of General Electric) articulated the change in perception this ushered in; "no longer attorneys for stockholders", he dubbed managers "trustees of an institution", owing duties to all the institution's stakeholders (Katz, 1960; p77). This re-envisioning so soon after the initial existence of the firm in the market and enabled the future tectonic shift in the governance conception of the manager as a fiduciary for the institution.

### 2.3.2 The firm and capital markets in the age of Berle and Means

The canonical work of Adolf Berle and Gardiner Means in 1932 introduced the first conventional academic theory of corporate governance that continues in relevance today. Monks and Minow (2008) introduce their corporate governance text book stating "most people begin the study of ownership in the context of the public corporation with Berle and Means". Hill (2010; p1005) concurs "…in corporate law, all paths radiate" from this work. It, alongside the Dodd-Berle exchange, is used by proponents advocating the director primacy view of ownership, Owen Young's "institutional trustee" owing a social service along with a profit function (Hutchison, 2011; Stout, 2007; Boatright, 1994). However, in adding to ambiguity in corporate governance, it is equally employed by proponents of the shareholder primacy school, advocating the fiduciary obligations arising from managing another's private property (Coelho et al., 2002; Greenwood, 1996; Jensen and Meckling, 1983; Hay, 1972). Again, the temporal context is important.  The economic boom of the Industrial Revolution had faded, the stock market crash of 1929 had ushered in the Great Depression and the markets were in shock (Ramirez, 2012; Reich-Graefe, 2011a; Tarver, 1968). Alongside the macroeconomic climate, the pattern of share ownership had rapidly dispersed.  At the turn of the century, directors (excluding relatives) owned an average 40 percent of equity in incorporated companies; by 1914 this had fallen to 20 percent (Pitts, 2002).  This change in demographics (and financial risk bearing entering non-traditional investment communities, see Sundaram and Inkpen, 2004) of share ownership led to a rethinking of private property rights and was the central refrain of the Berle and Means thesis (North, 1983).  Property rights theory had been grounded in the notion that business ventures were undertaken by individuals with their own assets (Boatright, 1994).  Berle and Means now observed that assets and their owners had become separated, shareholders were now simply risk-takers or "passive property owners", and corporate managers had become risk-free decision makers (Hay, 1972; p62). The inquiry at the core of the text was how managers should run corporations and what duties of protection they owed their shareholders, as a matter of legal and moral legitimacy of management power (Hendry, 2001).  They conceived of this duty as a fiduciary one:

> "Taking this doctrine back into the womb of equity, whence it sprang, the foundation becomes plain.  Wherever one man or a group of men entrusted another man or group with the management of property, the second group became fiduciaries.  As such they were obliged to act conscionably, which meant in fidelity to the interests of the persons

> whose wealth they had undertaken to handle.” (Berle and Means, 1932; p336).

In the subsequent Dodd-Berle exchanges for the rest of the 1930s the wisdom became more entrenched that management control was self-evident and acceptable to both the political and financial markets provided the suppliers of finance as passive private property to enterprise were protected (Hendry, 2001). The fiduciary duties management owed to shareholders should flow from societal requirements and public policy (Boatright, 1994). Shares were not property used in production, nor the primary finance raising model. They were a “channel for distributing income whose accumulation for capital purposes is not required [and] must conform to conceptions of civilization worked out through the democratic processes of the American constitutional government.”[9]. This influential academic exchange either coincided with, or ushered in an era of managerial capitalism that would last from the 1930s to the 1970s (Mostovicz et al., 2011; Bratton, 2001; Hendry, 2001; Hay, 1972) or as Cheffins and Bank (2009; p1) conceived it, their “characterization of matters quickly became received wisdom”. Although alluded to in The Modern Corporation and Private Property, the nature and cost of the agent relationship between manager and shareholder would not become explicit in the economic and legal theory of the firm until the 1970s, led by the works of economist, Milton Friedman and scholars Michael Jensen and William Meckling. Their combined influence would bring economics back into the boardroom and recast the identity of Berle and Mean’s “business statesman”

[9] Berle and Means, supra note 2 at xxxviii, footnote 78 in Hutchison 2001, p1244

managers as institutional trustees into a far more instrumental characterisation. The theory of firm management left the literature of duty in business ethics and corporate law scholarship, and became entrenched in economics and finance literature as a model capable of mathematical determination.

### 2.3.3 The firm and capital markets in the age of Milton Friedman

Managerial capitalism within the fiduciary framework had developed reasonably uncontested in the academy and capital markets until the beginning of the 1970s brought new developments in economic and information cost theory (Hendry, 2001; Bratton, 1994). This recast the firm as an economic fiction rather than a societal institution, a nexus of contracts seeking efficient equilibrium for utility maximisers (Jensen, 2001). Leading this thinking was Milton Friedman, an economist and statistician at the influential University of Chicago School of Economics and recipient of the Nobel Prize in Economic Sciences (Rodin, 2005). On his death, The Economist described him as "the most influential economist of the second half of the twentieth century...possibly of all of it."[10]

Friedman's business ethics are grounded in the freedom of markets (and democratic laws) to create the best product for the customer, the best employment conditions and the most efficient returns for those who risk their hard-earned money (Wagner-Tsukamoto, 2007). In 1970 he published his understanding of business ethics as management's unswerving devotion to the

[10] Available at http://www.economist.com/node/8313925 (accessed 10 February 2014)

shareholder as owner of the corporation in influential rhetoric, questioning the notion of business responsibility in “eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers. In fact, they are - or would be if they or anyone else took them seriously - preaching pure and unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.” (Friedman, 1970; p1). It is not permissible for managers to dilute legally acquired profits using moral justifications, as they are wrongfully appropriating assets they do not own (Rodin, 2005). He assigns managers the transformational duty of attending only to the business of profit maximisation “while conforming to the basic rules of society, both those embodied in the law and those embodied in ethical customs” (Friedman, 1970; p1). This era, says Boatright (2009) began the transition of manager from bureaucrat to shareholder partisan, participant and entrepreneur and the economic theory of fastening the manager’s motivations to the generation of shareholder profit, thereby decreasing the agency distance between Berle and Means’ owner and controller.

The formalisation of economic agency theory was laid down in Ross’ 1973 seminal treatise on both the moral hazard and allocation inefficiencies created by the information asymmetry benefiting the agent. The firm behaved like the markets, stakeholders will contract with the firm until the cost is too high and substitution is available, with shareholders being the residual claimants of the agent’s value creation process (Bainbridge, 2006; Jones, 1995; Jensen and Meckling, 1976). A body of work has developed around the concept of the rationally self-interested manager who requires controlling through market oriented mechanisms (Stieb, 2009; Jensen, 2001; Williamson, 1979). These agency theory mechanisms include aligning management desires with those of shareholders through performance based remuneration, the board of directors who act as monitors of management on behalf of shareholders and the stock market being an external market mechanism capable of corporate control and monitoring (Lan and Heracleous, 2010; Donaldson and Davis, 1991).

In 1972 Hay (1972; p71) theorised that further speculation over the shareholder owner and the profit principle was irrelevant unless changes were made to both economic and the legal theory: "Economic theory is underpinned by the utility (profit) maximisation motive and the courts have upheld this". Codified Anglo-American governance systems and corporate law also began to reflect this belief (Aguilera et al., 2006; Greenwood, 1996). Shareholder profit maximisation based on incentivised management alignment became the entrenched model of management in the "second era" of corporate governance (Mostovicz et al., 2011; Boatright, 2009) and the principal-agent literature proliferated as the primary apparatus for theorising about the firm, regardless of ethical criticism (see Boatright (2009; p472) on its role in misconduct, income inequality and "corporate social indifference"; Merino et al. (2010) on negative freedom of the sole economic objective; or Davis, (1973) on the decline in social expectations of corporate norms). Blair and Stout (2008; p722) commented of the principal-agent obsession of the era, "when your only tool is a hammer, every problem tends to look like a nail," before conceding that many influential academics continue to employ the model today. However, Coelho et al. (2002; p2) mount a strong defence for the “clear and unambiguous” responsibilities of management under the “only intellectually defensible” ethical paradigm available today. Wagner-Tsukamoto (2007; p213) uses Friedman’s logic to argue its salience for a reinterpretation of “active moral agency”. Green (1993) reflects that Friedman’s belief in managers’ duties as the fiduciary for shareholder “owners” still dominates corporate law as the duties freely undertaken when the agent agrees to serve their principal. Blair and Stout (2006; p722) speculate that under Thomas Kuhn’s paradigm shifting theory, “intellectual progress sometimes must await the arrival of new tools and technologies”. Agency theory, they conclude became the primary intellectual tool available to scholars yet it fails to reflect fundamental elements in the law by distilling the complex firm down to a simple economic problem. Agency theory, along with its dissenting theories, are examined in detail in Chapter 4. However, it cannot be considered without reference to a further fundamental development in the agency theory of corporate governance; the changing nature of the up-to-now homogeneous, dispersed and vulnerable shareholder.

### 2.3.4 The firm and capital markets post Reagan-Thatcher

> *“In the wake o*f the Great Depression and the Second World War, with the Keynesian revolution still young, championing the free market was deeply unfashionable, even (or especially) among economists. Mr Friedman and kindred spirits - such as Friedrich von Hayek, author of

> *"The Road to Serfdom"* - were seen as cranks. Surely the horrors of the Depression had shown that markets were not t*o be trusted?"*[11]

The capitalist system is characterised by resources being owned privately and owners increase the productivity of these resources through cooperation and specialisation (Alchian and Demsetz, 1972). The finance industry is a heterogeneous and complex system for achieving this private resource allocation (Porter, 2005). Until recent decades, its theoretical role was to broker the transactions between business and society in three main guises: 1) orchestrating loans to purchase private property using interest bearing savings banks (Hartman, 1993); 2) facilitating shareholding in publicly listed firms as Berle and Mean's passive private property stock markets; (Waring, 2006) and 3) uncertainty smoothing through insurance markets (Blackburn, 2006). The Reagan-Thatcher era reinforced Friedman's theory of untethering markets with a strong agenda of private property, market-led economic policy making, which in turn reinforced the principal-agent relationship between shareholders interacting through (stock) markets with their underlying firm agents (Hendry, 2001). Dunford (2007) calls this era "finance-led" capitalism, which Hendry (2001) characterised by the rise of hostile takeovers, rapid capital growth and the advent of the large and powerful institutional shareholder. These financial institutions were now controlling the majority of the equities issued on stock exchanges (from 10% in 1925 to 64% in the US this decade and 25% to 84% in the UK: (McSweeney, 2008)). Berle and Mean's separated 'owner' quickly became one step further removed from their

[11] The Economist, 23 November 2006, Available at http://www.economist.com/node/8313925 (accessed 10 February 2014)

managers. This heightened agency problem arose through the fact that institutional investors are mostly agents themselves, with responsibility for the funds of others (Aglietta's (2000) pooled and delegated savings of labour). They are intermediaries picking stocks for owners who are likely unaware of the firms (including employees, customers, suppliers, communities) they are invested in, allowing the new agent a level of detachment that tolerates performance pressure or divestment decisions based solely on financial requirements of their pooled principals rather than the health of the company their principals 'own' (McSweeney, 2008). This created two tiers of agency that separated the beneficiary and recipient of capital by another level of abstraction. Karmel (2004) chronicles how the new shareholders' agents were engaging with corporate managers in a way traditional shareholders had not. She contends that managers quickly came under pressure from powerful institutional shareholders to produce ever stronger short-term performance results in the bullish market of the 1980s and 1990s.

When the equities market collapsed in 2000, financial engineering became a route to maintain earnings growth and the consequent accounting scandals and accompanying implosions of giants such as Enron and WorldCom became inevitable (Carrington and Johed, 2007). Managers may have been motivated by the self-serving theory of economic agency seeking to maximise personal utility, buckled to pressure from powerful institutional share blocks, or acted out of normative agency duties to the shareholder and his rightful profit. Regardless, many accounts no longer reflected a true and fair view of the firm, and management failed to prevent the catastrophic losses that it wrought on all stakeholders (including shareholders). However, with this new breed of shareholder, coercive power and an instinct for self-preservation against losses should have ensured institutional investors were capable of efficiently monitoring their agents as they were remunerated to do, but failed (Karmel, 2004).

These intermediaries are not only capable of boardroom influence; they are politically powerful and capable of influencing regulation (Karmel, 2004). In the era they rose to prominence, shareholders were empirically and theoretically the firm's primary corporate governance concern. Hill (2010), McSweeney (2008) and Karmel (2004) call for a new corporate governance model that adequately acknowledges the new, expanding and powerful role played by financial intermediaries, grounded in establishing reciprocal duties for shareholders that prevent damage to the firm and its stakeholders.

Institutional intermediaries present three new challenges to reimagining governance: 1) The theory must definitively determine the private property conundrum of firm ownership; 2) the theory must guide intermediary management's appropriate relationship with their own shareholders; and 3) the theory must guide how their own governance structures should react to this shareholder's demand for profit maximisation. Intermediary profit maximisation for these shareholders can be achieved by wielding institutional power to drive potentially unsustainable performance from the assets they invest in. Alternatively, by increasing "the amount of targeted, or relative return withheld by the manager of assets for services provided that detach the targeted return from the risk premium paid by the owner of assets," (The Pensions Regulator (2016) calls this “wealth capture”). In light of this evolution in the nature of the firm, Section 2.4 examines whether corporate governance theory has kept pace with the fundamentally different and powerful modern institutional shareholder.

## 2.4 The implications of institutional intermediaries for corporate governance theory and practice

The firm has evolved as a concept over the centuries in different jurisdictions, each with different compliance regimes, court decisions and social climates that have shaped the rights and obligations it holds (North, 1983). Further, the evolution of corporate governance, a foundation concept in business ethics, has been influenced by the ontologies of multiple disciplines; including economics, law, finance and management (Ryan et al., 2010; Bebchuck and Weisbach, 2010). Gillan (2006) outlines the scope of its modern influence as including the role of antitakeover measures, board structure, capital market governance, compensation and incentives, debt and agency costs, director and officer labour markets, fraud, lawsuits, ownership structures, and regulation. During the turbulent corporate landscape of the twenty first century as the complexity of the financial markets and the firm has accelerated, the traditional theories of corporate governance scholarship have become increasingly unrepresentative of a shareholder no longer resembling Berle and Mean’s dispersed and rationally apathetic individual (Clarke, 2010; Hutchison, 2011; Bebchuk and Weisbach, 2010).

### 2.4.1 Definitions of corporate governance

The classical economic definition of corporate governance was attributed by Clarke (2010; p78) to Jensen and Meckling (1976) as “[t]he prevention of the exploitation of those who supply the money by those who control it”. Shleifer and Vishny (1997) define it as the way in which suppliers of finance assure themselves a return on their investment. LaPorta et al. (2000; p3) broaden participation, offering “how well investors, both shareholders and creditors, are protected by law from expropriation by the managers and controlling shareholders of firms.” Gillan and Starks (1998) define corporate governance mechanisms as the system of laws, rules, and factors that control operations at a company. Broader still from Mostovicz et al. (2011; p613); “[a] set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled, and its purpose is to influence directly or indirectly the behaviour of the organisation towards its stakeholders.” While the stakeholders are now explicit here, South Africa’s King Committee Review on corporate governance adopts a more philosophical tone (Fisher and Lovell, 2009; p295):

> *“Corporat*e governance is concerned with holding the balance between economic and social goals and between individual and community *goals…The aim is to align as nearly as possible the interests of individuals, corporations and society.”*

However, in the UK, the practical understanding of corporate governance, expressed by the Institute of Chartered Accountants of England and Wales is narrow and reasonably unambiguous:

> *“A fundamental tenet of capitalism is that a company is an entity of joint* enterprise between those who control it (i.e. the directors) and those who own it (i.e. the shareholders). Directors are responsible for acting in the best interests of the company for the benefit of shareholders. Shareholders in turn, empower the directors to lead the company in a fiduciary capacity, whilst maintaining a degree of decision-making control through incorporation rights. Agency theory applies where there is a separation of ownership and control and describes how misalignment can occur resulting in conflicts between the interests of those in control of the company and those who own it. Mitigating these conflicts through legal and regulatory frameworks which define the responsibilities, rights and owners of directors and shareholders, is a key corporate governance *objective.” (Waring, 2006; p16).*

Interpretation is important as shareholder investment is not attached to a lien over particular assets or contracts as many other stakeholders’ stakes are, and so is protected only by management assurance that the firm is prospering (Boatright, 1994). Thomsen (2005) refers to this problem as incomplete contracting, requiring non-market mechanisms to internalise good governance. Many scholars concur with the dominant practitioner view that the shareholder is the beneficiary of corporate governance (Mostovicz et al., 2011; Moore and

Reberioux, 2011; Rossouw, 2009; Deakin, 2005; Letza et al., 2004; Ryan and Buchholtz, 2001; Koslowski, 2000). However, the view has become ethically contested and Gillan and Starks (1998) see a broader role that incorporates other vulnerable financial suppliers. As business ethicists, management, strategy and legal scholars begin to challenge this dominant paradigm of governance for shareholders, Ayuso and Argandona (2007; p4) propose a definition of governance as "the design of institutions that induce or force management to internalize the welfare of stakeholders." In the case of an institutional investor, this includes the clients whose funds they manage that are also not attached to a lean or contract. This supplier of finance has been overlooked by corporate governance theory and practice.

### 2.4.2 Challenges to an appropriate contemporary theory of corporate governance

Corporate governance scholarship predicted the institutional investor, as illustrated by Berle as far back as 1928:

> "Suppose... trust companies were in the habit of accepting, on "custodian account," deposits of stocks from small shareholders, thereby gathering many small holdings into an institution commanding a block so large that protection was worthwhile, and that they also provided themselves with power to represent the depositors of stock. Such institutions could easily keep themselves informed as to the affairs of the corporation... and, as

> representing their clients, could take the action necessary to prevent or rectify violations of property rights.” (Berle, 1928; p76)

Soon after, the corporate law scholar was awarded a Rockefeller grant stipulating interdisciplinary governance research and so enlisted Gardiner Means, an economics scholar. Means’ empirical research showed the startling trajectory of corporate wealth concentrated into the hands of a small cadre of managers. His concern at this unbridled power shifted Berle’s advocacy from one of corporate self-regulation and legal light touch to one of strict government control. As Bratton (2001; p752) comments, “[c]orporate law thus met economics seventy years ago with results different from those usually attending such encounters today… Today economics tends to encourage lawyers to take deregulatory positions.” Corporate legal positioning has reinforced economic theory trends to codify the firm as a nexus of contracts benefiting the responsibility free shareholder into the corporate governance cannon. Berle’s predicted rise of the institutional shareholder with the power to enforce their own property rights failed to acknowledge the potential for destructive self-interest in the investor who is not invested with their own funds.

In 2003 Armour et al. concluded that the governance system in the UK, far from stabilising around the norm of shareholder primacy, was in a state of flux. The preceding sections have described that over the development of corporate governance during the managerial capitalist phase was strongly influenced by the fiduciary duties of managers at the helm of societal institutions; the business statesman. In the 1980s and 1990s a dissenting economic theory of governance became rapidly dominant. The next section considers the often dualistic views the different academic disciplines of economics and corporate law have developed on the purpose of the firm, and in particular whether the shareholder is the firm's primary obligation.

#### 2.4.2.1 The shareholder as owner view of the firm

> *"Two hundred years of work in economics and finance implies that in t*he absence of externalities and monopoly (and when all goods are priced), social welfare is maximized when each firm in an economy maximizes its *total market value." (Jensen, 2001)*

This view is consistent with Friedman (1970), Coelho et al. (2002) and Stieb (2009) that maximising returns on shareholders' private property assets is ethically consistent with utilitarianism, delivering the greatest good to the greatest number. Sundaram and Inkpen (2004) turn their attention to developments in the US with the widely cited legal case, Dodge vs. Ford Motor Company, 1919. When Henry Ford wanted to reinvest Ford Motor Company's retained earnings into the company rather than distribute it to shareholders a minority shareholder brought a legal suit alleging his intention to benefit employees and consumers was at the expense of shareholders. The court ruled "the business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end."[12] This ruling alongside the establishment of the

[12] Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919):p4

Securities and Exchange Commission[13] paved the way for a formalised corporate governance code of practice based on the foundation of shareholder ownership.

The financial markets provide what corporate governance calls "external control" (the ability of the market to monitor and punish or reward the firm via manipulating its share price; Kadyrzhanova and Rhodes-Kropf, 2011). Under the Anglo-American stock market regime, the role of the markets is to value the firm as a contributor to its economy. Consequently, owners can vote at the Annual General Meeting and can sell or increase their holding or take over the firm entirely based on their evaluation of firm performance (Gillan, 2006). These powers provide the most robust argument for shareholders as owners of the firm. This economic view is grounded in the logic of minimising agency costs through these monitoring and incentive mechanisms (Mostovicz, 2011; Lan and Heracleaous, 2010; Winkler, 2004). The shareholder view of the firm has added new mechanisms for monitoring and incentivising their agent (monitoring through Arthurs et al.'s (2008) board of directors; Morgan's (2002) reporting, regulatory and monitoring agencies; or Erkens et al.'s (2012) separation of CEO and chairman and incentivising through Spector and Spital's (2011) incentive-based pay; or Goergen and Renneboog's (2007) market for corporate control). The firm is a legal fiction more appropriately viewed as a system or "nexus of contracts" in dynamic motion (Reich-Graefe, 2011a; Blair and Stout, 2008; Jensen, 1985; Jensen and Meckling, 1983). It is a profit maximising mechanism that will rationally seek to externalise as many costs as possible to the sole benefit of its

[13] Through the passing of the Securities and Exchange Act of 1934 (see Gilson and Kraakman, 1993 for detailed developments)

owners, forcefully argued by the Jensen and Meckling cannon as being the residual claims due shareholders (Ramirez, 2005). This view is also grounded in the economic assumption that managers are self-interested agents, likely to advance their own wellbeing ahead of the principal whose assets they manage (Cheffins and Bank, 2009; Stout, 2003b; Hendry, 2001; Jensen and Meckling 1983). When faced with conflicting paths, managers must choose that which benefits the shareholder even at a cost to other stakeholders (Blair, 2003). To do otherwise is an ethical abuse of another's profits (Rodin, 2005; Coelho et al., 2002; Hasnas, 2001; Friedman, 1970) or an unauthorised transfer of wealth from owner to other (Jensen and Meckling, 1983; North's (1983) rent dissipation). However, when Jensen and Meckling (1983; p1981) says of the corporate purpose "investors are willing to hold wealth in the form of claims on such organisations, because (or to the extent that) management acts on their behalf", the premise need not lead to the conclusion. Investing in shares could be the simple advance of finance for a return on investment, as with debt.

Distaste for the theory has intensified in the light of corporate and shareholder scandals as directors' remuneration incentivise them to manipulate the share price without acknowledging market movements based on the economic health, change in consumer tastes or commodity prices, and pure market speculation (Fassin and Gosselin, 2011; Stout, 2007; Stout, 2003b). Notions of trustworthiness, duty or professionalism are not acknowledged or valued in this view of corporate governance, acknowledging only self-serving motivations that may encourage a self-fulfilling prophecy (Ghoshal, 2005; Stout, 2003a). Ramirez (2007) catalogues manager's soaring salaries since the 1980s, blaming the stock incentives for the 200 criminal probes into CEO backdated options immediately prior to the 2007 financial crisis. He argues the view of aligned owners and managers through stock incentives is now embedded in law despite being neither politically or economically sustainable. Ryan and Buchholtz (2001) remind us that the corporate governance scholarship has largely ignored the role or motivations shareholders bring to governance, surely they are responsible for allowing the over-compensation of their manager agents. The frequent calls to increase shareholder power to curb management excess (see Bebchuk and Weisbach, 2010; Bebchuk, 2005; Monks and Sykes, 2002) present a radical change to the traditional view of corporate governance, but do not prevent substituting management excess with shareholder excess, and deny any other recipients governance protection from the firm. It is also easy (perhaps purposefully easy) to misinterpret shareholders as the "suppliers of finance" in the finance industry, where trade in financial capital is the service of the business, making many stakeholders a supplier of finance (Triantis and Daniels, 1995). As Stout (2003a) highlights this view of corporate governance may not be empirically predictive. If not corporate governance codes cannot unambiguously assert that management are agents of shareholders. Codifying extensions to shareholder powers may simply perpetuate a myth of the firm that has no basis empirically.

#### 2.4.2.2 Debunking the shareholder-as-owner model

There are many empirical anomalies that threaten the shareholder as owner view the firm. Jensen and Meckling (1983; p327) proposes that the firm is an "equilibrium behaviours of a complex contractual system made up of maximising agents with diverse and conflicting objectives," managed for the shareholder as a principal by the management as an agent. Lan and Heracleous (2010) believes the "large and growing" body of empirical research fails to support the agency view. Some of the regularly described anomalies are outlined next.

#### 2.4.2.2.1 The firm as a juristic person

The shareholder ownership concept continues to dominate corporate governance scholarship, and agency is still the chief economic problem of interest in corporate law (Moore and Reberioux, 2011; Stout, 2007; Blair and Stout, 2006; Winkler, 2004; Armour et al., 2003; Bainbridge, 2002). However, from its inception, Jensen and Meckling's agency analysis failed to model the legal reality of the modern corporation. Corporations are independent legal entities created by the state; a juristic person (Bainbridge, 2006). The firm enjoys perpetual succession, and survives the death of any given shareholder (Crane and Matten, 2007). The US courts have upheld the constitutional rights of the firm as person and South African courts consistently hold that under law no person "whether natural or juristic" can be owned (Fisher and Lovell, 2009). The firm as a juristic person can sue or be sued (Verret, 2010; Iwai, 1999), hold and dispose of assets (Blair and Stout, 2008) and enter into contracts (Bainbridge, 2002) without recourse to shareholders, their purported principal.

##### 2.4.2.2.2 Directors' powers and duties do not resemble those of agents

In Delaware in 1988 in Blasius Industries, Inc. v. Atlas Corp[14] it was ruled that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests". Yet directors' undelegated powers are handed to them through the incorporation documents that precede any offering of shares to the public (Lan and Heracleous, 2010). These "sui generis" (unique in its characteristics) powers defy the principal-agent view of the firm and allow directors to control all aspects of the firm's activity including the decision to return any capital (dividends) at all to shareholders (Blair and Stout, 2008). Business strategy, executive appointments (including fees and salaries), preparation of the accounts, the declaration and distribution of dividends and deployment of corporate assets and earnings to stakeholders (creditors, employees, the local community, philanthropic causes) are made by directors with no legal requirement to consult the shareholder (Greenwood and Van Buren, 2010; Anabtawi and Stout, 2008; Bebchuk, 2007). As long as directors refrain from abuses of power the business judgment rule legally protects their decisions from shareholder challenge (Blair and Stout, 2006). As directors receive their powers from the law on incorporation and not from shareholders as agency implies; they cannot waive the duty to act in the best interests of the firm, even if the shareholder wishes it (Lan and Heracleous, 2010). Also, under the law of agency, an agent owes the principal a duty of obedience yet directors are not required to

[14] 564 A.2d 651 (Del. Ch. 1988) in Karmel 2010, footnote 5.

follow shareholder mandates (Blair and Stout, 2006). Directors' legal powers and responsibilities more closely resemble those of trustees (Ryan et al., 2010; Blair and Stout, 2006). Whereas honesty and transparency are moral duties in contracting, where it is assumed that parties meet as equals, trustees have enhanced duties by virtue of their dominant position (Blair and Stout, 2006).

This dominant position has encumbered directors' power with a strong statutory set of fiduciary duties. It marries a duty of loyalty and of care, adjudicated by the exclusive benefit rule prohibiting the fiduciary owner from acting in their own interests (Dunning, 2012; Anabtawi and Stout, 2008). Information asymmetry and power to control the firm's assets hand directors an advantageous position, and thereby a duty to take special care of the beneficiary's interests (Dunning, 2012; Graafland and van de Ven, 2011; Lan and Heracleous, 2010). They must review management decision making and ensure it is in the best interests of the firm (Section 172 of the UK Companies Act 2006 in Lan and Heracleous, 2010). A duty to the firm that is not required of the shareholder (Becker and Stromberg, 2012; Anabtawi and Stout, 2008).

The direction of this duty is to "the firm and its shareholders" and this conflicting recipient of the duty (shareholder or firm), provides the tension in governance research in corporate law (Ryan et al., 2010). When taken together, the directors and officers seem more legally designed to be trustees of the juristic person of the firm than the agents of shareholders.

#### 2.4.2.2.3 Shareholders' powers and duties do not resemble those of principals

If the corporation is akin to a "representative democracy" then shareholders would install directors and direct corporate decisions to serve their interests (Bebchuk, 2005). Yet much corporate law acts to limit shareholder power over corporate governance and corporate decision-making (Bainbridge, 2006). Blair and Stout (2006) view shares as being vested with such limited legal rights that shareholders of public corporations have too little control to be considered owners and no power to direct their agents to be considered principals. A principal can direct and easily remove an agent (Bebchuk, 2005; Greenwood, 1996). Bebchuck and Weisbach's (2010) investigation of litigation brought by shareholders firmly supports the courts' reluctance to undermine directors' and officers' powers unless the plaintiff can show negligence or abuse. An enforceable duty to maximise value for shareholders is very rarely imposed on directors and the majority of the legal cases to protect finance have been brought on behalf of banks or other creditors and not shareholders (Stout, 2007). In fact shareholders have very little opportunity to influence the firm even in major decisions such as winding up, key asset sales, or scaling down (Bebchuk, 2005). Laws addressing shareholder voting power remain weak (Bebchuck, 2007). Greenwood and Van Buren (2010) reference the ability to vote on the directors recommended, but not to nominate them or vote on most other activity. Shareholders have a private property interest over their own shares, and the decision to buy and sell, conversely they have no private property rights over the corporate assets (Karmel, 2004). Nor are they able to use or direct the use of these assets, a fundamental tenet of the private property rights of the principal (Freeman et al., 2004; Donaldson and Preston, 1995; Boatright, 1994). Shareholders' liability is limited to their share ownership, contrasting with directors' unlimited liability (Stout, 2007), they are unable to withdraw their own capital directly and their creditors cannot access the assets of the firm. Ultimately, as residual claimants to the firm, they cannot dictate dividend policy to ensure a return on their assets, if their assets were indeed the corporate assets (Lan and Heracleous, 2010; Blair and Stout, 2006). These statutory positions depart from the economic agency theory of a principal, as does the view of agency law.

Shareholders are also too unstable to be considered principals, changing identity daily as shares change hands. This Bratton and Wachter (2013) say requires taking a fictional view of the shareholder, not an individual desiring specific behaviour from the firm they "own", but a stylised and homogenised concept-being, immortal and impatient, desiring only value maximisation. La Porta et al. (2000) argued the legal view of the directors as trustees for the corporate personage is a more productive way of understanding corporate governance than the market systems view. Trustees of the corporate person hold the mechanisms to both model and enforce governance; the marriage of a prescriptive and predictive theory. They are also able to consider the humanistic view of firm behaviour, those of power, morality and obligation (Fisch, 2006; Greenwood, 1996), removing the influence of the anonymous, avaricious shareholder.

Stout (2003a) believes this view will actually benefit shareholders as firms attract more long-term sunk cost investment. The duty of obedience vested in legal agency is one of “unthinking faithfulness to a person, group or purpose, requiring the bearer to supress their own preferences, values and perspectives” (Fisher and Lovell, 2009; p295). Sandbu (2012; p99) says of any legal agency obligation; “representing someone, in the morally relevant sense, will entail tending to the moral responsibilities of those one represents”; both views contradicting the economic agency view of management’s self-interest being suppressed through monitoring and incentives available to anonymous principals.

### 2.4.3 Managers as trustees replacing managers as agents? The evolution of fiduciary duties

The literature on the object of managements’ fiduciary duties is reasonably consistent in acknowledging a duty owed to shareholders (see Anabtawi and Stout, 2008; Fisch, 2006; Gillan, 2006; Karmel, 2004; Armour et al., 2003; Hendry, 2001; Bratton, 1994). Indeed, Coelho et al. (2002; p2) address “the fiduciary duty to firms’ owners is the bedrock of capitalism and capitalism will wither without it.” In their policy guide “Capitalism without owners will fail,” Monks and Sykes (2002; p1) wholeheartedly agree. However, a growing body of work see these duties aimed at the firm, rather than the shareholder (see Atherton et al. (2011) for duties to the firm, Boatright (1994) for duties to the corporate assets, La Porta et al. (2000) to shareholders and creditors, or Greenwood (1996) to broader firm community wellbeing goals). However, according to Anabtawi and Stout (2008) and Marens and Wicks (1999) the real world impact of the direction of these duties has received little attention. Instead they have meandered from common law, not as an elegant set of well-defined principles, but through the incremental adoption of vague doctrines then “selectively applied toward solving practical business problems or settling a variety of disputes” (Marens and Wicks, 1999; p274), a path dependence that Ramirez (2007) described as dysfunctional and Reich-Graefe (2011a) agrees, providing no “modicum of predictive ability regarding director behaviour”. Atherton et al. (2011) believe this is because the duties have lost their way from the strong ethical and religious origins directed at man’s behaviour in society in the race to adopt an egoist corporate governance view of the conniving agent and vulnerable principal.

#### 2.4.3.1 Why the direction of corporate fiduciary duties is important to the study of pension governance

Corporate governance theory tells us that the corporate structure (external shareholders) and governance compliance regime of the firm will dictate the execution of their own fiduciary duties. Fund management firms in the UK pension market exist in numerous geographies as publicly traded companies, wholly owned subsidiaries of publicly traded companies, employee-owned companies or limited liability partnerships, each with their different levels of ‘owner’ separation. Under the current legal regime governing pensions, despite strong moral obligations to members, pension trustees are unable to pass these duties to this agent with a potentially conflicting fiduciary objective.

If the shareholder were replaced by the firm as the trustee oriented object of corporate governance, strengthened fiduciary duties may provide the underpinning values business ethics scholarship is searching for in the corporate governance problem. Trust law strongly dictates that one should not harm the beneficiary, even if it pays to do so, implying conceivably that management's duty to the firm would be to the long-term protection of its all stakeholders (Atherton et al., 2011; Graafland and van de Ven, 2011). From an empirical perspective self-esteem, professionalism, corporate prestige and general desire to act honestly are notions incorporated in the monitored and legally enforceable discharge of vested fiduciary duties, and need not be motivated by incentive based remuneration (Key, 1999; Donaldson and Preston, 1995; Jones, 1995; Donaldson and Davis, 1991). Indeed, Becht et al. (2011) observe that banks with lower levels of variable remuneration incurred fewer losses in the 2007 financial crisis. The same phenomenon has not been observed in pension fund management literature. From a theory perspective, Freeman (1994) believes managers and directors have fiduciary responsibility to numerous stakeholders, and that it is not optional, it is a moral obligation. Lan and Heracleous (2010) argue that the law has provided not only the normative framework for the development of stewardship theories, it also has the instrumental power to sanction. Twenty years ago Hartman (1993) called for the problem of the beneficiary of the fiduciary duty to be put to rest, branding both statutory and case law inadequate for protecting against directors' inappropriate favouritism of shareholders. However, as of today, both economics and the law concur that shareholders are owners of firms and beneficiaries of fiduciary duties (Anabtawi and Stout, 2008). Perhaps most importantly this opinion was developed with shareholders cast as citizens; homogenous and rationally apathetic individuals vulnerable to management abuse, an assumption Greenwood (1996) believes we can no longer hold. In the fund management industry specifically, the legal and moral protection of the shareholders of funds managers leaves pension scheme members vulnerable to shareholder abuse. When tracing the origin of pension funds, alongside with the corporate governance argument for protecting the suppliers of finance being the powerful institutional investor, it is the more defenceless principal which the ethical business should be protecting in Crespi's (2003) battle to return the fiduciary concept to the achieving of desirable social objectives.

## 2.5 Conclusion

A social science theory should deliver scholars and practitioners a model for viewing their problem both prescriptively and predictively. The path dependent development of firm theory has left contemporary Anglo-American governance scholars in broad agreement that the economic agency view of the firm, conceiving the shareholder as owner, has come to prevalence. Whether this is a satisfying state for research is certainly not agreed and a myriad of historical and empirical anomalies are frequently documented. Letza et al. (2004; p243) believe the current view of corporate governance is "over-abstracted and over-static" and constructed on centuries-old social contexts bearing no relevance to the present day. This history of protecting investors from management misappropriation left no room for reciprocal duties, and assumes they are not motivated or powerful enough to conduct the same self-interested rent seeking attributed to management. It also accords management no duties of morality or obligation, only assuming that they must be bought. This chapter introduces the lens by which the tension between the fiduciary duties of fund managers can be viewed. Many scholars deconstructed bank governance in the wake of the financial crisis (see Chapter 3) and found it to be different to that of other corporations. Banks, like all financial intermediaries, manage supplies of finance as their corporate objective. The finance industry is firmly rooted in the disciplines of economics, finance and accounting in a way that traditional industries are not. The economics of return on finance is the core business model (as opposed to return on production in traditional industry). Interestingly, pension fund managers escaped the post-financial crisis academic scrutiny the banks endured. Yet billions of uninsured pounds were wiped from the savings accounts of the UK's pension members while the industry specific fee structure was retained. Fund managers have not yet been found to owe special duties to pension clients (O'Brien, 2004). This scenario, Ingley and van der Walt (2004; p540) point out, "is structural… and has less to do with law enforcement and more to do with the way companies are owned and run". The Kay Review (2012) found that the implications for the investment industry are profound, criticising the disproportionate rewards extracted from exploited pension funds for intermediation of the trillions of pounds in employee savings. Monks (2002a; p116) observed the unusual fiduciary conflict of fund managers; "[w]hen fiduciaries have relationships such that 'exclusive benefit' is literally impossible, attention focuses on the conflict of interest between the fiduciaries and the plan beneficiaries. Where they face potentially conflicting interests, the fiduciary may need to step aside, at least temporarily, from the management of the assets." Aglietta (2000; p146) concludes this has created a systemic "financial fragility which questions the hypothetical advantage of private pension funds." This chapter lays the background foundations for an empirical examination of the governance structures of fund managers to determine whether their corporate governance supports the maxims of the shareholder wealth maximisation model as ownership becomes separated from management. If not, the study joins a growing body of research that explores and rejects the dominant shareholder theory and seeks to present a contribution to theory more representative of the real world grounded in the law of corporate agency, rather than the economics of agency. If the theory is empirically supported, this fiduciary inquiry becomes whether society can tolerate a universal pension provision system governed for the benefit of a small, privileged group of fund manager shareholder principals.

In an empirical examination of an agent with two principals, the chapter introduces ambiguity over whether one principal can even be conceived as such. This has important implications for the examination of pension governance. Chapter 3 presents an explanation of this second principal and the evolution of the fiduciary in finance ethics that supports their claim to a fiduciary duty from the fund managers as trustees of the firms that manage their assets.

# Chapter 3
# Literature review: The governance of pension funds management

> If you would understand anything, observe its beginning and its development ~ Aristotle, C4th BCE

## 3.1 Introduction

The objective of this chapter is to establish the literature regarding the fiduciary management of pension assets in the UK. The previous chapter explored the importance of Anglo-American corporate governance to the development of the stakeholder orientation of firms. However, the recent finance industry development of the rise to power of financial intermediary institutions has been largely overlooked by contemporary corporate governance theorists (Aglietta and Reberioux, 2005). These intermediaries are increasingly significant to the economy. Financial services profits as a percentage of total corporate profits in the US were 10% in the early 1980s and had reached 40% in the mid-2000s (Crotty, 2009). In 1980 Eugene Fama (1980) articulated their economic role (at the time mainly banks and insurance companies) as passive portfolio holders in frictionless competitive markets, with no institutional governance effects acknowledged. Simultaneously and conversely, Clark (1981; p561) declared the third stage of capitalism; “the age of financial intermediaries has entered its golden period.” He believed any clear, long-term pattern of change in the institutional arrangements for channelling capital had not been identified and interpreted; “One of the[ir] most intriguing features…is simply that they exist, and are begging to be placed in their historical context”. By 1985 Fama’s (1985) interpretation had evolved with the assumption that information distortions in intermediation had important theoretical consequences. This chapter describes pension asset management in general and financial intermediaries managing pension funds specifically to examine how it has disengaged from the assumptions of traditional finance theory and the theory of financial intermediation.  These economic theories view capital as a veil, channelled distortion-free between parties in the real economy for production and consumption (Boatright, 2009).  It took the arrival of information economics to recognise that it is not money that matters in the financial intermediation, but the institutional behaviour of the parties that collect and provide that money (Van Liedekerke, 2013).  Finance ethics have concentrated on the consequences of wrong-doing (for instance insider trading, short selling or options revaluing: see Boatright, 2011; Boatright, 2000), limiting themselves to the level of individual morality and leaving institutional behaviour analysis to economists (Van Liedekerke, 2013).  The chapter examines the literature of financial intermediaries, pension management, finance ethics and fiduciary duties to explore whether financial intermediaries fulfilling their legal corporate governance obligations may contravene an expected fiduciary duty to pension savings.

Financial intermediation theory assumes investors invest in the market directly, incurring a market-induced transaction cost for channelling pooled savings through the banking industry as borrowing and lending, or through the stock and commodities markets as investment in stocks (Zhao, 2013).  Corporate governance scholarship (Chapter 2) examines the fiduciary problem of shareholders protecting their private property from management abuse.  The underlying corporate governance objective - that the institutions entrusted with your money can be trusted to act in your interests - has overlooked the intermediary placing this money for a fee.  Allen (2001; p1166) argues “how can it be that when you give your money to a financial institution there is no agency problem, but when you give it to a firm there is?”  He concludes that both corporate governance theory and financial intermediation theory have left a gap, the assumption that a publicly listed financial intermediary corporation has no agency problem. Caprio and Levine (2002) register surprise that financial intermediaries have received such little corporate governance attention given their central role in capital allocation for economic functionality. Corporate social responsibility scholarship - what responsibilities corporations owe to whom - has largely ignored the finance industry for almost 100 years (Wells, 2003). Pensions academic Robert Monks (2002b; p119) observed, “the richest people do not run companies; the richest people run companies that manage investments”, demanding we question the value added by pension fund intermediation for the exorbitant cost. While Harris and Souder (2004) and Lewis et al. (2010) suggest the root cause of financial scandals can be traced back to capital market norms of self-enrichment, the thesis takes a structural view. Goulet (2002) derides such an objective as looking for just outcomes in an economic system that is structurally unjust. However, the previous chapter’s exploration of the governance duties corporations owe shareholders concluded that in the Anglo-American view of a firm, including a financial intermediary firm, fiduciary duties are owed to shareholders. This chapter now challenges these duties by investigating the normative duties owed by intermediary corporations to the pension funds they manage. It concludes that there is a conceptual conflict of interest for an agent balancing conflicting fiduciary claims.

The first section of the chapter explains these changes in the finance industry and their consequences in changing structure of the cost of intermediation. The second section outlines finance theory’s assumptions, still grounded in the finance industry of the 1950s, and examines whether they are being violated by the cost model of the new intermediaries. The final section describes the development of the fiduciary concept in finance, and how it may differ from the corporate governance codes of practice, or whether it even arises.

## 3.2 The governance framework of occupational pension provision: *The principal's problem*

Clark (2004) sees the proper functioning of occupational pension schemes as vital to Anglo-American workforces, given the modest value of current state pensions. Governments have come to rely on individuals making provision for their own retirement income requirements. This places great reliance on the "competence and consistency" of financial decision making in the schemes their constituents belong to (Clark et al., 2007). The government provides the framework in which these decisions occur. Barr (2006) describes that in 2005, in response to the Myner Report[15], the Pension Protection Fund was established (analogous to the Deposit Insurance required by retail banks), charging pension schemes a portfolio risk rated premium. Schemes were forced to de-risk their portfolios or incur deficit-inducing protection premiums (Barr, 2006). Within the legislative framework sit "nineteenth-century antecedents", the individual pension trusts, where trustees have wide-ranging fiduciary powers consistent with English common law to establish "a robust, process-oriented decision-making framework

[15] Described in Section 3.2.6.1

including administrative and oversight functions as well as due regard to the investment of pension fund assets" (Clark, 2004; p233). Unlike most financial services providers, the historical trust origins of pension schemes hand specific fiduciary duties to trustees in their protection of beneficiaries (Clark, 2004). When examining whether the industry structure supports trustee oversight, studies must consider the legal requirements of different pension scheme types that change the nature of the trust's risk and decision-making framework.

### 3.2.1 Description of the scheme types

The oldest and most common pension scheme type is one that precisely defines the benefit a contributing member will receive on retirement or early death. This defined benefit is independent of the member's total contribution, or the investment performance of the fund's assets. Population aging combined with shorter average employment periods and ongoing poor performance in equity markets have put many of these schemes into deficit (Kutsch and Lizieri, 2005). Pension sponsors began to shut them down in favour of schemes defined only by the contribution a member makes in total. While Petraki (2012) describes the difference as deceptively subtle, the consequences for trustee duties and the resulting financial benefit to members are demonstrably different.

#### 3.2.1.1 Defined benefit schemes

The definition of the Pensions Regulator of a Defined Benefit scheme (DB) is “a scheme in which the benefits are defined in the scheme rules and accrue independently of member contributions payable and investment returns. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring, and the length of pensionable service.”[16] (Also known as 'final salary' or 'salary-related' schemes). This is the scheme most studied as it creates the most complexities for trustees and has a long performance data record (Petraki, 2012). Its operation is akin to the insurance industry, where actuaries monitor the scheme’s liabilities, members are assured of the benefit they will receive, and trustees have separate control over the corresponding asset to manage as they deem appropriate provided they can honour the scheme’s liabilities (Kutsch and Lizieri, 2003).

The DB commits to an employee’s lifetime annuity on retirement, financed through co-payments by the employee and the employer (the plan’s sponsor). By law, the sponsor must maintain sufficient assets in the fund to cover all accrued vested benefits, even where the sponsor is insolvent (Blake, 2003). The trustees handle a duty of matching the net present value of future benefits owing against the expected financial returns from the invested assets. Matching shortfalls can be remedied by: 1) closing the fund to new members, although this means any gap remaining must be honoured by the sponsor (Mitchell et al., 2008); 2)

[16] http://www.thepensionsregulator.gov.uk/Glossary.aspx

decreasing benefits entitlements, such as the public service migration to average rather than final salary benefits (Kutsch and Lizieri, 2005); 3) demanding the sponsor contribute a lump sum to the shortfall, although this is politically difficult for trustees given their employment relationship with the sponsor (Hess and Impavido, 2003); so 4) seek premium performance from the assets under management (Barr, 2006).

#### 3.2.1.2 Defined contribution schemes

The definition of a defined contribution scheme is provided by the Pension Regulator as "a scheme in which a member's benefits are determined by the value of the pension fund at retirement. The fund, in turn, is determined by the contributions paid into it in respect of that member, and any investment returns."[17] (Also known as 'money purchase' scheme). Its operation is akin to the banking, where members deposit savings and receive these back plus any return (loss) on investment achieved (deducted) by the trust.

There are two important features of this scheme given that both the government and the employer have devolved the risk of securing retirement down to the level of individual. Firstly, the contributing individuals are rarely investment professionals, and so rely on the investment decision-making of the trust (Rosada, 2013). Secondly the linear relationship with salary does little to redress the poverty concerns that the lowest paid are the least able to afford retirement,

[17] http://www.thepensionsregulator.gov.uk/Glossary.aspx

and the DC pension provides no insurance against contributions lost from investment losses (Barr, 2006). According to Petraki (2012; p6) “since this shift from DB to DC is relatively recent there is still very little evidence whether DC pension funds are up to the challenge. First reports coming from the US indicate that this is not the case. Many DC plans are found to be rather inadequate to replace income at retirement. In view of the widespread change toward DC pensions this is disquieting particularly as there are very few studies on DC funds' performance.” The duties of the trustees under a DC scheme shift from asset - liability matching to a duty of hyper-vigilance in investing and efficiency in administrating the fund giving the contributors the best chance of maximising their returns (Ryan and Dennis, 2003).

#### 3.2.1.3 Hybrid and other schemes

Many large scheme sponsors operate a hybrid of DB and DC plans as they transition away from self-borne financial risk, or operate different plans for different sections of the workforce (Kutsch and Lizieri, 2005). There are also schemes designed by the regulators to be less burdensome on small employees such as stakeholder plans[18] and Group Personal Pension Plans (GPPP)[19]. The onus is entirely on the member to assess whether the cost and suitability of the plan meets their needs and the employer is not obligated with a duty of care to protect the member (Barr, 2006).

[18] http://www.thepensionsregulator.gov.uk/employers/about-stakeholder-pensions.aspx
[19] http://uk.practicallaw.com/7-107-6670?service=pensions

### 3.2.2 Implications of risk shifting towards the individual

Finance theory revolves around the analysis of the relationship between financial risk and reward. It makes the assumption that parties have perfect information about the financial risk they are assuming and that the anticipated reward adequately compensates this burden (Allen and Santomero, 2001). In the case of pension schemes it can also be inter-generational, as current contributing members bear the future risk that their benefit will default, not borne by current benefit recipients (Cui et al., 2009). As neo-classical economic thinking drove the global shift towards pension privatisation (Dixon and Hyde, 2003), what is critical to understand from a finance theory perspective is who bears downside risk and are they aware of their consequential exposure, or as Barr (2006; p8) interprets, “encouraging risk to where it is best managed.” Between 1948 to the early 1980s the risk of a pension shortfall lay with the public purse (Clark and Urwin, 2007). As pension management devolved to occupational schemes, the sponsor shouldered the risk of shortfall. Occupational trusts do not benefit from limited liability, and so the risk of shortfall to the sponsor cannot be externalised or transferred to the public through bankruptcy protection (Joly, 2010). To avoid a shortfall in a DB scheme (as all costs, including investment losses and administrative costs are absorbed) the sponsor must ensure that the pension scheme is expertly governed as the promised benefit to the member is contractual (Clark, 2004). Indeed, there is a strong correlation between pension governance and fund performance (Ambachtsheer et al., 2007). The other means the sponsor has available to avoid a shortfall is to shift the financial risk to members by switching to a DC scheme, the frequency of which is increasing

(Clark, 2004). Here the financially unsophisticated and resource constrained member bears the risk in a scheme whose governance and trustee duties rely on the sponsor to procure contracts for financial asset management where the return on investment performance is not underwritten by them, only the cost of administrative provision (Clark, 2004). A further devolution of financial risk to the individual is through the rise of individual accounts (GPPP or stakeholder plans). These plans are commercially operated by for-profit corporations and they charge the highest administration fees of the scheme options presented (Barr, 2006).

Risk management is at the heart of finance theory and yet the reality of who bears the risk, who receives the return on investment, and how equitable that distribution is receives no attention from the theory (Kolb, 2011). The average administration fee for a UK scheme is 1% of contributions, or an average of 20% of contributions over a typical contributions lifetime (Barr, 2006). This administration fee on gross contributions is additional to the cost borne by members for intermediating the scheme's assets. Where the member has peace of mind that their benefit is defined, this may represent a justifiable price for the security that the sponsor bears the financial responsibility for ensuring the benefit. Within the context of risk shifting in pension management, the chapter examines the fiduciary responsibilities (if any) the intermediaries contracted by UK pension schemes has to manage their assets to maintain the integrity of the risk/reward relationship for the asset owners.

### 3.3 The relationship between risk and reward in capital markets

This Section describes the theory of the financial system to contextualise how pension asset management should operate if either finance theory or agency theory is to be prescriptive and predictive. This requires an understanding of the historical developments in theoretical assumptions that have shaped the nature and role of markets in today's society (Ardalan, 2007). The financial system has three functions: 1) a payment system for the exchange of goods and services as the coordinating pricing mechanism; 2) a mechanism for pooling funds to undertake large-scale investment; and 3) a transfer mechanism for economic resources to move through time, by managing risk and uncertainty (Merton, 1995; Black and Coffee, 1994). Economic theory perceives rational, perfectly informed and risk-averse investors place their own savings into financial assets available for sale in frictionless markets (Ardalan, 2007). Illustrated by Boatright (2000), a glut of grain at harvest will depress prices for the farmer; a shortage will raise them for the miller. Instead of waiting until the harvest and exchanging at the market price they might agree a price in a contract that solves two problems; creating long term financial relationships and managing a lack of knowledge about the future where the agreement allows both parties to satisfy their utility. The relationship between the required return and the risk each party is prepared to take on in the attempt to achieve satisfaction encapsulates the study of finance (Allen, 2001).

### 3.3.1 The function of the financial system

Academic research in finance begins with the efficient market hypothesis (Fama, 1991; Fama, 1970). According to Fama (1970; p383) “The primary role of the capital market is allocation of ownership of the economy's capital stock. In general terms, the ideal is a market in which prices provide accurate signals for resource allocation: that is, a market in which firms can make production-investment decisions, and investors can choose among the securities that represent ownership of firms' activities under the assumption that security prices at any time "fully reflect" all available information.” Fama (1991) reiterated this view, individuals conduct financial transactions as rational economic agents in unfettered markets with the assumption that no interests conflict. Each individual is legitimately pursuing self-interest and no one party has any obligation to serve the interests of another (Boatright, 2000). The individual goal of each transaction is an inter-temporal or substitution transfer of consumption (Benston and Smith Jr, 1976). The financial system is thereby the continuous aggregated series of discrete, costless exchanges between coequal counterparties that can be revised as better opportunities arrive (Clark, 2004). Parties trade financial instruments (currency, stocks and bonds, futures, derivatives, etc) in accordance with their individual appetites for the risk of achieving a desired future return on investment (Zhao, 2013). The result of these counterparty negotiations, when all buyers and sellers reach agreement, is the price of the instrument at which market clears of buying and selling opportunities (Heath, 2006). The hypothesis asserts that the speed at which the price is reached indicates the liquidity of the instrument, its readiness to be traded as evidence of the market’s efficiency (Boatright, 2000).

There is considerable debate about the empirical and logical plausibility of this model (Clark, 2004). Many scholars challenge the conventional assumption of the omniscient, rational economic actor (from psychology (Thaler, 1985), corporate law (Stout, 2003a) or information economics (Spithoven, 2005)), suggesting that people act inconsistently with the economic assumption of utility maximisation. Parties should not buy or sell when they cannot ascertain that the characteristics of the good bears collinearity with the price, and finance theory assumes perfect information (Spithoven, 2005). This raises two questions for utility maximisation theory and the function of the financial services industry: 1) are markets actually efficient in allocating financial resources in the presence of imperfect information?; if so 2) why do financial intermediaries exist, imposing transactions costs to either buyer or seller that belies the efficiency hypothesis as a cost neither would agree to bear?

#### 3.3.1.1 Why financial intermediaries exist in theory

The only way that financial intermediaries can exist in a perfectly efficient economy is if they catalyse efficient distributions. If every party in the market is rationally utility maximising and perfectly informed, the transaction costs imposed by the financial middleman decrease efficiency and violate the concept of the markets as purely channels (Altman, 2000). The theory of financial intermediation assumes intermediaries are information aggregators in a market afflicted with information imperfections (Chan, 1983). By relaxing the perfect information assumption, financial intermediaries may have evolved to induce efficient allocations, stewarding buyer and seller both to a higher welfare state. It is a premise that can retain validity only if both the buyer and the seller believe their utility has been maximised at the lowest marginal cost of intermediation.

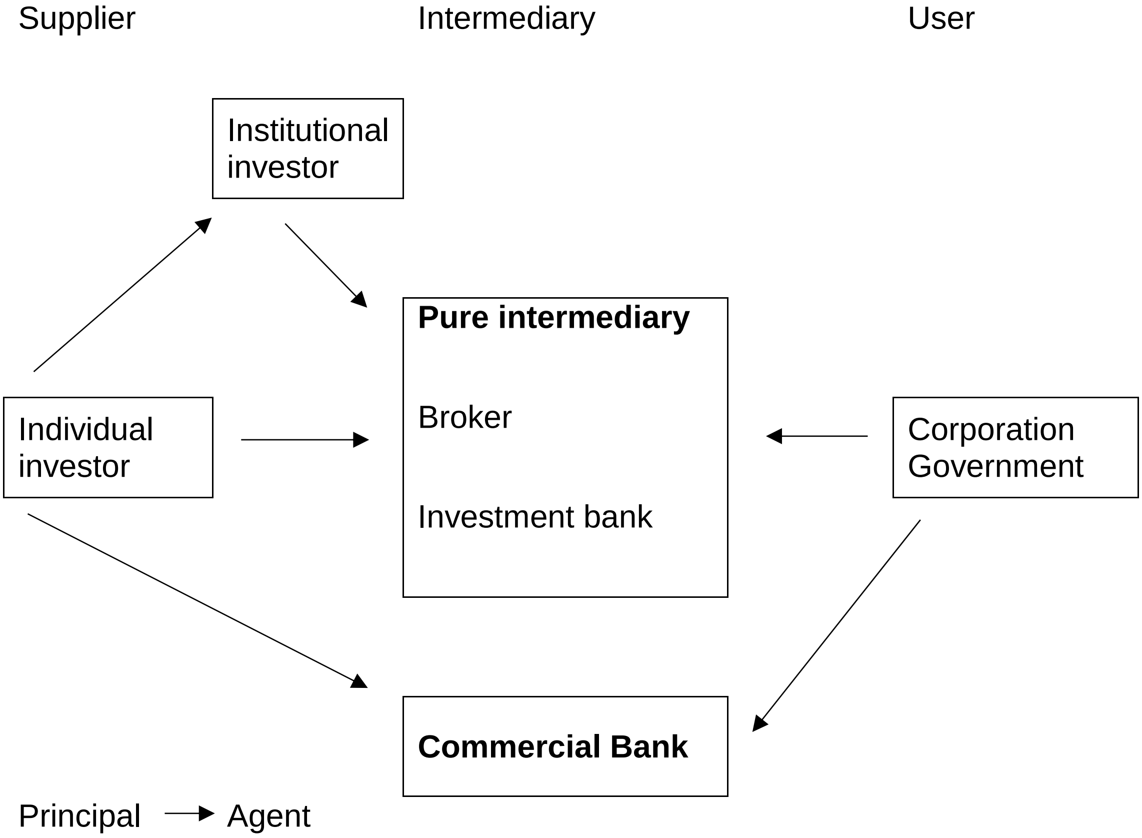
Given financial institutions are some of the largest corporations in the world, it is curious that they have been assumed away as a channel with no effect on real economy transactions (Allen, 2001). At a macroeconomic level finance theory has traditionally concentrated on the role of money in facilitating production and consumption patterns in the real economy, with the finance sector simply providing a platform for exchange (Liedekerke, 2013). Until relatively recently economists neglected to acknowledge the institutions of the financial system or credit them with any influence over behaviour in the finance industry (Liedekerke, 2013; Levine, 2005). It was not until the mid-1970s that an important new theory of the problem of agency caused information economics to begin to recognise the flaw in the premise that markets generated perfect information (Jensen and Meckling, 1976). In 1976 Benston and Smith Jr. (1976; p215) observed that "a proper framework has yet to be developed for the analysis of financial intermediation. The traditional macroeconomic analysis views financial intermediaries as passive conduits through which monetary policy is effected. Even when a more micro view is taken the analyses are often restricted to studying the effect on the rate of change and allocation of money and credit of required and desired reserve ratios, ceiling rates imposed on loans and deposits, etc." They further observed that the popularly deployed Capital Asset Pricing Model (CAPM), approximately 20 years old at this stage, modelled the portfolio of riskless and risky assets best able to achieve the utility maximising consumption desires of the consumer, yet incorporated no transactions costs in establishing the portfolio (mainly developed by the ground-breaking work of Treynor (1961) and Sharpe (1964)). It was not until 1985 that Eugene Fama cast banks as financial intermediaries with solutions to information distortions that had become a real instrument with real economy consequences that the CAPM could not capture (Fama, 1985).

Theorists quickly began drawing conclusions that intermediaries developed as facilitators of financial exchange, solving the structural asymmetric information problems between the market and the investor. The role of the financial intermediary was one of information aggregation and exchange facilitation (market making) and the efficiency of this value-adding transaction cost could be described as a solution to an agency problem (Pacces, 2000). Contracting parties never necessarily met in person and the complexity of financial transactions was escalating to the extent that a third party mediator was required (Boatright, 2000). Liedekerke (2013) defines this as the cost of channelling funds from ultimate savers into the hand of good borrowers, including screening, monitoring and accounting. Since financial intermediaries are also firms, and the accuracy and efficiency of their services are opaque, they should be analysed with the microeconomic tools that have been employed to analyse other industries, to determine the optimal institutional design (Stewart, 1990; Benston and Smith Jr, 1976). It is not the study of money that is important, but the parties who collect and provide money, and their conduct that has decisive consequences for the real economy, as the 2007 financial crisis painfully demonstrated (Liedekerke, 2013).

### 3.3.2 The financial services industry development over time: The uncoupling of risk and reward

At the most basic level the financial system is the function of allocation of economic resources between surplus funds (savers) and deficit funds (borrowers) (Allen and Santomero, 2001). Its conceptualisation has changed over time, and with increasing rapidity, that many scholars believe theory and reality are parting ways (Spithoven, 2005; Clark and Wojcik, 2003; Clark, 1981). As the evolution of the firm was discussed in Chapter 2, with its consequences for corporate governance theory, Clark (1981) similarly charted four stages (generations) of capitalism that have shaped the function of the finance industry. The first was the pre-Berle and Means bourgeois capitalist (promoter-investor-manager, or "robber baron") characterised by a low liquidity banking-led finance industry. The second generation was shaped by the work of Berle and Means (1932) where public investors enter the finance industry via the fledgling stock markets. The third stage of capitalism saw a new market entrant, the institutional investor. While the second stage of capitalism separated corporate ownership and control, the third stage of capitalism split the ownership function between those who supply the capital and those that invest the capital. It was during this stage that the theory of investing developed, including Modern Portfolio Theory (Hogan, 1994). This was the professionalisation of the investment function, characterised by the shift of all financial claims (stocks, bonds and other instruments) from household level to institutional level (illustrated in Figure 3.1). When Clark (1981; p565) was writing in 1981 he was predicting the fourth post World War II stage, describing it as "already discernible in its infancy", and labelling it the “professionalization of the savings-decision function”, made up of group health and life insurance policies and the rapid growth of employee pension plans.

Figure 3.1. The agency structure of the financial services industry


Supplier
Intermediary
User
Institutional investor
Pure intermediary
Broker
Investment bank
Individual investor
Corporation Government
Commercial Bank
Principal → Agent

Source: Palazzo and Rethel, 2008

This mirrors the four stages of development of the firm from Chapter 2. The following Section describes the fourth stage development of the markets; the rise of the institutional investor in pension funds management.

#### 3.3.2.1 Post-deregulation financial services industry: The boon to the financial services industry of social security savings

In October 1986 the Thatcher government deregulated the finance industry in the UK (Davies et al., 2010). It heralded several important changes in the City of London; the modern retail bank, the merging of brokers and market makers and the new financial products of aggregated intermediaries' services that has given rise to the descriptor "financial capitalism"[20]. Britain's regime change brought an influx of US firms who challenged the old City cliques. With them came deep-seated conflicts of interest in financial management introducing "the idea that, instead of being client-based, it was a transaction-based business. You change from long-termism to short-termism, from looking after the long-term interests of your client to making the biggest buck out of today's deal."[21] Steward and Goodley (2011) believe that the growing economic dominance of finance, accelerated by deregulation, helped to bring about profound changes in the UK's economy as responsible for creating an "out-of-kilter" economic model as the finance economy rose quickly to dwarf the manufacturing-led real economy.

In order to manage the rapid evolution in global pools of wealth, the financial services industry created a new intermediary, the fund manager (Walter, 2009) (alternatively asset manager (Clark and Urwin, 2007) or investment manager (Strieter and Singh, 2005)). Acknowledging the social and political importance of

[20] Aglietta and Reberious (2005) see this term describing financial product development designed to maximise the shareholder value of the issuing financial intermediary.

[21] Tony Greenham, Founder of the New Economics Think Tank, quoted in Stewart and Goodley (2011; p2)

safeguarding the funds these institutions manage, the institutions entrusted with them should be conceived of as providing social services to the originating members that is not risky profit maximisation, but lowest cost "or maximum benefit for a specific cost" portfolio management (Handley-Schachler et al., 2007; p625). Given the fund manager's task is risk free - the application of expertise to selecting a portfolio of assets that provides an appropriate return on investment relative to market conditions - its cost and value creation is of critical significance to the pension trustees in discharging fiduciary duties (Holland and Johanson, 2003). Harris and Souder (2004) see efficiency as the fundamental value proposition of these new intermediaries. The theory of financial intermediation would imply any loss of efficiency through the addition of a further intermediary should be minimised through substitution seeking in frictionless markets. Indeed, Streiter and Singh (2005) suggest that the increasing presence of foreign companies has intensified competition, increasing substitution opportunities. Dyck and Pomorski (2011), Coats and Hubbard (2007) and Latzko (1999) observed that competition and low barriers to entry in the mutual fund industry continue to drive participation costs down. However, while economic rationality would also infer encouraging a race to the bottom in the cost of intermediation, they find evidence of increased devotion to sales methods, distribution and customer service instead. Malkiel (2013, p98) is uncompromising in his assessment of fund management value creation, declaring it a "dead weight loss for investors".

According to Malkiel (2013), between 1980 and 2006, the financial services sector of the United States economy grew from 4.9 percent to 8.3 percent of GDP with a substantial share of that increase comprised of increases in the fees paid for funds management. In 2012 financial services accounted for 9.4% of the UK GDP, growing from 7% in 1997 (Maer and Broughton, 2012). Despite the economies of scale that should be offered through collectivised management, fee structures have actually risen over time to a substantial percentage of the assets managed (Malkiel, 2013). Fund management fee structures are asset-weighted, also called an asset based fee structures (Lynch and Musto, 1997). In its most basic iteration, if a fund manager has two clients, one with £10 million in assets under management and the other with £100 million, and a 1% fee structure, the first will pay £100,000 per annum and the other £1 million, for potentially identical portfolios and identical performance achieved. Lynch and Musto (1997) call this an illogical application of agency theory that bears no relationship with risk, arguing a returns-based contract would be more appropriate. In more complex iterations, Allen (2001; p1168) describes the "Sandy Grossman effect", founder of the first hedge fund allowing others to take advantage of his unique investment ability; the primary role of these intermediaries is to make investors do better than they otherwise would. However, hedge funds famously established the '2+20 rule', charging pension clients 2% of assets under management and 20% of returns on investment (with no corresponding penalty for losses) (Walter, 2009).

How should trustees assess the value for cost as their fiduciary duty dictates? Whitwell (2013; p1) outlines three empirical dimensions for analysing the appropriateness of fund management fees: 1) nominal returns; 2) risk; and 3) added value. The first dimension, nominal returns, he says is simple: "Did you make us money or not?", yet this question is deceptive in an industry that has managed to deflect responsibility for losses: “Although our return was -10%, our benchmark, the SandP 500 Index, was down 20%, so actually you did fantastic; we helped you outperform by 1,000 bps!” (Whitwell, 2013; p1). The second dimension of the fee structure analysis is risk. Investment managers have made the same case to potential investors as managers to shareholders, that performance fees align investor and manager interests because the fund manager earns a performance fee only if the fund produces new gains (Holland, 2011). This claim misrepresents risk accounting. If the investment loses money the investor alone suffers the loss of capital yet shares their reward disproportionately (Ryan and Dennis, 2003). Evaluating the last dimension, added value is the degree to which returns beat their benchmark. It is theoretically appropriate to pay intermediary fees for the added value component of the returns (alpha) above market average returns (beta) (Hoepner and Zeume, 2009). However, pension trustees are routinely guilty of two types of costly mistakes. First, they often pay alpha fee levels on beta returns for long periods of underperformance (Whitwell, 2013). Second, they conservatively miss out on more value-added investment opportunities that rationally come with higher fees (Ryan and Dennis, 2003). Whitwell (2013; p3) concludes “we frequently pass judgment on nominal fees before we even spend one minute assessing the three empirical dimensions of absolute returns, risk, and added value. In logic and statistics, this error is known as a Type II error, and it is one of material consequence in the business of asset management.”

This has placed the onus entirely on the pension trustees to determine the fair price for investment performance (reward sharing) given the risk borne. Business ethics in finance focuses on what, if any, fiduciary obligation arise between the parties in a private property transaction. In this case, given the asset exposure and information asymmetry the trustee is subject to, a fiduciary duty may be determined to belong to the fund managing agent. This duty would presumably extend to ensuring their client receives an appropriate proportion of the return on investment when setting fee structures.

### 3.4 Finance industry ethics: The fundamental role of the fiduciary duty

Any consideration of the role the finance industry currently serves as business contributing to society must acknowledge the role assigned to it by the discipline of business ethics as a functioning entity contributing to the larger aims of a political democracy (Glac, 2010). This is the firm's social licence to operate within the host society, a concept which scholars over decades have struggled to define (Glac, 2010; Flynn and Werhane, 2008; Iwai, 1999; Davis, 1973; Coase, 1960). The granting or abuse of a social licence to operate is still surrounded by confusion over the rightful place business ethics holds in the study of business behaviour. Trevino and Weaver (1994) differentiate between BUSINESS ethics and business ETHICS. The first is the study of business behaviour originating out of business disciplines. These include investigations into corporate social responsibility, responsible investing, the theory of the firm, or corporate governance. The latter originates from the examination of morality of the human individuals in business dealings. At its core, all business ethics explores the appropriate behaviour business should exhibit towards the citizens whose lives and rights they invariably affect (Silver, 2012). Dobson (1999) describes this as 25 years of business ethics theory built on the back of 2,500 years of moral philosophy used to classify the business profession into frameworks of either amoral (instrumental), immoral (illegal) or moral (normative) decision making.

Pension funds are compelled as fiduciaries to act as trustees for contributing beneficiaries for the “exclusive purpose of providing benefits to them and defraying administrative expenses” (Greenwood, 1996; p28). They have become “guardians of the investing public” promising explicit (often defined) guarantees of future income (Waring, 2006; p12). Beneficiaries are typically not wealthy individuals and the trust’s duty is to collateralise modest contributions into maximum long-term assets values (Monks, 2002b). To discharge the duty to defray expenses, pension funds must ensure that fund managers’ fee for handling their beneficiary’s money represents a fair price for members (Kay Review, 2012). When casting an ethical light on financial intermediaries however, Harris and Souder (2004; p201) see the need to examine why there are not a “few bad apples”, but a “widespread and systematically inter-connected nature of ethical lapses threatening the markets in a fundamental way.” This section focuses on the development of the fundamental financial principle of fiduciary trust and duty, and whether the fund manager has a duty to the pension trust to assist in their fiduciary objectives to beneficiaries.

### 3.4.1 The origins and development of fiduciary duties

To understand the role of trust and confidence in economic exchange, in the absence of government intervention or social convention any transaction involves some form of cooperative behaviour (Jones and Felps, 2013). The legal formalisation establishing and enforcing cooperative behaviour is the principle of fiduciary responsibility (Cosimano, 2004). Atherton et al.'s (2011; p8) historical definition of the fiduciary is "an essential code of conduct for those who have been entrusted to care for other peoples' property, carry out transactions, work for another, or aid persons who were vulnerable and dependent upon others." The concepts of fiduciary duty originated in the common law of Trust and Agency for cases involving one person entrusting property to another, but this concept has expanded over time to mediate situations in which one person relies on another's superior knowledge or skill (Boatright, 2000). Whereas honesty and transparency are moral duties in contracting, where it is assumed that parties meet as equals, trustees have a higher duty by virtue of their dominant position (Blair and Stout, 2006). Information asymmetry and power to control another's assets gives the fiduciary trustee the advantageous position, and thereby a duty to take special care of the beneficiary's interests (Dunning, 2012; Graafland and van de Ven, 2011; Lan and Heracleous, 2010). The legal requirements of fiduciary duty (from the Latin fiducia, or trust) are imbued with the strongest duty of moral care trust law provides (Anabtawi and Stout, 2008; Aguilera et al., 2006). Indeed, many scholars see the origins of this duty emanating from the Old and New Testaments (Atherton et al. (2011) provide a comprehensive history of this moral development). The law marries a duty of loyalty and of care, adjudicated by the exclusive benefit rule prohibiting the fiduciary agent from acting in their own interests (Dunning, 2012; Anabtawi and Stout, 2008). Technically, this duty to act in another's interest means without gaining any material benefit except with the knowledge and consent of that person (Boatright, 2000). The courts assess the degree to which the beneficiary has placed trust and confidence in the agent, which depends on extent of the responsibilities delegated, when assigning a fiduciary duty. Where an agent is given discretion in decision making, the law would suggest that the agent is deemed a fiduciary with respect to performance of that discretionary act (Yaron, 2005). To assess whether a fiduciary relationship arises at institutional level between the pension client and the fund manager engaged, the law would have to take a view on how much discretion fund managers have over the treatment of the pension client's assets, and how much power they have to impose contractual conditions that are advantageous to themselves.

### 3.4.2 The fiduciary duties of pension trustees

The trust structure as a legal institution matured in the UK through the nineteenth century as a vehicle to preserve and transfer generational wealth (Clark, 2004). The law provides the trustees considerable discretion outside the scrutiny of the regulatory authorities, to act in authority for beneficiaries, placing great reliance on the responsible decision-making of the trustees. Clark (2004; p236) describes this as "neither a contractual relationship nor a strictly commercial relationship – it was (and is) a form of obligation". The burden of this obligation placed on trustees is a fiduciary duty (obligation of loyalty) placed on the board of trustees directed towards the beneficiary members when investing their assets (see LCR, 2013b). In reality the fiduciary duties of pension trustees and corporate fiduciary obligations rarely interact, and while corporate governance scholarship proliferates (Ingley and van der Walt, 2004), the governance best practice of the fiduciary trustee remains under-examined (Joly, 2010; Ambachtsheer et al., 2007; Clark, 2004). In the finance industry, where the pension fund trust's contract with a fund management corporations, the fiduciary duties of the pension trust and their endowed fund management agent would seemingly come into direct competition, should the agent have "detached and powerless [external] shareholders"[22]. So do fiduciary obligations arise from the fund manager to the pension trust under a funds management contract? The degree of reliance perceived by the courts is the determining factor; where the power in the relationship puts the principal at risk, and where a fiduciary relationship is found, agents have an obligation to act in the fully disclosed best interests of the principal (Yaron, 2005). Kay (2012) believes the contract has the flavour of a fiduciary relationship (see Section 3.5). Mehran and Stulz (2007, p271) present empirical evidence that financial institutions can gain by taking actions that are unfavourable to the counterparty, to the "detriment of the efficiency of capital markets and the welfare of customers."

Fiduciary duties in financial advisers are embedded at individual (rather than firm) level through the self-regulating professional association requirements of the financial professional member (Dunfee and Gunter, 1999; Ettore, 1996). Palazzo

[22] As discussed in Chapter 2, owner-managers do not suffer the separation problem and subsequently hold fiduciary duties to the entity they govern

and Rethel (2008; p194) describe these: “The main duties of professionals are to perform services with competence and due care, to avoid conflicts of interest, to preserve confidentiality, and to uphold the ideals of the profession". However, the likelihood of a fiduciary relationship being explicitly identified at the institutional level is intensified by a special trust nature of the pension principal (Palazzo and Rethel, 2008). Boatright (2000; p201) describes this institution level conflict of interest as inherent in the industry:

> *“Financial services could scarcely be provided without raising conflicts of* interest. In acting as *intermediaries for people’s financial transactions* and as custodians of their financial assets, financial service providers are often forced to choose among the competing interests of others – and weigh those interests against their own.*”*

In choosing the principal the fund manager wishes to signal their fiduciary primacy to, Goodpaster (1991) sees two operational possibilities: strategic and multi-fiduciary. He sees the first as calculated self-selecting obligations (business without ethics) and the other an impossible conundrum of the man with two masters (ethics without business). Statutory clarification of the fiduciary duties in the supply chain has been resisted by the UK pensions industry, fearing a proscriptive narrowing of discretion in investment decision making[23]. Government clarification has also been reluctant, despite several parliamentary review recommendations, the subject of the next section. This leaves the

[23] http://www.professionalpensions.com/professional-pensions/analysis/2325571/industry-split-on-fiduciary-duty-legislation

interpretation of any fiduciary duties arising to the courts and precedent nature of their development to date.

### 3.5 The political framework examining fiduciary intermediation

> *“Many of these [fund management] charges are ‘‘invisible’’* - the brokerage costs are uncontrolled, are never segregated and reported as such, and are accounted only as a reduction in the market value of the portfolio. In American terms, management and brokerage fees from pension accounts must total close to US$50 billion. This is an important *source of revenue to a great many important people.” (Monks, 2002*a; p119)

There have been numerous government commissioned inquiries into tangential aspects of the corporate governance of the investment supply chain (for instance Cadbury Report, 1992; Hampel, 1998; Higgs Report, 2003), however there were two that specifically addressed pension governance. In 2001 HM Treasury’s Myners Report on pension fund governance and the relationship with funds management was published as Institutional Investment in the UK: A Review (Clark, 2004). A decade later the government commissioned Professor John Kay to undertake a review of the mechanisms of control and accountability provided by UK equity markets, and the behaviour of the agents in that process, published in 2012 as the Kay review of UK equity markets and long-term decision making: final report (Clark, 2013). This section briefly considers the findings of these reviews as officially sanctioned government analysis of privatised pension governance.

### 3.5.1 The Myners Report

Paul Myners, previous Financial Services Secretary for HM Treasury, delivered his findings on institutional investment in the UK in 2001. On the point of pension governance, he reported that pension trustees lack the expertise necessary to make independent judgements on the management of their assets and had become dependent on consultants and asset managers in the financial services industry. Yet the feedback from the consultants and asset managers was that trustees were highly risk adverse, preferring convention to strategic risk management or financial innovation (Clark, 2004). Myners further noted that few trustees had financial education or took training beyond 12 months post appointment, and spent little time preparing for fund investment decisions (Clark, 2004).

The review made the following recommendations for establishing:

- A set of principles for institutional investment decision-making;
- The replacement of the Minimum Funding Requirement with a scheme-specific regime based on transparency and disclosure;
- Incorporation of the US Employee Retirement Income Security Act (ERISA) principles on shareholder activism into UK law, making

intervention into companies, where it is in shareholders' and beneficiaries interests, a duty for fund managers;

- A Law Commission clarification of the legal ownership of surplus pension fund assets; and
- Reduction of the rate of tax on withdrawal of the surplus (Myners 2001).

The government responded if favour of legislation on all issues. However, in 2007 the National Association of Pension Funds undertook a review of the implementation progress, titled Institutional Investment in the UK: Six years on, finding:

> “The environment in which pension funds are operating has changed significantly since the Principles were first published in 2001. Then, many schemes were in surplus and the focus was on how to expand institutional investment into areas such as venture capital. Six years on that scenario has been turned on its head. Now the focus is on deficit correction, the strength of scheme sponsor covenants and scheme speci*fic funding… In response sponsors have closed schemes or* increased contributions and there has been a shift in investments from equities to bonds” (NAPF 2007; p6).

NAPF (2007; p6) also found that no agreement had been reached on assessing fund management performance or outsourced financial services provider performance. Then concluded, “In this new world of pensions, some of the Myners Principles appear less relevant…the spread of financial innovations has obliged trustees to delegate more to advisers, which runs counter to the Principles (intended to ensure that trustees can engage with, and if necessary challenge advisers and consultants)." Robert Monks commented on the Myners Report in 2002 (2002a) as being "perhaps the most important single development in the evolution of corporate governance in the Anglophone world. Bad governance in times past may have been ruinous to the rich; today it is a crime against the security of the pension promise." Ten years later Professor John Kay would re-examine pension governance once more.

### 3.5.2 The Kay Review

The fiduciary duties of pension plan sponsors and trustees are in little dispute; under Trust law and the Pensions Act 2008 they owe strong duties to their intergenerational beneficiaries. One of these duties is to invest the contributions of members with attention, expertise and care. To fulfil this duty, they outsource the pooled contributions to financial experts, specifically, the corporate intermediaries of the finance sector who have evolved quickly to serve this function for pensions (Clark, 2013).

In the 2012 Parliament Review commissioned economist Professor John Kay with the following Terms of Reference:

> "To examine the mechanisms of corporate control and accountability provided by UK equity markets and their impact on the long term

> competitive performance of UK businesses, and to make recommendations” (Kay, 2011; p1).

Specific to the focus of this chapter, the Review was to consider:

- Whether the current legal duties and responsibilities of asset owners[24] and fund managers, and the fee and pay structures in the investment chain, are consistent with asset owners’ long term objectives; and

- Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them (Kay, 2011; p2).

Professor Kay (2012) bestowed fiduciary expectations on the behaviour that financial intermediaries managing pension funds should afford their clients, as such:

> “Fiduciary stand*ards require that the client’s interests are put first, that* conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.” (Kay, 2012; p12)

[24] Pension schemes – ie. Owners of shares or bonds

He noted that fiduciary duties are a legal concept created by case law and so while clearly bestowed on pension trustees, there remained uncertainty over whether they arose to others in the investment chain when managing social savings. The Law Commission Review (LCR, 2013; p34) interpreted the fiduciary standard owed by the fund manager as “ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary”. This fiduciary flavour to the relationship differed from the opinions of pension trustees; the review finding that “many trustees were aware of their status as fiduciaries, which resonates with a sense of altruism. Trustees contrasted their special status as fiduciaries with the focus of others in the investment chain on making money” (LCR, 2013b; p23). The Myners Report and Kay Review both found room for improvement in the cost of outsourcing funds management to the financial services industry, costs neither visible to members, nor explicitly consented to. Social responsibility in pension governance should demand these costs should represent transparent value for money.

Beneficiaries knowingly sacrifice approximately 1 per cent of their contributions to the trust for administering their assets (Barr, 2006). They have no way of knowing how much more they are sacrificing for this administration to be outsourced. These views are echoed by Hess and Impavido (2003) who believe trustee boards have a demonstrable need to be strong and well-functioning to protect beneficiaries from outside exploitation. Both the Myners Report and Kay review placed exploitative conflicts at the feet of the financial services industry who manage the trust assets.  Monks (2002a, p119) is a strong critic of the profits derived in financial services from the pension assets pool, invisible to beneficiaries and accounted for only as a reduction in the market value of the pool.  He is particularly scathing of government apathy: “The ugliest truth is that government has continually and conspicuously failed to enforce the law of the land and, thereby, has enabled and condoned the conflicts of interest that envelope the institutional ownership world.  Look at the web of mutually self-supporting interests.  Somebody is missing from this cozy circle - who is it? It is the beneficiaries of the pension schemes whose neglect is the continuing disgrace of government.”

### 3.5.3 The nature of fund management contracts

Recently, there has been growing concern that fund managers are adopting extremely similar investment strategies (Ljungqvist et al., 2007).  One possible explanation for the phenomenon may be found in the remuneration schemes based on relative performance (Eichberger et al., 1999).  This form of fund management contract may be more desirable for the fund manager than the pension trustee.  In an empirical study of allocation mechanisms for public goods, Moreno and Moscoso (2012) found that allocations strongly favour the dictator, resulting in conflict between allocation incentives and other desirable characteristics such as fairness, equity or distributive justice.  The fund manager may be acting dictatorially when making the investment decisions obtaining high rewards when things go well and incredibly limited penalties when they do not (Allen, 2001).  Klumpes and McCrae (1999) found that the size of fees relative to nominal returns significantly reduced the periodic net income to pension funds over the period of the study. Further examination of the relative merits of these findings requires distinction between the two main styles of funds management. Ryan and Dennis (2003; p317) describe:

> *"*The passive fund manager's portfolio is partially or completely matched, or "indexed," to a market standard, such as the SandP 500. The advantages of this technique include lower administrative and transaction costs, given that stocks are seldom bought or sold. However, passive investing also diminishes the potential for higher-than-market returns, as these funds bear little or no idiosyncratic risk. Conversely, the active fund manager's portfolio consists of particular stocks and securities chosen for their projected potential to maximize fund value. The active fund manager constantly evaluates the present status of the financial market and individual stocks, making frequent buy and sell decisions that tend to incorporate a moderate to high degree of firm-specific, idiosyncratic risk. While this fund management technique offers the possibility of above-market returns, it is also characterized by more erratic returns, along with higher management fees and transaction costs.*"*

Harrison (2013)[25] describes the typical passive fee structure: "Most common is a base fee expressed as a percentage of assets and scaled with fees descending as assets increase, so greater assets merit a lower fee. These include most

[25] http://www.ft.com/cms/s/0/a1c40ac2-9558-11e2-a4fa-00144feabdc0.html#axzz48izt3nUJ

management fees but exclude trading costs.  The driver to a base fee is the performance of the overall markets not manager skill."  The ability the fund management industry has generated to demand a percentage of the total asset base per annum that "exclude trading costs" and does not require "manager skill" seems to violate the three dimensions of Whitwell's analysis.  By extracting a proportion of the asset base the fund manager had no role in amassing, passing on the additional cost of underlying intermediation applying no additional information aggregation value and bearing no risk of ROI losses, the service seems to contravene the theory of financial intermediary existence (in reducing information or transaction costs, or creating liquidity (Palazzo and Rethel, 2008)).  Harrison (2013) then explains the active fund managers' structure; "a variable performance fee normally applies not to all the assets but to the outperformance above a floor or hurdle.  Meaning returns above that are attributed to manager skill… tend to be vastly more expensive, often commanding 2 per cent base fees plus 20 per cent performance fees."  The fact that inventor of CAPM, William Sharpe observed that "under plausible circumstances, a person saving for retirement who chooses a low-fee over high-fee investments could have a 20 per cent higher standard of living in retirement" (quoted in Snyder, 2013) is contrary to his theory of the risk/reward relationship, yet consistent with Moreno and Moscoso's (2012) dictator hypothesis.  According to Scott (2010) the fee model overcompensates fund managers in rising markets, implies no sharing of economies of scale with the pension client and bears no relation to the value added by the manager.  Monks (2002a; p119) also cogently points out, "many of these charges are ''invisible'' – the brokerage costs are uncontrolled, are never segregated and reported as such, and are accounted only as a reduction in the market value of the portfolio. In American terms, management and brokerage fees from pension accounts must total close to US$50 billion. This is an important source of revenue to a great many important people."

This section outlined the considered opinions of academic commentators. It does not consider the opinion of the pension schemes or fund managers themselves. It would be rational to hypothesise that were tension to arise in unfair contracting between the principal and the agent, the conflict would be observable in the industry media (a proxy for the opinions of both parties) or with the law makers, in adjudicating the conflict to a resolution on who owes whom a duty in the management of funds. The next section examines the outputs of these subsidiary parties.

### 3.5.4 Fund manager contracts concluded in law and portrayed in the media

The courts assess the degree to which a beneficiary has placed trust and confidence in an agent, which depends on extent of the responsibilities delegated, when assigning a fiduciary duty (Anabtawi and Stout, 2008). Where an agent is given discretion in decision making, the law would suggest that the agent is deemed a fiduciary (Yaron, 2005). To assess whether a fiduciary relationship arises at institutional level between the pension client and the fund manager engaged, the law would have to take a view on how much discretion fund managers have over the treatment of the pension client's assets, and how much power they have to dictate contractual conditions that are advantageous to themselves.

In March this year Investment and Pensions Europe Magazine (Maton, 2016) asked what the going rate for asset management fees was. He concluded that “despite calls for a greater level of alignment between asset managers and pension funds, alternative fee models have not yet taken off.” He continues, “Trustees outsource more and more of the key decisions about how a fund is invested, but cannot renounce their fiduciary duties: in other words, they delegate power without responsibility. Whatever one's views about the specific services labelled as 'fiduciary management', there's no doubt that this is a wider trend - and one that raises fundamental questions about the nature of the fiduciary relationship.”

The key characteristics of the fiduciary relationship, according to the UK Law Commission (1995), are vulnerability and dependency on the part of the principal, and discretion and power to act on the part of the agent. According to Berry in Investments and Pensions Europe magazine (2011) “On this basis, it seems reasonable to conclude - as, indeed, the Law Commission did - that anyone given responsibility over key decisions about the management of somebody else's money is a fiduciary. That includes asset [fund] managers.”

Plender (2012) comments in the Financial Times on March 11, 2012 of the progress of the Kay Review into the fiduciary duties of intermediaries: “The biggest challenge will be to find a framework of incentives that eliminates the mismatch between the fund managers' business model and the interests of companies and beneficiaries. Because, as Prof Kay rightly observes, the metrics on which the asset management industry measures its performance are all wrong". The media has stated that the statutory tolerance for fund managers evading of fiduciary duties to clients may be waning. On April 29, 2010 the Financial Times (Guerrera and Masters, 2010) reported on the US Senate Sub-Select Committee investigation of Goldman Sachs selling of mortgage backed securities in lead-up to the 2008 financial crisis: "Perhaps the most interesting signal came during Senator Collins' questions. They suggested she is considering whether SEC regulated broker-dealers ought to be subject to fiduciary duties for clients. Her press statement also signals that she is interested in exploring fiduciary duties for broker dealers . . . If this idea from a senior Republican gains any traction it could dramatically change the way broker dealers and Wall Street firms do business."

Nevertheless, from the standpoint of the tension between the fiduciary obligations to pension asset management versus fund manager corporate governance, Guerrera and Masters (2010) reported that following the press statement Goldman's shares rose more than 2 per cent in New York that day, adding $850m to its market capitalisation when no fiduciary duty was established. This is key to the proposition of the thesis; that the agent has conflicting principals. On the basis of these media commentaries it would appear that fiduciary agency has not been established in financial intermediaries.

#### 3.5.4.1 Legal Sources

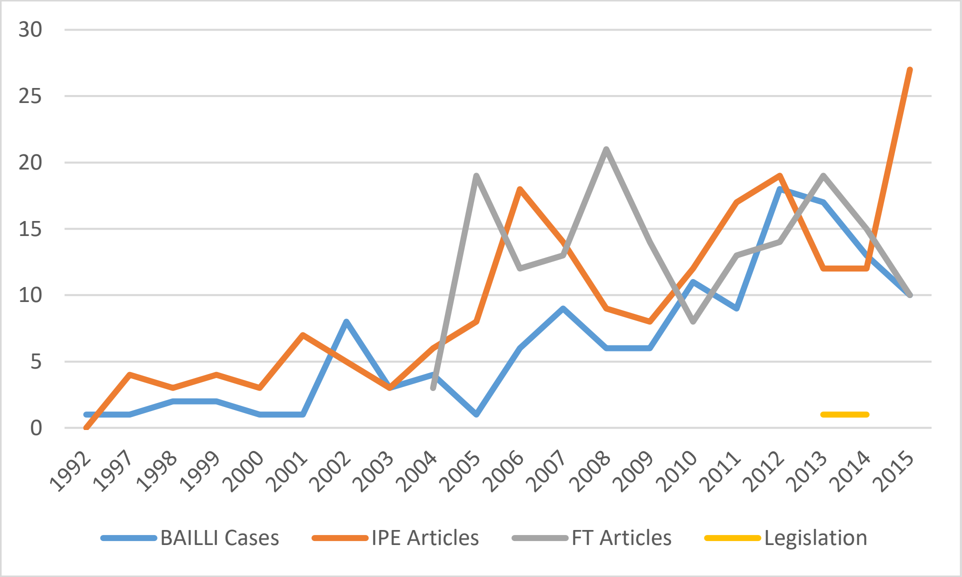
The two sources of legitimate law making evidence are databases of case law and databases of legislation over time. The sources selected for the characteristics of completeness and industry representativeness were the British and Irish Legal Information Institute (BAILII) for case law and the Government Legislation Portal (legislation.gov.uk) for statute law.

#### 3.5.4.2 Rationale for Industry press selection

The role of the media in shaping pension trustee and fund manager behaviour has not been examined in the literature. According to the Pension Professionals (2016), statutory clarification of the fiduciary duties of fund managers has been resisted by the UK pensions industry, fearing a prescriptive narrowing of discretion in investment decision making. According to an Investment and Pensions Europe Journal article (Lokhandwala, 2014), “viewing fiduciary duty as legal duty ‘first mistake’ in asset management.” The article went on to quote Head of EMEA for BlackRock as saying “It is a trust people put in us as asset managers. If you start on the legal side and putting it into contracts, we are going to lose clients again.” Two media sources with different readership demographics were examined: 1) the European focused industry journal Investments and Pensions Europe (IPE), with specialist content and an overwhelming trustee demographic; and 2) Financial Times (FT) which caters to a broader range of perceptions of the function of the pensions industry.

As illustrated by Figure 3.2, the trend in speculating on the fiduciary agency relationship is increasing in volume in the IPE, when it is decreasing or static in the other categories.  The FT peaked in volume around the time of the 2007-2008 financial crisis, however the number of articles published are less than half that of the media associated with pension trustees and the number of total references to fiduciary fund management is only 19.3% of the IPE.  Closer inspection of these articles in the next Section will determine whether they are thematically different, as their alternative audiences may imply.

Figure 3.2 Volume of cases and articles per year by category



With regards to the determinates of the fiduciary relationship, the volume of case law peaked in 2013.  There were 133 cases in the search results on the BAILLI website, however searching the content revealed only 15 cases that included all subsequent search references (less than one case a year).  This paucity of case law is evidence of the nature of cases coming before the courts.  They are not explorative but combative in intent, when one counterparty takes fiduciary issue with another. The courts express wariness in judgements to maintain the historical roots of the duty in an industry that has become far more complex than at the time of the duty's origins. This makes interpreting the intention of the courts less challenging, as each follows thematically from the previous case, but also convoluted as they express and explore both sides of the fiduciary debate. However, the conclusive evidence for the status of the financial intermediary duty to the client is in the progress of legislation. In 2013 MP Phil Wilson introduced a Bill to parliament entitled Investment Management (Fiduciary Duties). It was debated on 5th February 2014, commencing with the refrain:

> One place where trust and professionalism are vital is in the financial and investment services industry, but here is the problem: the agent of the *agent of the saver can lose sight of the ultimate customer's best interest.* Nowhere is that clearer than in the investments of our pension industry, which is worth more than £2 trillion, or 135% of the size of the UK economy. With those statistics in mind, and with auto-enrolment bringing an additional 11 million savers into the system—many of them low-paid—the industry has a great responsibility to get it right. (House of Commons Hansard, 5 February 2014 Column 277).

In 2004, shortly after the equities crash instigated by the fall of giants Enron, Tyco, World Com and others, the Financial Times wrote (Fuller, 2004; July 9):

> "Jack Brennan, chairman of Vanguard, the US mutual funds group, set out his five principles for success in running money for individuals at a

> fund forum in Monaco this week. These were: it is never about "my firm" but about what's best for the client; never about the short-term but about long-term results for the client; never about selling but about **fiduciary duty to the client; never about meeting the letter of the law but about a culture of integrity**; never measured by assets under management but by the depth of the client's trust.
>
> One fund manager told me that he had heard it all before, but maybe it had more resonance now. That is the understatement of the year.*”* [emphasis added]

If the media believe the fund manager is a fiduciary to the pension client, this is not supported by case law or legislation. Nor does the media narrative reference litigation or legislative contemplation of the pension asset fiduciary. The two subsidiary parties in funds management are divorced in their analysis of the issue. The following Section outlines the current legal status on the fiduciary in financial intermediation.

#### 3.5.4.3 Financial intermediary fiduciary duties in the law

Table 3.1 examines the individual cases from the BAILLI search results to determine the focus of the cases and the courts’ development of the fiduciary concept. Fifteen cases were examined and categorised as follows: 1) fiduciary duties of the director to the corporation (corporate fiduciary); 2) fiduciary duties of the public official to public assets (public fiduciary); 3) fiduciary duties of the investment manager to the asset owner (investment fiduciary); and 4) other fiduciary duties (other fiduciary). It also records the word count frequency for "fiduciary" to indicate the importance the duty held to the case.

Table 3.1 The BAILLI Search result classifications of cases by fiduciary focus

| Case | Fiduciary classification | Word frequency |
|---|---|---|
| Republic of Brazil v Durant [2012] JRC 211 (16 November 2012)[26] | Public fiduciary | N=23 |
| Barclays v Equity [2014] JRC 102D (2 May 2014)[27] | Investment fiduciary | N=48 |
| AP-Fonden v Bank of New York Mellon SA/NV & Ors [2013] EWHC 3127 (Comm) (16 October 2013)[28] | Investment fiduciary | N=55 |
| Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LP & Ors [2012] EWHC 3259 (Comm) (16 November 2012)[29] | Investment fiduciary / Corporate fiduciary | N=3 |
| Doohan & Anor -v- Irish Life Assurance PLC & Anor [2015] IEHC 789 (01 December 2015)[30] | Investment fiduciary | N=6 |
| Excalibur Ventures LLC v Texas Keystone Inc & Ors (Rev 1) [2013] EWHC 2767 (Comm) (13 December 2013)[31] | Investment fiduciary | N=60 |
| F&C Alternative Investments (Holdings) Ltd v Barthelemy & Anor [2011] EWHC 1731 (Ch) (14 July 2011) | Corporate fiduciary | N=147 |
| Fyffes Plc v DCC Plc & Ors [2005] IEHC 477 (21 December 2005) | Corporate fiduciary | N=37 |
| Greck v. Henderson Asia Pacific Equity Partners & Ors [2008][32] | Corporate fiduciary | N=1 |

[26] http://www.bailii.org/je/cases/JRC/2012/211.html (accessed 21 June 2016)
[27] http://www.bailii.org/je/cases/JRC/2014/102D.html (accessed 21 June 2016)
[28] http://www.bailii.org/ew/cases/EWHC/Comm/2013/3127.html (accessed 21 June 2016)
[29] www.bailii.org/ew/cases/EWHC/Comm/2012/3259.html (accessed 21 June 2016)
[30] http://www.bailii.org/ie/cases/IEHC/2015/H789.html
[31] http://www.bailii.org/ew/cases/EWHC/Comm/2013/2767.html
[32] http://www.bailii.org/scot/cases/ScotCS/2008/CSOH_2.html (accessed 21 June 2016)

| | | |
|---|---|---|
| Independent Trustee Service Ltd v GP Noble Trustees Ltd & Ors [2010] EWHC 1653 (Ch) (01 July 2010)[33] | Investment fiduciary | N=7 |
| Keith v. Chambers & Ors [2002] ScotCS 257 (11 September 2002)[34] | Corporate fiduciary | N=86 |
| Koger Inc. & Anor -v- O'Donnell & Ors [2010] IEHC 350 (8 October 2010)[35] | Corporate fiduciary | N=6 |
| Murphy v Rayner & Ors [2011] EWHC 1 (Ch) (18 January 2011)[36] | Other fiduciary | N=24 |
| Nestle v National Westminster Bank [1992] EWCA Civ 12 (06 May 1992)[37] | Public fiduciary | N=1 |
| Vigeland v Ennismore Fund Management Ltd & Anor [2012] EWHC 3099 (Ch) (07 November 2012)[38] | Corporate fiduciary | N=8 |

There are seven (44%) corporate fiduciary cases, 6 (38%) investment fiduciary cases, 2 (12%) public fiduciary cases and 1 (6%) involving the fiduciary of carers. However, with the use of language being an indicator of the courts' time in exploring the definition, corporate directors' and officers' fiduciary duty dominates the word count frequency (288, 62%). The cases that investigate the fiduciary duty in investing made less of an impact on the court's time, with 131 (28%) counts. Public and other tied with 24 (5%) counts.

The courts have had more demand placed on them to identify a breach of director's duties than other forms of fiduciary duty. In the cases that examined fiduciary duties in investing, the courts' interpretation is aligned with the trustees'

[33] http://www.bailii.org/ew/cases/EWHC/Ch/2010/1653.html (accessed 21 June 2016)
[34] http://www.bailii.org/scot/cases/ScotCS/2002/257.html (accessed 21 June 2016)
[35] http://www.bailii.org/ie/cases/IEHC/2010/H350.html
[36] http://www.bailii.org/ew/cases/EWHC/Ch/2011/1.html
[37] http://www.bailii.org/ew/cases/EWCA/Civ/1992/12.html
[38] http://www.bailii.org/ew/cases/EWHC/Ch/2012/3099.html

perceptions that there is no clear understanding regarding when a fiduciary duty arises in the management of assets. In Barclays v Equity [2014] JRC 102D (2 May 2014) the presiding judge opened the ruling with an observation of fiduciary duties in trust entities: “There is some academic and professional literature exploring these questions, not all of it unanimous in its conclusions, but little judicial authority” (Para.1). His interpretation was straightforward:

> *I pointed out during the hearing that the phrase “fiduciary duty” is used in* a variety of meanings, not always in the strict sense insisted on by Millett LJ in the Mothew case. Advocate Harvey-*Hills also referred to Vestey’s* Executors v IRC [1941] 1 All ER 1108, a decision of the House of Lords in which duties in regard to investment (to be executed, as it happens, by *“authorised persons” who were not the trustees of the rel*evant *settlement) were held to be fiduciary. What he says is that the plaintiffs’* claim under this heading is based on a wider meaning of the phrase than the more specific meaning identified in Mothew. (Para. 78)

In the case of the unit trust in question he deliberated that any person authorised to execute a transaction on behalf of the trust was a fiduciary, and this included managers as well as trustees. He also observed that this duty cannot be disavowed by the contract between the manager and the trust. Conversely, in the AP-Fonden v Bank of New York Mellon (16 October 2013), the bank “did not owe fiduciary duties to AP” (Para. 469) despite being the pension scheme’s security bond manager and holding bonds they knew were in financial distress. Indeed, Doohan v Irish Life Assurance PLC [2015] IEHC 789 (1 December 2015) states that “the fiduciary duty is coextensive with, but no greater than, their contractual duty and duty of care.” Where a contract is in place, as is the case with the fund manager and pension trust, the law assumes that the duties of the parties are set out in the contract. A fiduciary duty is not necessary. This was reiterated in Excalibur Ventures LLC v Texas Keystone Inc & Ors (Rev 1) [2013] EWHC 2767 (Comm) (13 December 2013, Para. 1161):

> The circumstances in which someone will be classified as a fiduciary are not precisely defined. I am content to proceed on the basis of the summary in Chapter 7 of Snell's Equity, approved in Ross River Ltd v Waverly Communications [2012] EWHC 81 at [235]-[238] per Morgan J that (i) a fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence; (ii) the concept captures a situation where one person is in a relationship with another which gives rise to a legitimate expectation, which equity will recognise, that the fiduciary will not utilise his or her position in a way which is adverse to the interests of the principal.

The case went on to say “whilst fiduciary relationships may arise in a commercial relationship, this is uncommon, not least because it is normally inappropriate to expect a commercial party to subordinate its own interests to those of another commercial party. But if that expectation is not inappropriate in the circumstances of the relationship, then fiduciary duties will arise." This was later reiterated:

> Unless the particular agreement establishes a relationship of trust, one will not spring from a finder's contract in and of itself, for without some agreed-to-nexus, there is no relationship of trust and, thus, no duty of highest loyalty.
>
> Before courts can infer and superimpose a duty of the finest loyalty, the contract and relationship of the parties must be plumbed. We recognize that "[m]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. (Meinhard v. Salmon, 249 N Y; Para. 458).

Chief Judge Cardozo's oft-quoted maxim is a timeless reminder that "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive. If the parties find themselves or place themselves in the milieu of the "workaday" mundane marketplace, and if they do not create their own relationship of higher trust, courts should not ordinarily transport them to the higher realm of relationship and fashion the stricter duty for them? Courts look to the parties' agreements to discover, not generate, the nexus of relationship and the particular contractual expression establishing the parties' interdependency."  (Meinhard v. Salmon, 249 NY; Para. 464).

This view supports F&C Alternative Investments (Holdings) Ltd v Barthelemy & Anor [2011] EWHC 1731 (Ch) (14 July 2011: Para. 223): “In commercial contexts, care has to be taken in identifying any fiduciary obligations which may arise that the court does not distort the bargain made by the parties.” Pacific Equity Partners & Ors [2008] agrees that it is not the role of the court to impose conditions on contracting parties. As do Excalibur Ventures LLC v Texas Keystone Inc. (Para 162): "If Wellington wanted fiduciary-like relationships or responsibilities, it could have bargained for and specified for them in the contract."

The courts have been clear in one matter, the contract is the area under investigation when examining the nature of the principal-agent relationship. Unlike company directors and officers, who have externally applied fiduciary duties, the courts have consistently found no duties existing outside investment contracts. Given the undeniable fiduciary nature the trustees hold to the pension beneficiaries it has been left their responsibility to write the duties into fund management contract. The courts would then be able to take a view on whether this presents an untenable fiduciary conflict for the directors and officers of fund management firms.

#### 3.5.4.4 Fiduciary duties to investment agents in legislation

The first reading of the Bill entitled “Investment Management (Fiduciary Duties) Bill 2013-2014[39] took place on 5th February 2014. Member of Parliament for Sedgefield Phil Wilson (Lab) commenced, “That leave be given to bring in a Bill to place a fiduciary duty on those involved in managing an investment to act in the best interest of investors, including pension savers, in a transparent and

[39] http://services.parliament.uk/bills/2013-14/investmentmanagementfiduciaryduties.html

accountable way; and for connected purposes." (IMFD Bill 2014; Column 277). Mr Wilson outlined why he believed the Bill was imperative. He made the observation that agents of agents lost sight that the money being managed is the pensions savings of the hard-working people of our economy. Crucially, he emphasised the necessity for a fiduciary duty to control costs: "The Bill would also ensure that fees paid to pension managers and other intermediaries should be transparent, including an explanation of how much they are and why they are necessary. The Office of Fair Trading has discovered 18 different charges levied on pension funds, many of which we are not even told about. All of this matters because it is unacceptable for fees to eat up as much as 40% of a pension pot." (IMFD Bill 2014; Column 278). Sadly, the Parliament.UK website concludes, "The Bill failed to complete its passage through Parliament before the end of the session. This means the Bill will make no further progress." (See footnote 27).

There is general agreement between statute law and case law that fund managers do not have separate fiduciary duties. The duties of the agent are those laid out in the contract and rely on the principal's ability to negotiate with large financial institutions. The Law Commission Review into Fiduciary Duties for Investment Intermediaries (LCR, 2013; p206) summarised the situation eloquently: "There are major difficulties in relying on "judge-made" law to control complex and fast-moving financial markets. Judges can only decide the cases brought before them. Very few cases are brought – and those most vulnerable to poor practice may be those least able to mount legal challenges. Further, rules are developed only after the event – often long after the event." The duties in trust investing are unambiguous and concern the very nature and function of a trust as fiduciary for the beneficiary. However, when the trust enters a contract with a management firm all legal sources agree that currently only the duties specified in the contract are binding on the agent.

### 3.5.5 Continued discord between the industry subsidiaries

There is clearly a need to explore whether fiduciary obligations are really being understood and fulfilled (Berry, 2011). Statutes define the fiduciary duties of company directors (Companies Act, 2006). Common law imposes demanding fiduciary obligations on the trustees of pension funds (Verret, 2010). Ultimately, legal clarity can only come from regulators, governments or the courts, but there's also a need for self-examination within the industry about what it means to be a fiduciary in an outsourced capacity.

Against this backdrop, pension fund trustees rely upon the financial expertise of these agents in making decisions on investing their assets (Coco and Ferri, 2010). This has often included relying on the assumption that they are fiduciarily obligated. The primary duty to safeguard the pension's assets invariably hands the fund manager a custodian role with broader public implications to the private property of workforce contributions (Palazzo and Rethel, 2008). However, in the industry literature analysis of statute and common law for evidence of the legal frameworks supporting fiduciary duties, both law makers communicated that any intention for fund managers to adopt a fiduciary agency over pension assets is absent.

In 1984 a case was brought by Arthur Scargill, the leader of Britain's main mining union seeking the end of coal board investments in overseas businesses. The judge rejected Scargill's claim on the basis that the duty of trustees is to increase the fund's value for its beneficiaries, regardless of their moral or political views (McDonnell, 2003). According to the perceptions of the Kay Review (2013; p12) "such rigour and relative clarity is rare" in legal findings. Kay concludes common law fiduciary obligations may exist in other areas of finance but the extent is uncertain, and contracts such as those of fund managers, often attempt to exclude fiduciary obligations. "For most people outside the financial services sector, it is obvious the only people you can trust with your money are those who are willing to pursue your interests rather than their own. The public would be surprised that the imposition of fiduciary standards on those who work in advisory or discretionary roles should even be controversial." (Kay, 2013; p56).

In 2014 the Financial Times reported that fund managers were coercing pension funds into signing non-disclosure agreements (Marriage and Newlands, 2014). In the article David Blake, director of the Pensions Institute at Cass Business School in London, said: "Local authorities are not allowed to compare fee deals, and that is an outrage. It should be made illegal that fund managers demand an investment mandate is confidential." In defence of fund managers, Daniel Godfrey, chief executive of the Investment Management Association, rebutted "Companies also have the commercial right to require commercial arrangements to be confidential." This is in keeping with the trend of current case law, but departs from the spirit of a fiduciary duty to transparency.

Trustee oriented media often states there is a fiduciary duty arising in the fund manager agent, despite evidence to the contrary in the legal sources. Conversely, the litigation and legislation on fiduciary duties were not found to be reported in the media.

Case law has consistently upheld that the duties owed by the fund manager are those found in the funds management contract alone. To this point, the investment community (FT) has been more vocal about the need to review fee structures than the trustee community. This, alongside the surprising predominance of communication on fiduciary management suggests that trustees are concentrating on working with fund managers to take on the power (yet not responsibility) of their duties rather than exercise them in restraining the fund manager contract.

In 2016 the IPE reported that the Transparency Task Force had been formed to call for fiduciary duties to be imposed on fund managers, particularly in relation to fees (Williams, 2016). The fund management industry was reported as warning against imposing a fiduciary duty on the industry, repeatedly arguing it was not a legal principle but rather a set of morals. This is contrary to the opinion of the courts and parliamentary reviews and debate, who contend that any moral obligations should be explicit in the contract between commercial parties. The state of the fiduciary duty of the fund manager clearly continues to be the source of much ambiguity among pensions practitioners and the lack of cooperative policy making and practice between the standard setters and compliers will not alleviate this research problem, only continue to emphasise its importance.

Further research will be a valuable in continuing the investigation of fund management as more industry and state review pressure comes to bear, in particular, revisiting the industry discussion after the publication of the Financial Conduct Authority review on asset management pricing due out in 2017.

### 3.6 Conclusion and implications for the research

If fund managers on aggregate have harnessed the ability to dictate contractual terms that bear no theoretical relationship with the value to be gained by the use of financial intermediation, pension trustees have a responsibility to impose discipline on the agent (Clark, 2004). However, they must be empowered to do so. Clark's (2013; p58) analysis of the Kay Review concluded "the key recommendations, aimed at applying a stronger conception of fiduciary duty to investment managers, will have little impact if asset holders[40] are not effective clients of the global financial services industry." The chapter paid particular reference to institutional governance in recognition that it is not money that matters in the financial intermediation, but the institutional behaviour of the parties that collect and provide that money (Liedekerke, 2013). For this behaviour to be appraised effectively there will need to be consensus on two material issues. Firstly, the appropriate relationship between the risk and reward and how financial intermediaries should be evaluated as efficient resource allocators to be deemed legitimate. Secondly, the current state of fiduciary responsibility - for what and to

[40] Asset holders (also asset owners) are pension funds, the beneficiary owner of the assets.

whom?  The academic literature has concentrated on the responsibilities pension funds have to control fund managers, but is quiet on the responsibilities fund managers have to act in fiduciary agency to the principals whose funds they manage.  The industry literature is ambiguous.  Much of the industry press exhorts the need, and actual existence of this reciprocal duty.  However this is almost unanimously contradicted by both sets of law makers.

The next chapter builds a conceptual framework for considering the behaviour of the fund manager.  If the fees charged for fiduciary asset management are no longer reflective of the relationship between risk and reward as finance theory would suggest, then its viability as a contemporary theory must be questionable. The theory of the fund manager as agent with the egoist perquisite assumptions upon which economic agency theory is founded may be a more predictive empirical representation of the industry's function.  The contribution to this theory is exploring which principal the agent is signalling their exclusive best efforts to; the principal with the statutory fiduciary rights or the principal with ambiguous fiduciary claims despite unlimited liability.  If the former, then can be argued that fund managers are acting judiciously by over-charging pension trusts in the profit-making best interests of their shareholders given there is no legal precedent of a duty of exclusive best interest arising to the pension principal.

# Chapter 4
# Conceptual framework:  The theories employed to examine pension agency

## 4.1 Introduction

Chapters 2 and 3 described the development of the pensions industry as the contemplation of two principals with assets reliant on their financial intermediary agent. The first was the shareholder of a funds management corporation. The second was the client of the corporation; the pension fund asset holder. This chapter brings these interacting entities together into a conceptual framework grounded in the apposite theories of academia. It illustrates the pension phenomenon through the lens of these theories, with the intention of establishing the conceptual foundation for the research design.

It was not until 1948 that parliament passed the National Assistance Act 1948, establishing the universal entitlement to social retirement security. The age of eligibility for the retirement pension was set at 65 years when average life expectancy was 60 years (Harris, 1996). In the mid-1980s, as part of a programme of deregulation, the Thatcher government enacted the Social Security Act in 1986, significantly cutting back State pension funding commitments and widening private provision through personal contributions-based retirement insurance (Blackburn, 2006). With current life expectancy averaging 80 years in the UK, prospective retirees have the challenge of sacrificing sufficient current earnings to investments supplementing a deficient State pension for the average 15 years of life post work, while retaining an acceptable present-day standard of living. The role of UK occupational pension schemes is to invest their member contributions to achieve the necessary return on investment for that undertaking to be realised.

As discussed; the vast majority of trustees operate in a voluntary capacity, possessing no specialist financial management expertise, and accordingly outsource their members' funds to professional fund management firms. In doing so they establish a principal-agent relationship characterised by the principal incentivising and monitoring the agent in order that the agent acts according to their wishes (Holland, 2011).

Agency theory rests on the economic assumption of self-interested agents, and the mechanisms principals must employ to ensure agents act in the best interest of their assets (Hasnas, 1998). However, as Chapter 2 illustrated, the duties fund managers owe to their shareholders are codified, and may encourage them to enter into inefficient contracts with pension clients that over-reward and under-monitor their effort and expertise for the benefit of fiduciarily protected shareholders. This conflict of interest that sets the fiduciary duties held to shareholders against the agency duties held to a client vulnerable to information asymmetry and imperfect monitoring opportunities was illustrated by the significant losses suffered by pension schemes through the 2007-2008 financial crisis where the government commissioned Kay Review noted:

> *"*The long term public goal for equity markets is in securing the public purposes of high performing companies and strong returns to savers through an effective asset management industry, and in ensuring that the profits earned by companies are as far as possible translated into returns to beneficiaries **by minimising the costs of intermediation***… It would* seem fair to say that equity markets today serve the **needs of the**

> **players in these markets better than they serve either those who put up the money** or the businesses wanting finance to support growth.*"* (Kay Review, 2012; p6) [Emphasis added]

In the contextual background of fiduciary finance, the chapter describes the rationale for employing an agency theory prism for the analysis of fiduciary pension assets management, after assessing finance theory and stakeholder theory. It concludes that fund managers have established an industry norm of remuneration based on absolute size of assets, rather than (or sometimes inclusive of) return on investment performance (O'Brien, 2004). This counterintuitive practice assumes they are free of agency conflicts and always value-adding when establishing the efficient cost of intermediation. Agency theory also posits the additional assertion that the fund manager is governed in the profit-maximising best interests of their shareholders (Beltratti, 2005). This suggests a conflicted relationship, or correlation between cost of intermediation (fees for asset management) and shareholder profit pressure. The chapter concludes that agency theory presents a more accurate reflection of the fiduciary behaviour fund managers exhibit in pension asset management as the guide to the research design.

## 4.2 The theoretical foundations for the thesis and research design

Neither agency theory nor stakeholder theory are designed for multiple principals of the agent in the literature. They typically consider that one agent has one principal (or principals not in conflict) or that one entity has stakeholders, all with no stakeholders of their own. Neither provides the theoretical guidance for interactions between a firm/agent and two incompatibly motivated principals, both with fiduciary claims over the agent. To explore the agency governance effects these theories may exert on funds management industry inquires requires examination of the characteristics upon which these theories have been built.

Dobson (1999) sees agency theory as the worst philosophical justification for corporate decision making, seeing a management scapegoat from having to reconcile diverse moral perspectives, instead promoting reliance on the market mechanism to translate moral concerns into economic signals. Coco and Ferri (2010) see its assumption of shareholder wealth maximisation correlating with the unsustainable risk taking that led to retail bank failure in the financial crisis of 2008. However, Beck (2005) argues that corporate governance rules are distributively neutral and provides evidence to support the claim that regulatory alternatives may not positively affect distributive justice for stakeholders any more successfully. Macey and O'Hara (2003; p94) said of stakeholder governance, "when directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected." Yet Relano (2011) compares the performance of social and traditional banks, finding social banks with a stakeholder focus prove surprisingly competitive. The fund management business model is different as their shareholders are not bearing the risk of poor corporate performance, they get remunerated as a percentage of assets under management regardless of results. This presents a challenge for the existing theories of firm behaviour. Freeman

(1994) calls for a new academic theory that resituates the raison d'être of the firm. The conceptual framework developed in this chapter proposes that agency theory can be modified to accommodate the fund management business model.

### 4.2.1 The choice of theory for the research frame for interpreting firm behaviour

In a positivist inquiry, the research should commence with a theory best suited to the research questions in order to determine whether the deductive reasoning of the theory and empirical observations of the research phenomena follows as a logical consequence, i.e. the observation has been predicted and so the rule and explanation of the theory can continue to be inferred (Yin, 2009). This requires a theory capable of such testing. This section compares agency theory and stakeholder theory as competitors to the traditional view of the finance industry through finance theory in order to establish rationale for the theory framing the research design.

### 4.2.2 Stakeholder theory and legitimacy theory

In 1984 Freeman published a landmark thesis, “Strategic Management: A Stakeholder Approach.” It was written as both a criticism of, and antidote to, the dominant theory of corporate governance, shareholder theory. Concerned that “managerial capitalism” or the dominant position shareholder wealth building occupied in the efforts of management, Freeman reframed managements’ obligations to all stakeholders, being “any group or individual who can affect or is affected by the achievement of the organization’s objectives,” (Freeman, 1984; Freeman et al., 2004). Key (1999) accords Freeman’s 1984 work as the closest attempt at developing a new theory to challenge the old. The interests of “legitimate” stakeholders hold intrinsic value and no one group can assume to dominate the rights of others when it comes to management decision making, contrary to the existing paradigm of shareholder bias. Jones and Wicks (1999) view stakeholder theory as a group of narrative stories about firm behaviour (unlike the customary social science one-view theory), logically embedded in sociology, or normative business ethics. Numerous authors have referred to stakeholder theory as Kantian capitalism (Wicks, 1998; Bowie, 1998), able to install moral imperatives within the business construct. A central tenet of stakeholder theory is that the firm remains viable, and managers who prioritise impractical normative behaviour are not “advancing the stakes of all stakeholders” (Jones and Wicks, 1999). Stakeholders would not gravitate to a financially unviable firm. Freeman (1994) explains a stake as being equity, economic or influence in nature. Key (1999) describes these as forms of power that may provide the theory logic required, however she concludes that Freeman has not provided this as the basis for explaining firm behaviour. Mitchell et al. (1997) concur that Freeman offers no explanatory power over whom and what the manager should pay attention to. They use risk (of harm both to the firm and the stake) as being the basis of a “legitimate” stake rather than any participant in an exchange relationship with the firm. Reviewing the stakeholder literature, they summarise scholarly attempts to define legitimate claims as contract, exchange, legal title or right, moral rights, at-risk status or moral interest. Their counter proposed definition of whom and what managers attend to is power to influence the firm, regardless of legitimate stake.

Stakeholder theory has been criticised on several grounds; 1) the obligations of the agent to the principal are singular and greater than those to third parties (Freeman, 1994); 2) traditional value maximisation gives managers a clear and principled objective (Jensen, 2001); 3) the theory leaves managers and directors unaccountable through traditional (legislative and reporting) means by claiming stakeholder fiduciary demands for aberrant results of their resource distribution (Jensen, 2001); 4) it makes the assumption that business as usual pays no heed to any constituent or influence, either internal or external (Key, 1999); 5) it lends legitimacy or power to a variety of special interest groups without retaining the a set of principles to reject claims (Jensen, 2001) and 6) it has a firm centric view that implies the firm's environment (society) is a single (static) stakeholder (Key, 1999).

Stakeholder theory, according to Stieb (2009), is arguably one of the most prominent to arrive at business management from the school of philosophy. Taking a possibly contentious view, he sees Freeman's 1984 treatise and subsequent attempts to clarify its explanatory and predictive power not as a theory of the firm but as a philosophical call to "redistribute the wealth [to] offer solace and compassion". It does not, he says, offer guidance on who should be given more decision making power, nor on who is empowered to redistribute decision making power. The ability to trust those who manage money is the simple foundation of the fiduciary concept in finance disregarded by stakeholder theory.

Jones and Wicks (1999; p206) use Bacharach's definition of theory as "a statement of relations among concepts within a set of boundary assumptions and constraints". It must possess sufficient explanatory power and be logically falsifiable. Key (1999; p317) applies Mills description of a theory as a "systematic attempt to understand what is observable in the world" and notes that a good theory has both explanatory and predictive power. While parsimony is desirable, it is not essential as social system complexity resists modelling. Logic, however, is essential and Goodpaster (1991) notes that attempts to build on introduction of ethical values as the underlying logic in stakeholder theory may not provide the logic to explain firm behaviour, normative ethics being prescriptive rather than explanatory or predictive. Freeman (1994) acknowledges that stakeholder theory is pragmatic; less about "what is true" in favour of "how should we live". Freeman (1994; p12) elaborates, "for too long philosophers, ethicists, liberal theorists and others have looked down their noses at business as not worthy of serious intellectual attention", concluding "there is no such thing as stakeholder theory...[but] a genre of stories about how we could live". While possibly not designed to be theory, it is a way of thinking about the firm that challenges the dominant paradigm of agency theory. According to Key (1999) "current conceptualizations of stakeholder theory do not meet the requirements of scientific theory." Miles (2015; p1) concurs, stakeholder theory is not a theory but a collection of narratives that are "highly problematic for theory development and empirical testing."

### 4.2.3 Agency theory

The problems of agency and the separation of ownership and control conundrum have been recognised as far back as Thomas Hobbs (for a description of the social contract theory offered in Leviathan (1651), see Sandbu, 2012) and Adam Smith (for an analysis of the separation of ownership and control in An Enquiry into the Nature and Causes of The Wealth of Nations (1759), see Jensen and Meckling, 1976), and has been studied by scholars in accounting, economics, finance, political science, organisational behaviour and sociology (Eisenhardt, 1989). In 1972 two scholars from Pennsylvania University began work on the theories of agency, unknown to each other; Stephen Ross ((1973) an economist) and Barry Mitnick (2012; 1973) an organisational behaviour scholar). Ross' economic theory of agency quickly came to dominance and was later powerfully entrenched when in 1976 Jensen and Meckling's (1976) seminal work outlined a theory of agency as a set of parsimonious economic principles that overlooked Mitnick's behavioural consequences, and continues to influence contemporary finance and corporate governance thinking in academia, accounting standards and corporate law.

#### 4.2.3.1 The definition of agency theory

Agency theory describes relationships in which "one party (the principal) delegates work to another (the agent) who performs that work" (Eisenhardt, 1989; p60). Agency relationships exist in all parts of society such as the politician and constituent (Culpan and Trussel, 2005), the lawyer and client (Blair and Stout, 2006), the doctor and patient (Langer et al., 2009) or the firm manager and shareholders (Jensen, 2001). The agency problem is mainly articulated as the principal and the agent having 1) conflicting motivations that either agent or principal bears the cost of mediating and monitoring (Donaldson and Davis, 1991); 2) different risk propensities (Jones, 1995); and 3) information asymmetry benefiting the agent (Ross, 1973). Under this model it is the principal's problem of adverse selection when entering the relationship at being unable to properly estimate potential for performance through lack of information (Cormier et al., 2011). As the relationship progresses the principal faces the moral hazard of being unable to impose or afford monitoring mechanisms on the agent to detect underperformance, perquisites (undue rewards) or overpayment (Myerson, 2012). Khan (2006) sees these conflicts of interest being mediated in the theory by the power of the principal, as a dominant principal over a submissive agent in negotiating terms. The unit of analysis between the agent and the principal is the contract and so the focus of the theory is on the most efficient contract governing the principal-agent relationship. According to Eisenhardt (1989; p58) "Specifically, the question becomes, is a behaviour-oriented contract (eg. salaries, hierarchical governance) more efficient than an outcome-oriented contract (eg. commissions, stock options, transfer of property rights, market governance)." See Table 4.1 for the assumptions of agency theory.

Table 4.1 Agency theory overview

| | |
|---|---|
| **KEY IDEA** | Principal-agent relationships should reflect efficient organisation of information and risk-bearing costs |
| **UNIT OF ANALYSIS** | Contract between principal and agent |
| **HUMAN ASSUMPTIONS** | Self-interest, bounded rationality, risk aversion |
| **ORGANISATION ASSUMPTIONS** | Partial goal conflict among participants, Efficiency as the effectiveness criteria, information asymmetry between principal and agent |
| **INFORMATION ASSUMPTION** | Information as a purchasable commodity |
| **CONTRACTING PROBLEMS** | Agency (moral hazard and adverse selection), risk-sharing |
| **PROBLEM DOMAIN** | Relationships in which the principal and agent have partly differing goals and risk preferences (eg. Compensation, regulation, leadership, impression management, whistleblowing, vertical integration, transfer pricing. |

Source: Eisenhardt, 1989; p59

The next section examines how agency theory came to be shaped by various academic disciplines, specifically economics and corporate law. These disciplines bring different perspectives to rent seeking and externalities in agency theory.

#### 4.2.3.2 Agency theory interpreted through economics

The agency problem manifests the moment principals believe agents have deviated from their interests (Dunning, 2012). The formalisation of economic agency theory laid down in Ross' 1973 seminal treatise addresses both the moral hazard and allocation inefficiencies created by the information asymmetry benefiting the agent. In 1976 Jensen and Meckling outlined the economic argument for binding agent motives to the principal's gain through incentives and monitoring. Principals will contract with the agent until the cost is too high and substitution is available, with the principal being the residual claimants of any value creation in the process (Bainbridge, 2006; Jones, 1995; Jensen and Meckling, 1976). A body of work has developed around the concept of the rationally self-interested agent who requires controlling through market oriented mechanisms (Stieb, 2009; Jensen, 2001; Williamson, 1979). These mechanisms include aligning the agent's desires with those of the principal through performance based remuneration, monitoring and the market for competition (Lan and Heracleous, 2010; Donaldson and Davis, 1991). Theoretically this easily describes the pension trust handing its assets to the fund manager.

Economic theory is still underpinned by the utility (profit) maximisation motive and the courts have upheld this (Hay, 1972). Distaste for agency theory has intensified in the light of agent incentives failing to take account of notions of trustworthiness, duty or professionalism, acknowledging only self-serving motivations (Ghoshal, 2005; Stout, 2003a). Agency theory became the primary intellectual tool available to scholars in the finance industry, yet it fails to predict fundamental elements in the law by simplifying the economic problem down to getting agents to act as principals require of them (Blair and Stout, 2006). In the case of the fund manager with two principals, the agency relationship is twofold. Shareholders will monitor and incentivise the fund manager to maximise shareholder value. Pension clients will monitor and incentivise them to maximise residual claims from the value creation of their assets under management. The contract between the pension client and the fund manager at any given time is a bellwether of the influence this principal exerts over the economic behaviour of the agent and may not fully reflect the investor relationship the fund manager develops with their shareholders to maximise the profit of the financial intermediary.

#### 4.2.3.3 Legal contradictions in economic agency theory

The story of the chimney and the wall; Coase (1960) used the legal case of Bryant v. Lefever[41] to illustrate the different resource allocation viewpoints arrived at by economics and the law. The plaintiff and defendant were neighbours, both in similar houses. Until 1876 the plaintiff was able to light fires in the house. After the defendant rebuilt a taller house, smoke from the fires no longer escaped the plaintiff's chimneys, causing a nuisance. The Judge ruled that the plaintiff had no right to the passage of air, the defendant had done nothing wrong in rebuilding their house and the plaintiff caused the nuisance to himself by lighting the fires for which he had not provided an effective means of escape. No damages were awarded to the plaintiff. While judges must apply the law to legal liability, when viewed from an economic perspective the nuisance was caused by both the wall and the fire as in the absence of either there would be no nuisance. To achieve optimum resource allocation (or maximum utility), both should account for the nuisance in decision making otherwise it remains an externality imposed by one party on another. The defendant must compensate the plaintiff for half his losses to achieve resource efficiency (and internalising the externality). Reasoning employed in the courts often seems irrelevant to the economic pursuit of maximising the value of overall production ("not what shall be done by whom, but who has the legal right to do what" in Coase, 1960; p15). When property rights are clear and market transactions are nil, legal outcomes should be predictable.

[41] Bryant v Lefever (1879), 4 CPD 172

When this is not the case, legal activity (either via the courts or government) influences economic activity.

There is no question that the fund manager is the agent of the pension client. Sandbu (2012; p106) says of any agency obligation; “representing someone, in the morally relevant sense, will entail tending to the moral responsibilities of those one represents,” in criticising the normatively neutral utility principle of economic agency. The duty of obedience vested in legal agency one of “unthinking faithfulness to a person, group or purpose, requiring the bearer to supress their own preferences, values and perspectives” (Fisher and Lovell, 2009; p302) as opposed to the economic agency relationship which requires incentivising and monitoring to align these interests. Information asymmetry and power to control the pension’s assets gives the fund manager the advantageous position, and thereby a duty to take special care of the principal’s interests (Dunning, 2012; Graafland and van de Ven, 2011; Lan and Heracleous, 2010). Honesty and transparency are moral duties in contracting, where it is assumed that parties meet as equals, however where one party has an inherent power or information advantage and the other is vulnerable, the law hands agents higher duties to prevent their dominant position harming the vulnerable party (Blair and Stout, 2006). While legal theory makes a strong case for fund managers to be viewed as fiduciary agents of the pension fund’s substantial wealth, there is no formal fiduciary relationship between them. This leaves the contract as a potential manifestation of economic agency theory with the accompanying hazards to the principal vulnerable to an agent maximising their wealth capture.

## 4.3 Agency theory as the conceptual framework for the research design

Daily et al. (2003) urge that agency theory continues to, but need not dominate studies of corporate governance. For this research financial intermediation theory, stakeholder theory, transaction cost theory and finance theory are similar contenders. However, empirical testing of agency theory shares a strong body of work in the literature to support the research design (see Table 4.2 for a taxonomy). Given there is little evidence in the literature for empirical testing of the corporate governance of financial intermediaries, using the established corporate governance ontology makes the novelty of a fund management institution examination less undetermined. The contribution this brings to the ontology is an additional study of an underexplored industry to the body of work and the theoretical discussion of the agency theory dominance of institutional governance.

Table 4.2 A taxonomy of empirical studies of agency theory in the corporate governance and business ethics literature

| AGENCY CHARACTERISTIC | EMPIRICAL STUDIES |
|---|---|
| **AGENCY COSTS** | Yu, 2012; Howorth & Moro, 2012; Lassoued & Elmir, 2012; Mande et al., 2012; Francis et al., 2011; Renou, 2008; Khan, 2006; Hutchison & Gul, 2003; Mutairi et al., 2001; Rao & Neilsen, 1992; Kim & Sorensen, 1986; Easterbrook, 1984. |
| **AGENT EFFICIENCY** | Chan et al., 2013; Rossi, 2010; Fogarty et al., 2009; Lee, 2009; Arthurs et al., 2008; Zyglidopoulos et al., 2008; Arnold & Lange, 2004; Lie, 2000; Due, 1959. |
| **ALTERNATIVE THEORY COMPARISONS** | Heracleous & Lan, 2012; Laan et al., 2008; Van der Laan et al., 2007; Culpan & Trussel, 2005; Coombs & Gilley, 2005; Yoshimori, 2005; Ogden & Watson, 1999; Clarkson, 1995; Wray et al., 1994; Donaldson & Davis, 1991; Reidenbach & Robin, 1990; Oviatt, 1988. |
| **BUSINESS ETHICS / SUSTAINABILITY** | Freeman & Groom, 2013; Becker & Stromberg, 2012; Moore, 2012; Yu & Ting, 2012; Eccles et al., 2011; Fernando & Chowdhury, 2010; Haddock-Fraser & Tourelle, 2010; Rost et al., 2010; Kaptein, 2008; Fernando et al., 2008; James Jr, 2006. |
| **INCENTIVES** | Fleming & Schaupp, 2012; Chapman & Kelliher, 2011; Fahlenbrach et al., 2011; Mainelli, 2009; Grabke-Rundell & Gomex-Mejia, 2002; David et al., 1998; Ittner et al., 1997; Zajac & Westphal, 1994. |
| **INFORMATION ASYMMETRY** | Eckerd & Hill, 2012; Fakhfakh et al., 2012; Jung et al., 2012; Hoffman & Fieseler, 2012; Gibilaro & Mattarocci, 2011; Cormier et al., 2011; Lehtimaki etal., 2011; Drobetz et al., 2010; Ming Te l et al., 2010; Yeoh, 2010; Waller & Lanis, 2009; Gibson & O'Donovan, 2007; Martin & Nisar, 2007; Arcot & Bruno, 2006. |
| **MORAL HAZARD** | Davison & Stevens, 2013; Yusuf, 2011; Garcia-Meca & Sanchez-Ballesta, 2009; Anderson et al., 2008; Long & Driscoll, 2008; McCarthy & Puffer, 2008; Westphal, 1999; Millon & Thakor, 1985. |
| **OWNERSHIP STRUCTURES** | Jiraport et al., 2012; Renders & Gaeremynck, 2012; Frank & Sundgren, 2012; Kathyayini & Rao, 2012; Osemeke, 2012; Ting, 2011; Margaritis & Psillaki, 2010; Yeh, et al., 2008; Goergen & Renneboog, 2007. |
| **RISK** | Cooper & Uzun, 2012; Klimczak, 2008; Berger & Bonaccorsi de Patti, 2006; Bloom & Milkovich, 1998. |

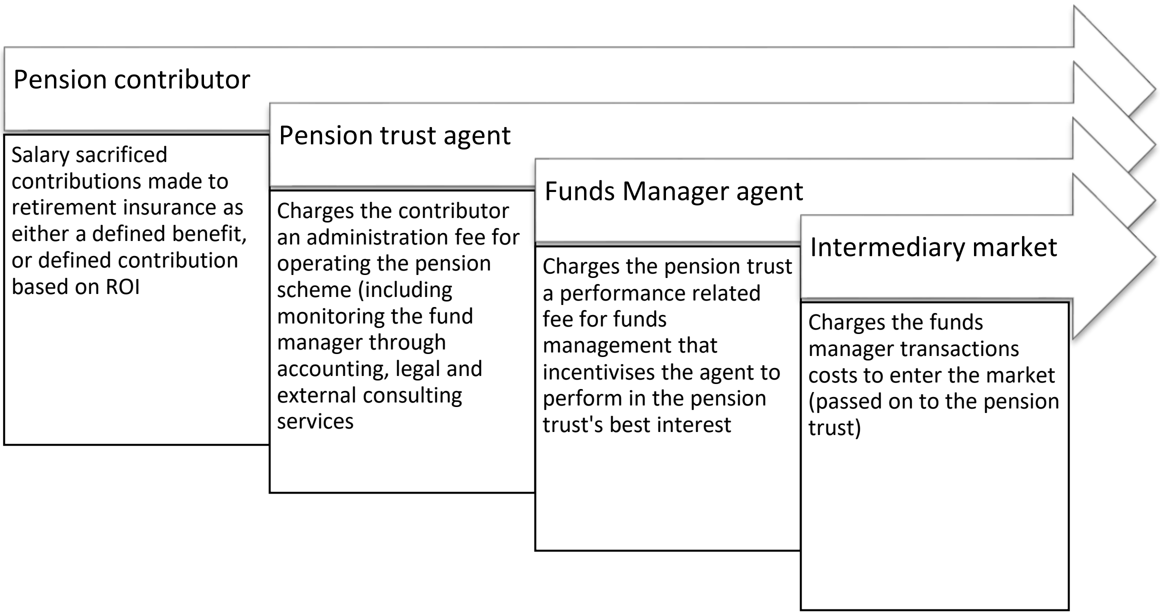
The appropriate unit of measurement for analysis of the effect the agent has over a pension principal is the net outcome of the investment performance achieved by the fund manager after all fees and charges (Lan and Heracleous, 2010). Economic agency theory hypothesises that the pension trust will incentivise the fund manager to the extent that it is in the efficient best interest of the agent to deliver this optimally (Jensen and Meckling, 1976). Pension trusts are compelled by law to act for contributing beneficiaries for the “exclusive purpose of providing benefits to them and defraying administrative expenses” (Greenwood, 1996; p28;

see Cowan v Scargill for the landmark case law on duties). To discharge the latter duty, pension funds must ensure that the fund managers' fee for handling their assets represents a fair price for members (Kay, 2012). Depending on where the fund manager sits on the governance spectrum, they are presented with a conflict of interest that pits their fiduciary duties to shareholders against their agency duties to a client vulnerable to information asymmetry. The LCR (2013, p21) interpreted the fiduciary standard owed by the fund manager as "ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary." Conversely, in its consultation with pension trustees, it found that "many trustees were aware of their status as fiduciaries, which resonates with a sense of altruism. Trustees contrasted their special status as fiduciaries with the focus of others in the investment chain on making money" (LCR, 2013, p7). This sentiment is endorsed by the Nicholl and Brown (2013; p7) survey into investment management fees, concluding that disclosure may be an issue for pension trusts "particularly as the[se] fees are high in relation to the returns achieved". In contrast the Investment Management Association asserted fund managers' rights to pressure pension trusts into non-disclosure agreements regarding fees; a development David Blake of The Pensions Institute describes as "an outrage" (Sharman, 2014). This agency problem of the conflicting fiduciary beneficiary of the agent's efforts has been described by Blackburn (2006) as inviting the systematic failure of modern day pension provision.

### 4.3.1 Agency and finance theory in financial intermediation

As an institutional investor in their own right, pension funds benefit from regular inflows of funds, yet the majority of their investment activities are delegated to professional financial intermediaries. This creates a chain of agency relationships (Klumps and McCrae, 1999; see Figure 4.1). This chain of agency relationships is rarely acknowledged in empirical studies evaluating the financial performance of pension funds (Holland, 2006). These studies typically use CAPM-based measures of performance to analyse the absolute and risk adjusted rates of return earned through the investment of pooled fund assets, with the assumptions of perfectly elastic demand for the underlying assets and informationally efficient stock markets (Klumps and McCrae, 1999).

Figure 4.1 The chain of agency wealth capture of ROI in pension fund management



Pension contributor
Salary sacrificed contributions made to retirement insurance as either a defined benefit, or defined contribution based on ROI
Pension trust agent
Charges the contributor an administration fee for operating the pension scheme (including monitoring the fund manager through accounting, legal and external consulting services
Funds Manager agent
Charges the pension trust a performance related fee for funds management that incentivises the agent to perform in the pension trust's best interest
Intermediary market
Charges the funds manager transactions costs to enter the market (passed on to the pension trust)

Source: Author

Holland (2011) sees this adherence to CAPM modelling in pension performance as no longer representative of the investing reality. In reality, pension trustees subject their fund assets to multiple sets of intermediation costs, even while applying their own. Cox et al., (2004) found fund managers with less competition when courting clients produced weaker financial results. Ippolito and Turner (1987) found average pension performance significantly underperforms both the SandP 500 Index and equivalent mutual funds. Lakonishok et al. (1992) uncover evidence of distortion in fund management investment behaviour such as lock-in strategies. Christopherson et al. (1997) and Brown et al. (1997) both found that US and UK pension funds retained fund managers even when CAPM modelling suggested negative returns for doing so. This pension trustee tolerance for underperformance, as both Holland (2011) and Klumps and McCrae (1999) suggest, is in keeping with the expectations of economic agency theory, yet has departed from the rational investor behaviour predicted by finance theory to the detriment of pension contributors and any measure of the contributors' wellbeing. Table 4.3 takes agency theory assumptions and compares them with the finance theory perspective.

Table 4.3 The conflicting theoretical views of the principal-agent contract

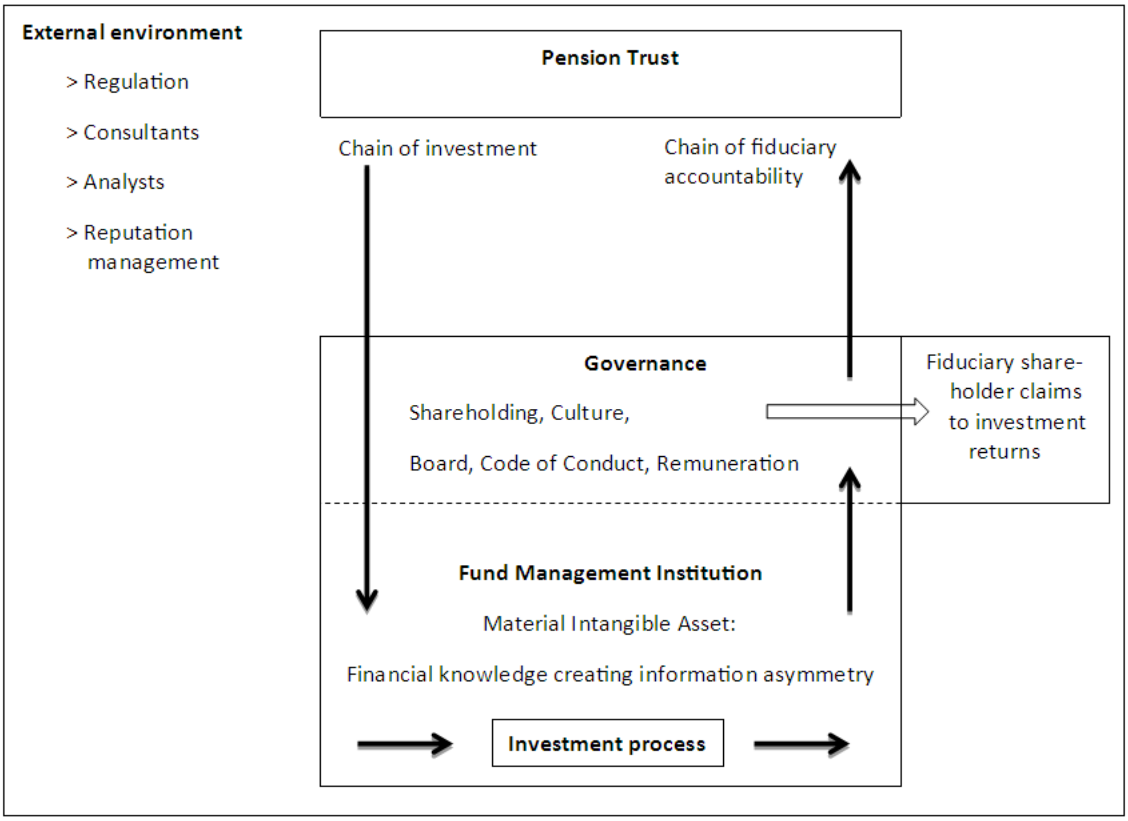
| CHARACTERISTIC | FINANCE THEORY | AGENCY THEORY | FUND MANAGEMENT RELATIONSHIP |
|---|---|---|---|
| **GOAL INCONGRUITY** | Parties meet as equals and will only contract when both goals are met by the contract<br>(Mehran and Stulz, 2007) | The principal must incentivise and monitor the agent to align their effort with the principal's interests. The contract will be either behavioural based (professional fee) or outcome based (performance pay)<br>(Eisenhardt, 1989) | The outcome based contract (for passive or active management) incentivises the agent to invest assets to beat the market<br>(Whitwell, 2013) |
| **INFORMATION ASYMMETRY** | Both parties are perfectly informed<br>(Chan, 1983) | Information asymmetry benefits the agent, leaving the principal vulnerable to adverse selection and moral hazard<br>(Walter, 2004) | The pension trustees are unsophisticated investors reliant on the financial expertise of the agent will little ability to monitor or assess the actions of the agent<br>(Clark, 2004) |
| **RISK ALIGNMENT** | Risk is fully anticipated and born by the party with the most appetite in anticipation of higher rewards yet prepared to taken on the downside scenario<br>(Kolb, 2011) | The agent is assumed to be more risk adverse than the principal and must be incentivised to shoulder risk they would otherwise shirk<br>(Caprio and Levine, 2002) | The fund manager bears little risk; the contracted fee provides for a percentage of the assets. The pension fund risk is to the full amount of the assets managed<br>(Eichberger et. al., 1999) |
| **FAIR PRICE** | The price is that which the parties agree for the contract to take place and is distributively neutral<br>(Allen and Santomero, 2001) | In performance-based compensation contracts, earnings are expected to provide accurate information on managerial effort<br>(Wesley and Ndofor, 2013) | The key recommendations of the Kay Review (2012), aimed at applying a stronger conception of fiduciary duty to investment managers, will have little impact if asset holders are not effective clients of the global financial services industry.<br>(Clark, 2013) |
| **OWNERSHIP STRUCTURE** | Prevailing stock prices will reflect all information currently publicly available in relation to any company, as stated by the efficient capital markets hypothesis (ECMH) in finance theory<br>(Moore and Reberioux, 2011) | Economic ownership structure is a nexus of contracts with shareholders as residual claimants.<br>(Jensen and Meckling, 1976) | Redefining the principal from shareholders to the corporation, redefining the status of the board from shareholders' agents to autonomous fiduciaries, and redefining the role of the board from monitors to mediating hierarchs will enable fiduciary financial intermediation.<br>(Lan and Heracleous, 2010) |

| | | | |
|---|---|---|---|
| **FIDUCIARY DUTY** | Advances in both behavioural finance theory and in empirical testing have suggested that securities markets may be more flawed than systematic previously believed in protecting fiduciaries (McDonnell, 2003) | Corporate scholarship is premised on the shareholder primacy norm – a norm that was developed in the context of fiduciary principles.<br>(Fisch, 2004) | "The British government's response to the final report of the Kay Review was lukewarm, deferring on its recommendations on fiduciary duty."<br>(Clark, 2013; p54) |

Adapted from (Eisenhardt, 1989).

The relative neglect economic and finance theory has shown the institutions of the finance industry may be partly to blame for why its behaviour has not been exposed to the assumptions of agency theory. Using agency theory to explore the relationship between the pension fund and the fund manager is a well-supported research design in the literature of parallel industries, particularly in the research of corporate governance. The economic agency relationship between agent and principals can be conceptualised by Figure 4.2. The corporate governance characteristics of the fund manager are proposed to legitimately decrease the flow of pension assets.

Figure 4.2 The fiduciary governance decision of the fund manager determining shareholder wealth maximisation income withheld from the return on investment of pension assets


External environment
> Regulation
> Consultants
> Analysts
> Reputation management
Pension Trust
Chain of investment
Chain of fiduciary accountability
Governance
Shareholding, Culture,
Board, Code of Conduct, Remuneration
Fiduciary share-holder claims to investment returns
Fund Management Institution
Material Intangible Asset:
Financial knowledge creating information asymmetry
Investment process

Source: Adapted from Holland, 2011

→ Flow of pension assets
⇒ Wealth capture of pension assets

Holland (2011) investigated the reasons for pervasive and systematic fund management doctrine of fees as a percentage of assets under management regardless of service performance to illustrate the limits of conventional finance theory in explaining fund manager behaviour. Figure 4.2 adapts Holland's (2011) qualitative grounded theory study of fund manager corporate governance along with Reich-Graeffe's (2011a) concept of management behaviour influenced by their governance characteristics to construct a conceptual framework for the research. Holland's (2011; p159) work in his own words has created a "new way to use theory and literature in a coherent analytic framework to interpret the empirical phenomena" of fund management governance.

## 4.4 The characteristics *of the agent's principals*

One of the acknowledged founders of agency theory, Stephen A Ross (Ross, 1973; p134) described the agency relationship as one of the "oldest and commonest codified modes of social interaction," suggesting consequential knowledge should be of great importance to the study of business. While Husted (2007; p178) said that the study of business ethics cannot be reduced to simple mechanics, "proper design of incentives and structures needs to be taken into account." He continues, "the point of the principal-agent model is to help scholars and practitioners to identify relevant organizational mechanisms and allow them to design those mechanisms so that they support ethical objectives." These mechanisms have been developed in agency theory to include internal incentives (e.g. executive remuneration) and external monitors (e.g. the market for corporate control) described in Chapter 2. This study, limited by publicly available data, yet consistent with Heracleous and Lan's (2012) recommendations, uses a limited set of external characteristics to explore what governance trends can be inferred in UK pension financial intermediation. Agency theory in corporate governance has been developed and empirically examined in the academic literature using a set of foundational assumptions: 1) the separation problem of powerful management controlling public corporations with weak and dispersed shareholder owners (ownership structure) (Kangis and Kareklis, 2001); 2) the comparative assumption that the primacy of shareholder rights is more entrenched in Anglo-American economic regimes (governance compliance regime) (Iwai, 1999); 3) The size of the agent delivering coercive power over the vulnerable principal (Chan et al., 2009; Chen, 2004); 4) the principal's problem of an inability to monitor whether the agent is providing value at capacity (moral hazard) (Yusuf, 2011); and 5) the principal's problem of selecting an under-performing agent due to information deficiencies benefiting the agent (adverse selection) (Mande et al., 2012).

### 4.4.1 Ownership structure effect on governance for the shareholder

In 1983 a seminal article by Eugene Fama and Michael Jensen observed that the separation of decision and risk-bearing functions in listed firms required very different management monitoring and incentives to that of partnerships. In 1988 Oviatt called for further research on whether institutional investor shareholders affected firm shareholder wealth, observing that understanding the effect of changes in ownership structures was becoming increasingly important. Ownership structures have been recognised as a central agency characteristic by numerous scholars (Kangis and Kareklis, 2001; Byrd et al., 1998; Steiner, 1996; Kim and Sorensen, 1986). Kangis and Kareklis (2001) found significantly closer alignment between manager motivations and corporate objectives in private banks over public banks. Erkens et al. (2012) found financial institutions with institutional ownership took on more risk and incurred greater losses during the 2007 - 2008 financial crisis. Laeven and Levine (2007) find that large financial conglomerates are undervalued by shareholders compared to smaller specialist intermediaries, concluding agency costs of monitoring unwieldy conglomerates outweigh diversification advantages. Conversely, Berger and Bonaccorsi de Patti (2006) found block or institutional ownership in banks lowered the agency monitoring costs. Goergen and Renneboog (2007) investigated the ownership change from initial founder shareholder to the disciplining role of the market for corporate control before and after IPO, finding a significant positive and sustained effect on firm value. These and similar studies imply that ownership structures have an important effect on firm behaviour, have an important effect on behaviour in the finance industry specifically, and had a role in the wealth destruction of the financial crisis. In keeping with the Reich-Graefe (2011a) hypothesis, the ownership structure of professional fund managers is presumed to influence their profit maximising behaviour to the benefit of the shareholder.

Proposition 1: Total pension funds per member will be lower when managed by fund managers with external shareholders (Berle and Means, 1932) ownership structures.

### 4.4.2 Political regime effect on governance for the shareholder

Comparative corporate governance and the study of the geography of corporate governance is gaining momentum as an important tool for dynamic analysis. Different political regimes, incorporation environments, cultural norms and legal histories all impact the governance structures of firms (Clarke, 2010). Bebchuk and Roe (1999; p127) call this “path dependence” and advise students of corporate governance that its incorporation into research is critical to understanding firm behaviour. Arcot and Bruno (2006) outline the effects of the legislative history of corporate governance regime in the UK on compliance behaviour. Armour et al. (2003) examine the mediating influence the European

Union has had on UK corporate governance compared with the unrelenting shareholder primacy view of the United States. Moore and Reberioux (2011) believe it important to compare the influence of the UK on European structures. Renders and Gaeremynck (2012) analyse the effect of corporate governance on principal-principal conflicts in European companies. Roberts (2005) compares Anglo-American corporate governance models with those in China. Iwai (1997; p40) says “what goes under the name of capitalism differs widely from country to country, even among advanced industrial societies. Nowhere is this difference more marked than between America and Japan in regard to the ‘purpose’ of a corporation.” Ryan and Schneider (2003) and McDonnell (2003) note fundamental governance differences at incorporation lead to different manifestations of the firm across state borders in the United States (the Delaware effect).

While pension schemes in the UK share the same governance regime the professional fund managers handling their assets are global and subject to their own regulatory, cultural and historical pressure. The pension mandate to the fund manager must comply with the two UK regulatory bodies[42] and the Pensions Act 2008 (LCR, 2013; Freshfields et al., 2005), yet fund managers are left largely unfettered in decisions on portfolio risk, fee structure and contractual exit. Bebchuck and Weisbach (2010) specifically analyse cross-border investments in global capital markets from the view of their different governance regimes. Salter

[42] The Financial Conduct Authority and the Prudential Regulation Authority

(2012) sees the Anglo-American corporate governance regime as moving relentlessly towards short-term shareholder value maximisation at the cost of long-term firm value creation.  Bogle (2009; p16) agrees, putting America ahead of the UK in developing a financial culture of abuse of trust, or shift from “there are some things that one simply does not do”, to one of “if everyone else is doing it, I can do it too.”  To this point, Rossouw (2009) takes an ethical perspective to each continent’s governance tendencies to describe the relationships companies in Europe, Asia and Africa share with society compared with the Anglo-American economies.  Gray (2008) points to Canada’s interlocking directorates for its surprising departure from the Anglo-American model in favour of stakeholder governance.  The geographical influence of the fund manager’s headquarters will influence their shareholder wealth maximising behaviour.

Proposition 2: Total pension funds per member will be lower when managed by fund managers located in dominant shareholder-agency economic environments.

### 4.4.3 Size of the fund manager’s assets effect on governance of the fund manager

Studies of mutual funds have found that not only do performance differences exist in funds of different size, they persist over time (Brown and Goetzmann, 1995; Goetzmann and Ibbotson, 1994; Grinblatt and Titman, 1992).  Prather and Middleton’s (2002) study of mutual funds finds performance can be attributed to team decision making in large funds being superior to individual decisions.  Eberl and Schwaiger (2005) found that corporate brand reputation has a significant effect on future financial performance in German companies. Firer and Williams (2003) found strong evidence for a link between physical corporate capital and financial performance. Conversely, a meta-analysis by Capon et al. (1990) suggested that growth was a predictor of performance, rather than size.

Further evidence has been published of financial performance having a positive relationship with customer loyalty (Smith and Wright, 2004) and effective human resource management (Huselid et al., 1997), both further resourced in larger fund managers.

Proposition 3: Total pension funds per member will be lower when managed by larger fund managers.

### 4.4.4 Principals avoiding moral hazard

A foundation concept of agency theory is the ethical and economic problem arising from incomplete or asymmetric information (Husted, 2007). Information asymmetry need not be a problem where the agent and principal's interests are perfectly aligned and benefits flow to the principal (Caers et al., 2006). However, a moral hazard arises when 1) the agent's true dedication to the principal is concealed or unobservable (Yusuf, 2011; Bosse and Phillips, 2011); 2) the principal suspects that the agent is egoistic (Lin and Huang, 2011); or 3) the agent owns performance information not in their best interests to divulge (Woodbyne and Taylor, 2006). To prevent this, the principal provides contractual incentives (Fogarty et al., 2009), or incurs monitoring costs (Caers et al., 2006) to ensure they receive the entire benefit of the agent's effort. Myerson (2012; p847) warns that moral hazard lies at the heart of financial intermediation in all capitalist economies:

> "A successful economy requires industrial concentrations of capital that *are vastly larger than any typical individual's wealth, and the mass of* small investors must rely on specialists to do the work of identifying good investment opportunities. So the flow of capital to industrial investments must depend on a relatively small group of financial intermediaries, in banks and other financial institutions, who decide how to invest great *sums of other people's wealth. But individuals who hold such financial* power may be tempted to abuse it for their own personal profit. To solve this problem of financial moral hazard, a successful capitalist economy needs a system of incentives for bankers and other financial intermediaries that can deter such abuse of power."

This describes Hall's (2007; p718) problematic and secret nature of "knowledge rich communities of practice" such as financial intermediaries. Further potential for moral hazard arises in financial intermediation as agents take risks without bearing the consequences (Mainelli, 2009). In order to transfer some risk to the agent, intermediary contracts are outcome (contingency) based rather than effort (fee) based, however this rent shift need not occur if monitoring was perfect (Caers et al., 2006). Herein lie agency theory's multiple ethical dilemmas summarised by Dees (1992) as 1) obligations are ignored; 2) the agent is portrayed as untrustworthy; 3) fairness is unaccounted for; and 4) ethical norms are absent.

Moral hazard in the finance industry has been empirically examined. Howorth and Moro (2012) studied the relationship between banks and Italian firms concluding heavy monitoring implies a lack of trust. Myerson (2012) believes the liquidity freeze in the 2007 financial crisis was amplified by mere concerns over the potential for moral hazard in intermediation. Drobetz et al. (2010) examined its role in leading to excessive cash holding. Yusuf (2011) studied agent opportunism and private information in insurance brokers, with the effect on rising premiums. Massa and Rehman (2008) found financial conglomerates exploit privileged inside information to boost self-owned mutual funds returns. Hall (2007) found Wall Street banks form information networks for self-dealing. Engelberg et al. (2011) however, credit interpersonal information linkages between banks and loan recipients as providing better information and better monitoring thereby lower interest rates. Lin and Huang (2011) concur for Taiwanese banks. Becht et al. (2009) credit the outperformance of the Hermes Focus Fund as being due to private information rather than stock selection. Jung et al. (2012) find a positive relationship between analysts' information acquisition efforts and firm performance. However, information asymmetry can be used by agents to redistribute value away from the principal (Jacobides and Crosons, 2001). When the agent has powerful owners and small clients, incapable of extensive monitoring, the client is in moral hazard.

Proposition 4: Total pension funds per member will be higher when pension clients are larger, avoiding wealth capture by the agent.

### 4.4.5 Principals avoiding adverse selection

Information is knowledge at a particular time of the values of different constructs that influence decisions (Husted, 2007). Adverse selection is the phenomenon where the principal is unable to observe the characteristics of the agent prior to contracting with them (Caers et al., 2006). The term originated in the insurance industry as the insurance firm's inability to evaluate the health of a customer before providing insurance (Husted, 2007). Mainelli (2009) describes a smart person who is intellectually below average for a job yet smart enough to secure an above average salary as adverse selection. It creates frigidity over entering into a contract with trust (Howorth and Moro, 2012). Engelberg et al. (2011) found firms with credit ratings of BBB or above were able to secure interest rate concessions on loans, yet those with lower or non-existent ratings were punished above the interest rate. It makes the cost of external financing higher (Drobetz et al., 2010), and encourages firms to hold excess cash (Myers and Majluf, 1984). Gorton (2009; p4) argues that a bank's essential function is to provide "informationally-insensitive" debt to investors who have no access to privileged information. Jiraporn et al. (2012) report the quality of corporate governance shared an inverse relationship with adverse selection in stock selection on the Singapore Stock Exchange. Mande et al. (2012) report equity financing is sought by firms after strong results are confirmed by high quality auditors, in a bid to signal to market they will not suffer adverse selection. For pension clients to avoid adverse selection they must choose fund managers they trust are capable of producing the highest returns. A method of insuring against a single adverse selection is to hedge the performance against numerous fund managers, limiting exposure to a single poor selection and creating private knowledge on the realistic expectations of contract positions and relative performance.

Proposition 5: Total pension funds per member will be higher when pension clients have more agents, avoiding adverse selection of an underperforming agent.

### 4.4.6. The assets under management per member: Establishing the rationale for the proxy variable: The dependent variable

The total assets under management of any given pension scheme will be determined by many factors aside from the taxonomy of scheme alone. These will include the age of the scheme, the number of members and size of their contributions, the ratio of active to retired members, and whether the scheme is in deficit as material examples. Another material factor is the scheme's investment track record and crucially, how many fees and withdrawals are being paid for the investment performance returned by the scheme's fund managers. To faithfully compare these net returns across the heterogeneous population of the 2,154 pension schemes, their assets under management must be standardised into a fungible unit of measurement. The members of any given pension scheme are workforce participants reliant on the net returns of their pension assets under management for their retirement security, and yet each member in the pension population belongs to a scheme with a variety of different characteristics to the next. Limited by the transparency the data and public information allows, the logical fungible unit of measurement, or dependant variable, is the amount of assets allocated to a single member at the time of the data capture:

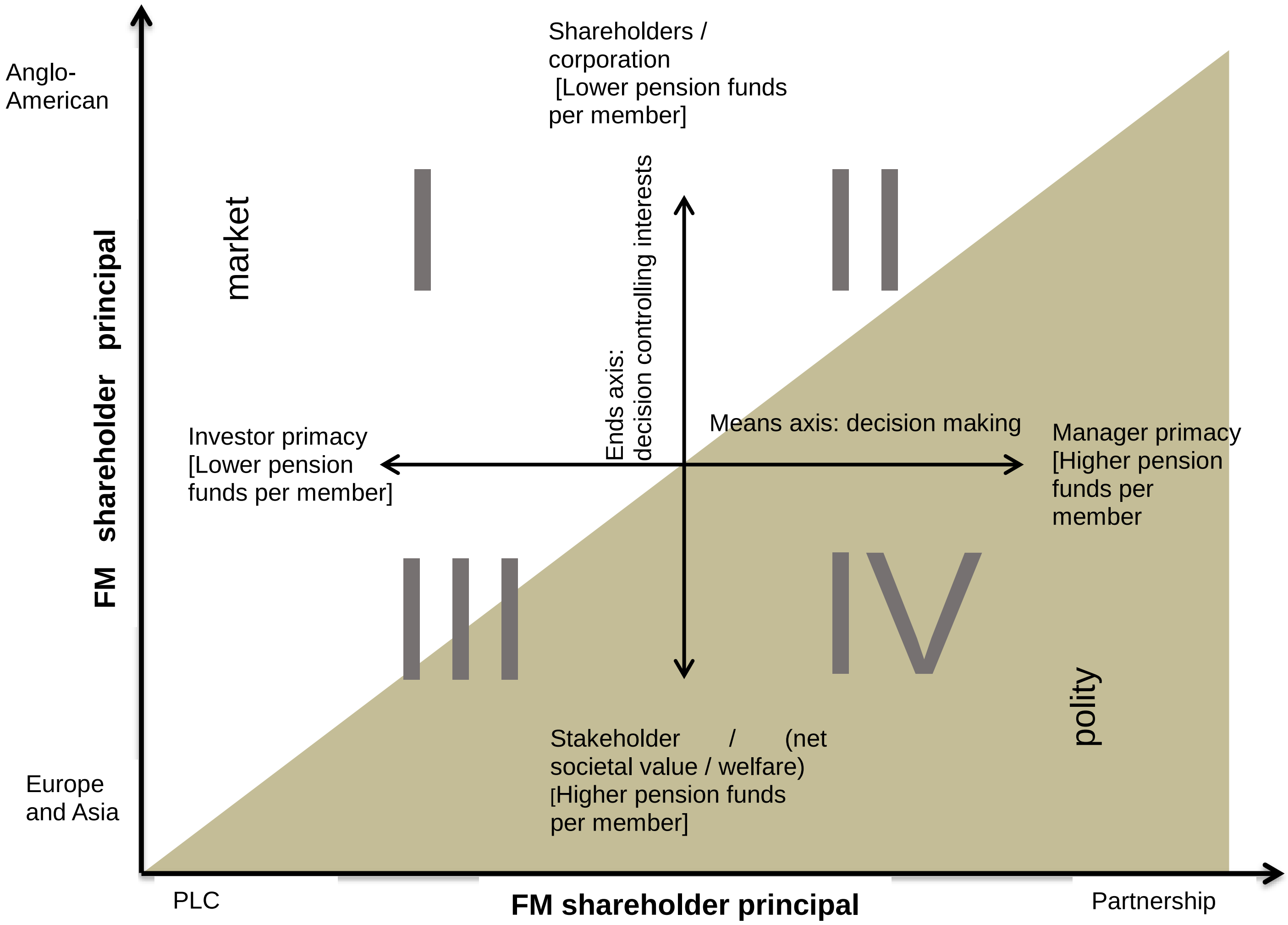
Assets Under Management per Member [AUMPM] =

$$\frac{\text{Total pension assets under management}}{\text{Total members}}$$

## 4.5 The conceptual framework accommodating the propositions

Figure 4.3 adapts Reich-Graefe’s (2011a) corporate governance model of the attention the agent pays to the owner and client principal in line with these five proposed constructs in the previous sections (Section 4.4.1-4.4.6). It forms the conceptual framework for the research methodology outlined in Chapter 5. The premise is that as the corporate governance of the fund manager shifts along the spectrum of shareholder ownership and shareholder primacy governance orientation, the fees capture by the fund manager will negatively affect the assets of the contributing members. The four quadrants of the framework represent the different combinations of governance proposed, and are described below.

Figure 4.3 *Deconstructing Corporate Governance: Conceptual framework of the principals'* influence over the agent*'s decision to wealth capture*


Anglo-American
Shareholders / corporation [Lower pension funds per member]
I
II
market
FM shareholder principal
Ends axis: decision controlling interests
Means axis: decision making
Investor primacy [Lower pension funds per member]
Manager primacy [Higher pension funds per member
III
IV
polity
Stakeholder / (net societal value / welfare) [Higher pension funds per member]
Europe and Asia
PLC
FM shareholder principal
Partnership

Source: Adapted from Reich-Graeffe 2011a

Interpretation of the four quadrants:

1. The publicly listed fund manager will decision-make in favour of shareholders in the shareholder decision-controlling Anglo-American corporate governance regime (market oriented governance). This will be mitigated by the size of the pension scheme and the number of fund managers the pension scheme engages.

2. The privately owned fund manager will have discretion to decision-make in favour of pension clients despite the shareholder decision-controlling Anglo-American corporate governance regime. This will be intensified by the size of the pension scheme and the number of fund managers the pension scheme engages.
3. The publicly listed fund manager will decision-make in favour of shareholders despite the stakeholder decision-controlling European corporate governance regimes. This will be intensified by the size of the pension scheme and the number of fund managers the pension scheme engages.
4. The privately owned fund manager will have discretion to decision-make in favour of pension clients in the stakeholder decision-controlling European corporate governance regime (polity oriented governance). This will be intensified by the size of the pension scheme and the number of fund managers the pension scheme engages.

The conceptual framework in Figure 4.3 represents the theoretical models of agency in the corporation described by Reich-Graeffe (2011a; p341), focusing on corporate governance attempts to answer a deceptively simple, but fundamentally elusive question: “Whose interests ultimately control those in control of the corporation?” The question remains contentious within the models developed to date by corporate scholars (Bainbridge, 2006). The conceptual framework prescribes that the principal of primary benefit in the pension asset management contract depends on the governance characteristics of the underlying funds management agent.

Based on the conceptual relationships proposed in Figure 4.3 the pension principal can resist exploitative contracts when they dominate the fund manager: either they are larger (overcoming the moral hazard of agency) or when they engage in multiple contracts (overcoming the adverse selection problem of selecting the wrong agent). This framework of the agency of the fund manager informs the research design and methodology in Chapter 5. The contributions of the conceptual framework are to support the rare empirical examinations of an industry that the Myners Report (2001), the Kay Review (2012) and the Law Commission Review (2013) all recommend needing efforts to close the gap between legal agency ideals and the economic agency reality.

## 4.6 Conclusion

The Chapter has established the conceptual framework for using agency theory to consider multiple principals. In agreement with Bratton and Wachter (2013) and Jones (1983), it calls for a remodelling of agency theory incorporating an explicit place for distributive justice or consideration of another stakeholder that will allow fiduciary duties to be imposed more readily on multiple principals. Kuhn's characteristics of a paradigm are: 1) a unifying or integrating theme; 2) substantial orthodoxy in the basic parameters of research; and 3) predictive or explanatory capability. Stakeholder theory has made a legitimate contribution to the business ethics literature, however fails to fulfil Kuhn's characteristics for a paradigm shift in theory, nor guides the director as to which stakeholder is or should be more privileged. Using a paradigmatic view of multi-agency theory governing the behaviour of the fund manager may provide the path towards a progressive agency theory that evolves beyond the economic parsimony of egoism.

# Chapter 5
# Research design, methodology and methods

> It is worth remembering that what we observe is not nature itself, but nature exposed to our method of questioning ~ Werner Heisenberg, *Founder of Quantum Mechanics (in O'Leary, 2010; p.90)*

## 5.1 Introduction

This Chapter outlines the post-positivist philosophy underlying the development of a research design. It describes why this epistemology is appropriate both to the research questions and to the generation of plausible knowledge. It then designs sequential quantitative methods within a methodology framework to examine the overarching propositions. In order to validate the research design and the methods of testing, the Chapter refers to the literature empirically testing agency theory. The population of the UK registered with occupational pension schemes, composed by the Office of National Statistics (ONS) annual survey, is compared against the sample the analyses chapters will draw on to ascertain that the sample is representative of the ONS population. The methods are developed in line with the requirements that post-positive research is neutral, authentic, dependable, transferable and auditable. The objective of this chapter is to produce the robust framework logically connecting agency theory from the literature chapters with the selected methods for testing it.

## 5.2 Philosophy, epistemology and ontology: The researcher situated in the research

The research strategy develops to fit the questions posed by the researcher. It must comply with the researcher's interpretation of how things are currently understood and categorised (their ontology) and how we have come to develop legitimate rules for knowing (their epistemology) (O'Leary, 2010). Marrying the existing ontology of the field with the researcher's epistemology creates the intersection of the researcher's philosophy, the strategy for inquiry and the specific methods employed to operationalise the inquiry (Creswell, 2009). Relativism is the belief that there is no universal understanding of truth, it will be constructed by the researcher in relation to their own socio-historic context. Reflexivity is the acknowledgement that the research is to a certain extent the researcher's social construction, moderated by a valid methodology to contribute to the ontology of the discipline (O'Leary, 2010; Vogt, 1993). In order to acknowledge this potential weakness of the researcher's prism, its design must ensure that certain credibility indicators are made plain and accounted for (see Table 5.1). In this way the research design provides the assurance that the process of knowledge production is legitimate and reliable, but also acknowledges that unlike in the natural sciences, controlled experimental methods are rarely available to the researcher in the fluid world of the social sciences (O'Leary, 2010). The methods of collection and analysis nested in the research framework should be capable of the assurance this process was adhered to; that the research is neutral, replicable and auditable, yet recognise there will be subjectivity and this is valid provided it is transparent.

Table 5.1 Credibility indicators by issues and paradigm

| POSITIVIST INDICATORS | POST-POSITIVIST INDICATORS |
|---|---|
| Have subjectivities been acknowledged and managed? | |
| Objectivity<br>Conclusions based on observable phenomena; not influenced by emotions, personal prejudices or subjectivities | Neutrality<br>Subjectivities recognised and negotiated in a manner that attempts to avoid biasing results/conclusions<br>Subjectivity with transparency – acceptance and disclosure of subjective positioning and how it might impact on the research process, including conclusions drawn |
| Has 'true essence' been captured? | |
| Validity<br>Concerned with truth value, ie. whether conclusions are 'correct'. Also considers whether methods, approaches, and techniques actually relate to what is being explored | Authenticity<br>Concerned with truth value while recognising that multiple truths may exist. Also concerned with describing the deep structure of experience /phenomena in a manner that is 'true' to the experience |
| Are methods approached with consistency? | |
| Reliability<br>Concerned with internal consistency, ie, whether data/results collected, measured or generated are the same under repeat trials | Dependability<br>Accepts that reliability in studies of the social may not be possible, but attests that methods are systematic, well documented and designed to account for research subjectivities |
| Are arguments relevant and appropriate? | |
| Generalizability<br>Whether findings and/or conclusions from a sample, setting, or group are directly applicable to a larger population, a different setting or to another group | Transferability<br>Whether findings and/or conclusions from a sample, setting, or group lead to lessons learned that may be germane to a larger population, a different setting, or to another group |
| Can the research be verified? | |
| Reproducibility<br>Concerned with whether results/conclusions would be supported if the same methodology was used in a different study with the same /similar context | Auditability<br>Accepts the importance of the research context and therefore seeks full explication of methods to allow others to see how and why the researchers arrived at their conclusions |

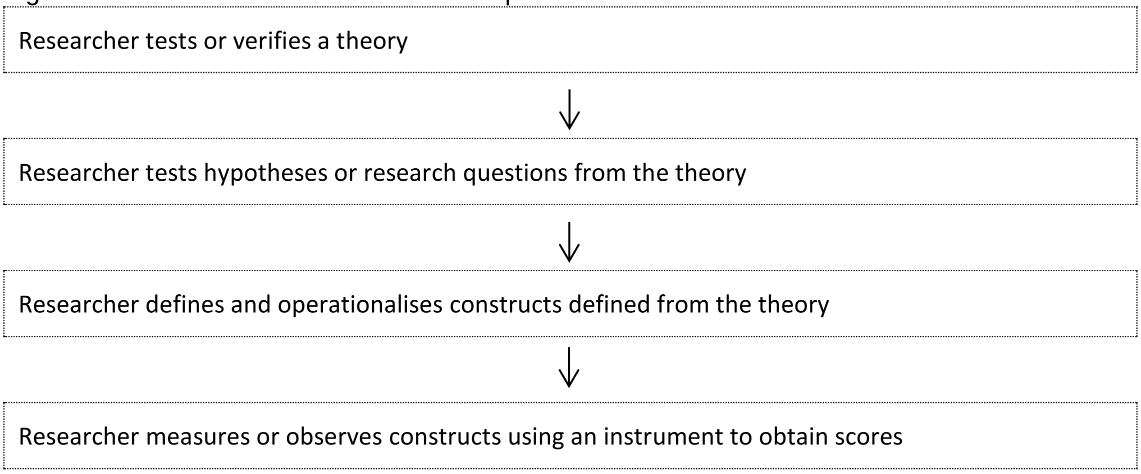
Source: O'Leary (2010; p43)

This thesis adopts a post-positivist philosophy, described in the next section, with the rationale that: 1) the research aim and objectives seek to find relationships in a novel empirical phenomenon that are postulated to exist in the literature. This novelty is one of the contributions of the research; and 2) the ontology of agency theory research remains firmly imbedded in the post-positivist philosophy, so the research is complying with ontological norms.

### 5.2.1 Researching in a post- positivist paradigm

The two main philosophies upon which social science research is based are the schools of positivism (or post-positivism: Creswell, 2009) and interpretivism (Parsa, 2001). Whereas interpretivism is associated with qualitative social science reasoning (collaboratively constructing a meaningful reality), positivist research is grounded in the scientific method (hypo-deduction or experimentation). It is the deterministic philosophy that causes probability determined outcomes, and involves the rigorous and controlled search for cause and effect, or the key determinant of a change in the object of the inquiry (O'Leary, 2010; Creswell, 2009). It starts with a theory to test and collects data that either supports or rejects the theory in an iterative process until a revised theory can be supported by empirical evidence (Creswell, 2009). A theory in this process is a "set of interrelated constructs (constructs), definitions and propositions that presents a systematic view of phenomena…specifically how and why the constructs and relational statements are interrelated" (Creswell, 2009; p51: See also Figure 5.1).

Figure 5.1 The deductive method of quantitative research



Researcher tests or verifies a theory

Researcher tests hypotheses or research questions from the theory

Researcher defines and operationalises constructs defined from the theory

Researcher measures or observes constructs using an instrument to obtain scores

Source: O'Leary (2010; p125)

As knowledge is man-made, and therefore fallible this does not “prove” the theory, it simply finds no evidence to reject it (Creswell, 2009). Matere and Ketokivi (2013) outline the criteria for sound scientific reasoning with an example: 1) these beans are from this bag (the explanation); 2) All the beans in this bag are white (the rule); and so 3) These beans are white (the observation), where the observation necessarily follows as a logical consequence of the rule and explanation; that is the observation has been predicted and so the rule and the explanation can continue to be inferred. In the study of pension governance via the prism of agency theory, finding a correlation is not a discovery of cause and effect, there are other factors that determine the cause of the correlation, and as controlling the real world environment is not practical it cannot attribute a cause or rule out a coincidence (O’Leary, 2010). In the quantitative analysis of this phenomenon, the post-positive result of significance is correlations that are statistically strong enough to infer a trend or coordinated movement between two constructs (Creswell, 2009). This limitation to interpretation will be reflected in the analysis of results.

Based on the theory of agency in the literature established previous chapters, the Chapter develops a research design of methods that are appropriate for studying the corporate governance of the fund manager agents.

### 5.3 The methodology operationalising the conceptual framework

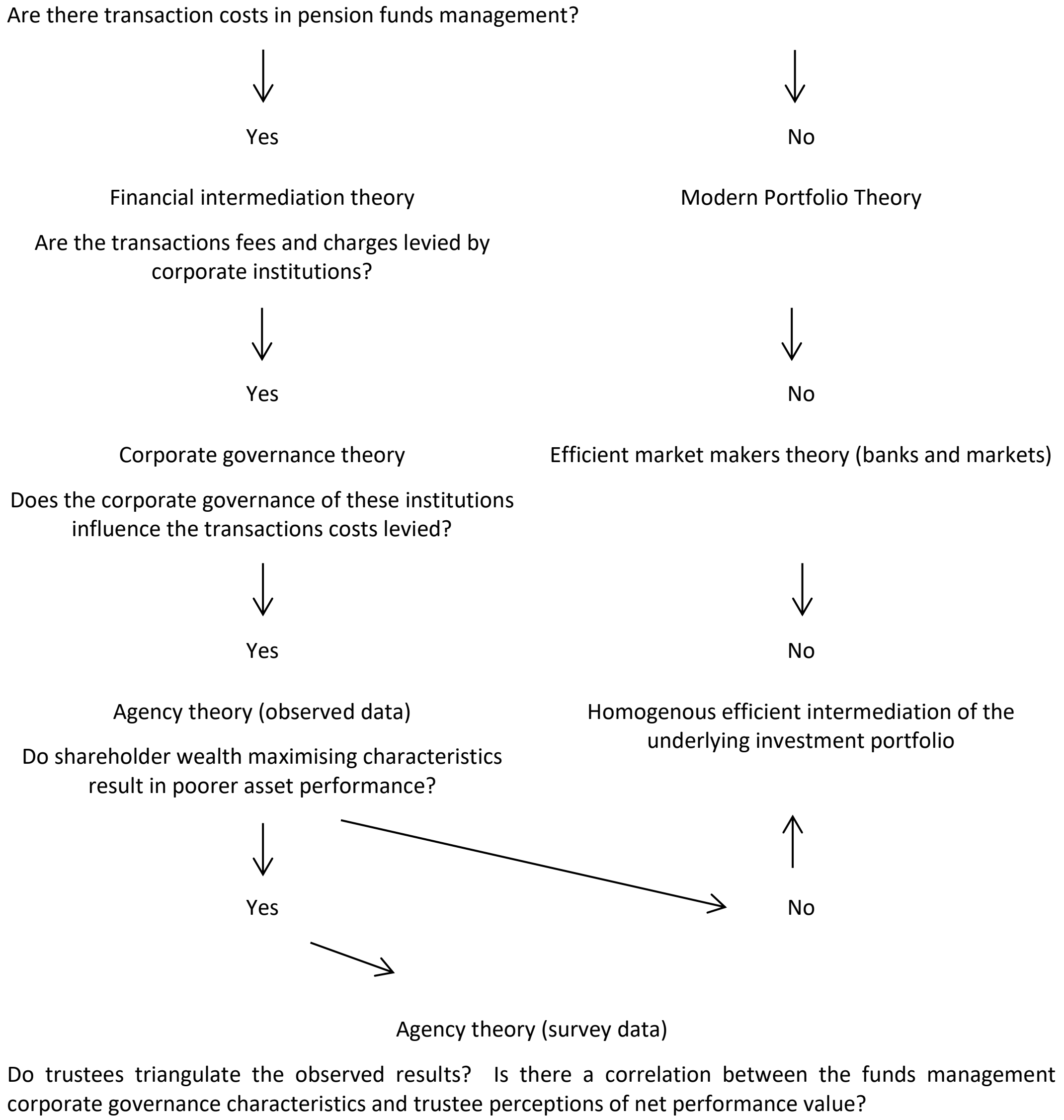
Chapter 4 provides the framework supporting the research design (Figure 4.3). It establishes the use of agency theory in a multi-principal environment. This section institutes the process of operationalising the concept into the methods that allow empirical assessment.

The ends (Y) axis represents the decision control over prioritising the shareholder principal. This implies that shareholders in geo-political regimes with more corporate governance protection can influence their publicly listed agent to act in their fiduciary best interests. Alternatively, the means (X) axis represents the decision making the agent makes on behalf of its pension principal, depending on the corporate governance influence exerted as firms become increasingly externally owned. These two effects are proposed to be mediated by the principal's ability to monitor and incentivise the agent according to the characteristics of agency theory. This prediction of fund management behaviour is adapted from Reich-Graeffe's (2011a) corporate governance model of shareholder versus management primacy, where managers with primacy have the discretion to resist shareholder fiduciary pressure in protection of other entitled stakeholders. This conception as an empirical application to the fund management phenomenon represents an important contribution the thesis.

### 5.3.1 Converting the conceptual framework into a research design

Chapter 4 rationalised a post-positivist use of agency theory for the analysis of a financial intermediation phenomenon. Chapter 3 suggested that finance theory assumes away an agency problem whereas Chapter 2 assumes all principals will encounter them. The majority of empirical research into the financial intermediation of pension assets has been constructed around finance theory to determine whether specific traits of an asset class or investment style result in superior returns on investment. These have included fund managers employing traditional versus sustainable investment management (such as compensation for risk in Mănescu (2011) or mean risk-adjusted performance in Gill (2006)). They have also examined active versus passive investment strategies (such as the cost of active investing in French (2008) or the measure of active investing skill in Berk and Van Binsbergen (2015)). While an abundance of studies examine the connection between corporate governance characteristics and investment performance in the traditional economy, pension fund management has avoided this scrutiny. As the objectives of the research are to study the corporate governance of fund managers and any correlation with fiduciary conflict, Figure 5.2 introduces the decision logic for converting the conceptual framework into stage one of a research design.

Figure 5.2 Identifying the theory for empirical research into pension fund management


Are there transaction costs in pension funds management?
Yes
No
Financial intermediation theory
Modern Portfolio Theory
Are the transactions fees and charges levied by corporate institutions?
Yes
No
Corporate governance theory
Efficient market makers theory (banks and markets)
Does the corporate governance of these institutions influence the transactions costs levied?
Yes
No
Agency theory (observed data)
Homogenous efficient intermediation of the underlying investment portfolio
Do shareholder wealth maximising characteristics result in poorer asset performance?
Yes
No
Agency theory (survey data)
Do trustees triangulate the observed results? Is there a correlation between the funds management corporate governance characteristics and trustee perceptions of net performance value?

Source: Author

## 5.4 The research design

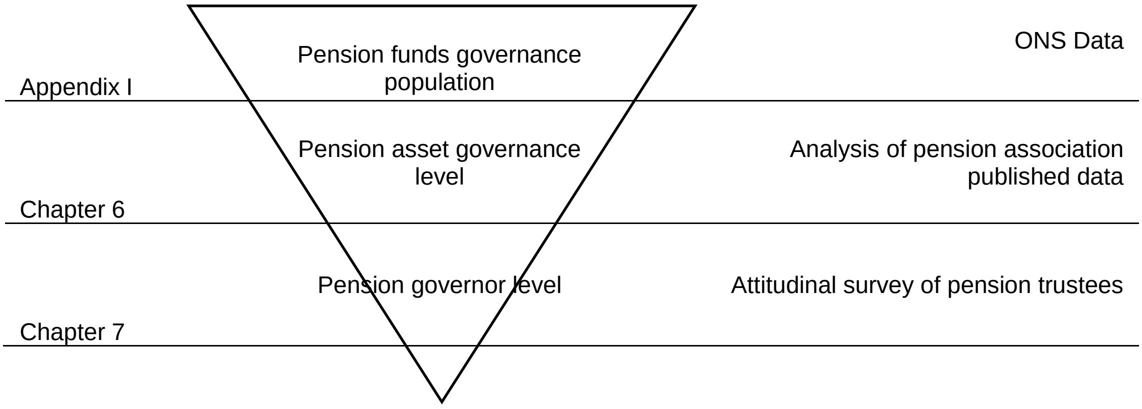
Research design is the plan that brings the broader philosophical questions of researching in a particular paradigm to the specific questions set out by the researcher, culminating in the plan that will legitimise knowledge production through a well-considered process that acknowledges the responsibilities and controversies of knowledge production (O'Leary, 2010). The objective of a post-positivist research design is to test a theory rather develop it and the research design framework is the organising model for the research questions that do this (Creswell, 2009). In quantitative studies the literature is used deductively as the basis for advancing the research objectives into the design format (Creswell, 2009; Chapters 2, 3 and 4 form this deduction). The design is organised into a methodology, being the "overarching macro-level frameworks that offer principles of reasoning associated with particular paradigmatic assumptions that legitimate various schools of research methodologies provide both the strategies and grounding for the conduct of a study" (O'Leary, 2010; p89). In order to operationalise the methodological framework, the methods are the "actual micro-level techniques used to collect and analyse data. Methods of data collection include interviewing, surveying, observation and unobtrusive methods" (O'Leary, 2010; p89). Figure 5.3 summarises the design of the research and cross-references detailed descriptions of these methods.

Figure 5.3 The methodology operationalising the objectives of the thesis

<table>
<tr><td><b>OBJECTIVE 1</b></td><td>To describe the various corporate governance structures of the professional fund managers with UK pension clients.</td></tr>
<tr><td colspan="2">The data required for this objective is described in Section 5.5.1. Descriptive statistics of the governance structures of professional fund managers in the UK by the governance constructs are described Chapter 6 as:<br>1. Ownership structure;<br>2. Geo-political reporting regime; and<br>3. Assets under management.</td></tr>
<tr><td><b>OBJECTIVE 2</b></td><td>To investigate whether different corporate governance characteristics of professional fund managers correlate with the total asset outcomes of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations.</td></tr>
<tr><td colspan="2">The empirical investigation of evidence of the corporate governance of a fund manager relationship with the assets per member of the pension clients they manage tested using the characteristics of agency theory.<br>The method and propositions outlined in Section 5.6 and the results displayed in Chapter 6.</td></tr>
<tr><td><b>OBJECTIVE 3</b></td><td>To investigate whether pension clients perceive that the corporate governance of the fund manager may influence the fiduciary sustainability of asset management for their inter-temporal contributors.</td></tr>
<tr><td colspan="2">A survey of pension trustees based on the table of constructs developed in Chapter 7 guided by the results from the empirical analysis of objectives 1 and 2. The survey is attached as Appendix IV and was administered between January and June 2015.<br>The method is described in Section 5.7 and the results discussed in Chapter 7.</td></tr>
<tr><td><b>OBJECTIVE 4</b></td><td>To determine whether pension clients believe the fiduciary duties of professional fund managers influences the delivery of sustainable wealth management.</td></tr>
<tr><td colspan="2">See Objective three.<br>The method and results are discussed in Chapter 7.</td></tr>
<tr><td colspan="2"><b>DISCUSSION</b><br>The implications of the combined findings from the research outcomes of objectives 1 to 4 are discussed and the ramifications for the sustainability of funds management deliberated in Chapter 8.</td></tr>
</table>

The design proposes a sequential process of three data collection methods. The first is composed of historical observations of the corporate governance characteristics of fund managers appointed by UK registered pension schemes, and their relationship with the characteristics of the scheme, in order to explore the first two objectives (Chapter 6). These findings will be incorporated into a survey of pension trustees, to determine whether the trustees from this sample view their relationship with the fund manager(s) they have engaged as resembling one of fiduciary agency, given the embedded vulnerability of information asymmetry (Chapter 7). Figure 5.4 illustrates why this series of methods in essential to properly capturing the socially constructed understanding of pension funds management. Triangulation of the results and their combined implications are discussed in a separate chapter (Chapter 8).

Figure 5.4 The sequential research methods capturing the funds management population


ONS Data
Pension funds governance population
Appendix I
Pension asset governance level
Analysis of pension association published data
Chapter 6
Pension governor level
Attitudinal survey of pension trustees
Chapter 7

The analysis chapters are designed to complement one another by adding depth and breadth to the understanding of the fiduciary agent from the viewpoint of impact on the pension governance. This commences with the official government statistics overview for an appreciation of the breadth of the industry and concludes with a limited survey of trustees for the granular understanding of fiduciary agency at individual level.

### 5.4.1 The contribution of a sequential design

The data retrieved from the National Association of Pension Funds (NAPF) Directory of Pension Funds and their Advisors (Wilmington, 2013; Chapter 6) are combined with the corporate governance constructs researched from the websites of the fund managers listed in the Directory. This creates a proprietary dataset as a contribution to the empirical observation of the merged properties of the agent and the two principals hitherto unavailable in research. The findings inform the creation of propositions that generate the questions to pension trustees in a directed survey. Through this sequential process the survey questions can reflect any correlations between the corporate governance constructs of fund managers and the agency constructs of pension trusts. Fundamental to the contribution, the survey data provides trustee perceptions on the possible cause of any relationship, something that cannot be determined by the first dataset. In this design, the first dataset is playing an identification role, and the second a confirmatory (confounding) role.

## 5.5 Analysis Chapter 6: Meeting the Research Objectives 1 and 2

The first analysis chapter conducted extensive research to determine the conjoined pension and corporate governance information available in the public domain. This became crucial in determining not only what characteristics were empirically measurable, but those that can be shared across all sets of analysis sequentially.

### 5.5.1 The construction of the first dataset

The Wilmington Directory of Occupational Pensions and their Advisors (2013) describes the occupational pension schemes in the UK by scheme type, number of members, assets under management and the advisors they engage as consultants, custodians and fund managers. It also provides the name and contact email for a trustee of each scheme. The Directory is produced in association with the National Association of Pension Funds (NAPF; now Pensions and Lifetime Savings Association), the national industry association. The data were exported from the Directory manually into Microsoft Excel 2010 and IBM SPSS v.21 between September 2013 and January 2014.

This process resulted in the creation of two bespoke datasets; the first cataloguing 502 fund managers servicing UK pension investments by name and services offered only. Each fund manager's website yielded the analytical constructs of ownership structure (legal entity), headquarters and assets under management. The second dataset recorded 2,154 pension schemes. The pension schemes were described as the scheme type (Defined Benefit Open, Defined Benefit Closed, Hybrid and Defined Contribution), membership type (active or passive), assets under management, and identity of fund managers engaged.

Crucially, the dataset allowed the link between the pension scheme characteristics and the governance characteristics of the individual fund managers they engage to be manifest. This data creation that allows the relationship to be observed is essential to the research objectives and not a publicly available source of information. The main challenge to data creation was the high level of variability number of fund managers engaged, with pension schemes appointing between 0 and 67 fund managers. The challenge this presents the analysis when the two databases were converged is discussed in Chapter 6.

## 5.6 Principal One: The governance constructs and possible decision control of shareholders over the agent

A foundation concept of agency theory is the ethical and economic problem arising from incomplete or asymmetric information (Husted, 2007). Information asymmetry need not be a problem where the agent and the principal's interests align perfectly and the benefits flow to the principal (Caers et al., 2006). However, it can be used by agents to redistribute value away from the principal (Jacobides and Crosons, 2001). A multiple principal environment can confuse to whom agents should signal their fiduciary efforts (Fogarty et al., 2009; Arthurs et al., 2008). The literature review in Chapter 2 concluded that the corporate governance of the agent is material to directing their behaviour, and questioned whether management of fund manager firms can be considered agents of both shareholders and clients (Heath, 2009).

In an industry beset by asymmetric information, over-the-counter deals and bespoke contracting, data on the corporate governance of fund managers is difficult to obtain (see Blake, 2014). The empirical description of the governance structures of UK fund managers identified in the Wilmington Directory formed three important constructs mandatorily available in the public domain: 1) ownership structure; 2) corporate headquarters; and 3) assets under management. The method for collecting and categorising these data are described in Table 5.2.

Table 5.2 Table of fund manager governance constructs

| VARIABLE DESCRIPTION | VARIABLE ID | CATEGORISATION | EXPECTED EFFECT |
|---|---|---|---|
| **FUND MANAGER IDENTITY** | FMID | See Appendix III for list | N/A |
| **FUND MANAGER OWNERSHIP STRUCTURE** | FMOS | Categorical variable:<br>1 = publicly listed entity<br>2 = privately owned entity<br>3 = employee owned entity<br>4 = partnership entity<br>5 = other / defunct | See Section 5.6.1 |
| **FUND MANAGER CORPORATE GOVERNANCE COMPLIANCE REGIME (REPORTING REGIME)** | FMRR | Categorical variable:<br>1 = United States<br>2 = United Kingdom<br>3 = Asia Pacific<br>4 = Europe Other<br>5 = European Union | See Section 5.6.2 |
| **FUND MANAGER ASSETS UNDER MANAGEMENT** | FMAUM | Normally distributed scale | See Section 5.6.3 |

### 5.6.1 The proposed effect of ownership structure on the fund management corporate governance (Fund Management Ownership Structure [FMOS])

The categories of ownership structure are reasonably heterogeneous and presumed in the literature to have influence over their profit maximising behaviour. As ownership becomes separated from management and the agent's principal of fiduciary concern becomes their external owner(s) rather than an internal firm owner's own fiduciary duty to the firm itself. This expected agency observation is hypothesised in Figure 5.5.

Figure 5.5 The principal-agent tipping point in the corporate governance spectrum of fund managers

| **Description** | Micro business | Small Enterprise | Medium Enterprise | Private equity/ conglomerate | Publicly listed |
|---|---|---|---|---|---|
| **Structure** | Sole trader | Partnership | Employee owned | PTY/LLC | PLC/INC |
| **Governance** | | Owner / manager | | External owner | Dissipated owner |
| **Primary principal** | Pension trust | | | | Shareholder |

Source: Author

A partnership or sole trader encumbered with the legal liability to remain a going concern may presume that client maintenance is the best way of achieving this fiduciary objective. Conversely, a conglomerate or publicly listed corporation has a conflicting, legal and fiduciary corporate governance obligation. Agency theory would predict that as ownership becomes external, the agent will appropriate the client's performance returns in the form of higher fees and charges.

### 5.6.2 Fund manager corporate governance compliance regime (Fund Management Reporting Regime [FMRR])

The geographical influence of the fund manager's corporate governance legislative compliance regime asserts growing pressure in the corporate governance literature as an important area of research. The effect it exerts on the fund manager's relationship with the principal (shareholder) and consequently the instrumentality of the relationship with the other principal (pension client).

The fund manager corporate governance compliance regimes were cross referenced for current validity with the Financial Conduct Authority Register (2014) to ensure the accuracy of the data sample[43]. Where the entity is operating as a satellite in the United Kingdom for pension fund management, the reporting regimes were interpreted as the country of the corporate headquarters. These were characterised as a spectrum of Anglo-American shareholder primacy regimes (United States and United Kingdom) through to more paternalistic stakeholder regimes (Asia Pacific, Europe Other, and European Union) in line with the Chapter 4 conceptual framework.

Consideration is given in the analysis Chapter 6 to combining Europe, EU and Asia Pacific as the more paternalistic stakeholder regimes in order to enhance comparability with the US and UK categories. From the conclusion in the

[43] The FCA keeps a register of fund managers licenced to manage investment funds (https://register.fca.org.uk/). All of the fund managers listed in the Wilmington Pensions Directory (2013) had FCA approval to manage funds at the time of analysis except for the cases researched as defunct in the proprietary database. See Section 6.3 for details.

Chapter 2 literature review, the expected observation would be the relationship described in Figure 5.6.

Figure 5.6 The principal-agent tipping point in the geo-political reporting regime of fund managers

| **Description** | Stakeholder oriented legislative regimes | | | Shareholder oriented regimes | |
|---|---|---|---|---|---|
| **Legislative geography** | EU | Europe Other | Asia Pacific | UK | USA |
| | ← | | | | → |
| **Governance** | | Stakeholder prominence | | Shareholder prominence | |
| **Primary principal** | Pension trust | | | | Shareholder |

Source: Author

The literature posits that fund managers in less rigid shareholder primacy reporting regimes will be capable of enhanced fiduciary agency towards pension schemes in the form of lower incentives for performance. This is characterised in the conceptual framework as enhanced managerial discretion to the right of the X axis.

### 5.6.3 Assets under management effect on the fund management entity (Fund Management Assets Under Management [FMAUM])

While much of the research into investment decision making studies the relationship between stock selection and timing policies, little research has been published on the relationship between fund size and net fund performance. Fund yield trackers such as Morningstar[44] track and rate yields on the funds that fund

[44] http://www.morningstar.co.uk/uk/research/funds

managers run, and show great variability between them. What it fails to capture is the cost of purchasing these investment services. Large fund management corporations will have the resources to entice the best investment talent, the best human resources management, the most physical capital and pursue aggressive growth and client acquisition strategies. Yet pension schemes may be purchasing the brand reputation of large fund manager at a price premium as a method of justifying risky investment decisions and hence fulfilling their fiduciary duty to members.

The results of these three constructs are described in Chapter 6. Figure 5.3 outlined the intention of the research design to apply this Directory dataset to the first two objectives. The next section outlines the method by which the data will be analysed in fulfilment of the first and second objective.

## 5.7 Principal 2: Pension clients and decision making influence

The conceptual framework proposes that the pension client principal be more capable of monitoring and incentivising their agent when they are less vulnerable to the agent. This, according to Mitchell et al. (1997), can be determined by power, dependence and reciprocity. When the characteristics of the pension principal are dominant over the agent in these areas, the principal may be capable of demanding fiduciary agency despite the existence of the agent's shareholders. The Thesis contends that the observable characteristics aligned with this theory are the size of their assets under management (power) and the number of fund managers they engage (resisting dependence).

### 5.7.1 Pension scheme assets under management [PSAUM]

The pension principal should also possess characteristics that may allow them to monitor and incentivise the agent.  These include (yet not limited to) the pension scheme's own financial clout (assets under management) assisting them in resisting the moral hazard of too few resources to monitor and influence.  These constructs surmise on the interrelation of the pension principal's power to demand fiduciary obedience from their agent in the face of variability in the fund manager's corporate governance characteristics.

### 5.7.2 Negotiating the uncertainty of adverse selection with multiple fund managers (Pension Scheme Multiple Fund Managers [PSMFM])

For pension clients to avoid adverse selection they must a priori choose fund managers they trust are capable of producing the highest post-fee returns.  A method of insuring against a single adverse selection event is to hedge the performance amongst numerous fund managers, limiting exposure to one poor selection and creating private knowledge on the realistic expectations of contract positions and relative performance (benchmarking across fund managers). Pension schemes with multiple fund managers should outperform those with few or one as their ability to monitor for underperformance is enhanced. This construct proposes the interrelation of the pension principal's power to demand fiduciary obedience from multiple agents in the spirit of competitive advantage.

It is possible that from an agency theory perspective the principal of note is the pension scheme, and this principal should possess characteristics that allow it to monitor and incentivise their agent to act in their exclusive best interest. Table 5.3 links the corporate governance constructs of the fund managers with the proposed characteristics of the pension scheme. The Chapter 6 analysis looks for relationships between these constructs based on the measure of assets per single member to propose that larger pension schemes are better acting as principals.

Table 5.3 Agency characteristics of the pension scheme and fund manager owner

| AGENCY CHARACTERISTIC | VARIABLE | PROPOSAL |
|---|---|---|
| Goal incongruence<br>(Eisenhardt, 1989) | Ownership structure | Pension funds per member are lower when managed by fund managers with external shareholding. |
| Ownership (Clarke, 2010) | Geo-political reporting regime | Pension funds per member are lower when fund managers are housed in dominant shareholder primacy governance regimes. |
| Risk aversion (Erkens et al., 2012) | Assets under management | Pension funds per member are lower when managed by large fund managers to avoid risk[45]. |
| Information asymmetry (moral hazard) (Myerson, 2012) | Pension fund assets under management | Pension funds per member are higher in larger pension clients capable of monitoring. |
| Uncertainty (adverse selection) (Jiraporn et al., 2012) | Multiple fund manager engagement | Pension funds per member are higher when pension clients have multiple fund managers. |

[45] Smaller pension schemes engaging marque brands to mitigate their exposure to fiduciary liability

The results of these predictions are presented in Chapter 6.

## 5.8 Applying the Objectives 1 and 2 results to Objectives 3 and 4

Figure 5.3 outlined the intention of the research design to apply the results from the previous two objectives to the next two objectives, guiding the formation of the survey of pension trustees.

This section outlines the method by which the data was collected and analysed in fulfilment of the next two objectives:

Objective 3: To investigate whether pension clients perceive that the corporate governance of the fund manager matters to the fiduciary governance of asset management for their beneficiaries; and
Objective 4: To determine whether pension clients believe the fiduciary duties of professional fund managers conflict with the delivery of fiduciary asset management.

The survey was created in accordance with research methods guidance on the production of reliable results, discussed in the next section. The survey (attached as Appendix II) was administered between January and June 2015.

### 5.8.1 The method of survey research

The attitudinal survey was designed to triangulate results from the analyses of the other two methods. It was intended as a tool to examine the perceptions pension trustees hold regarding the fiduciary management of their assets. To achieve this intention requires survey validity, considered in Bernard's (2006) nine steps for questionnaire development:

1. Establish what information is required:

    Information in support of Objectives three and four is conceptualised into constructs which are the basis for the survey questions in Chapter 7.

2. Define the target respondents:

    The dataset from Objectives 1 and 2 included the name and contact email for 1,243 pension trustee contacts. Contacts were removed where they disclosed consultant engagement such as AON Hewitt or Mercer rather than fund manager engagement.

3. Choose the method(s) of reaching your target respondents:

    The 1,243 respondents were emailed individually between January and June 2014. Chapter 7 outlines the process of survey delivery.

4. Decide on question content:

    The transformation from constructs to questions is described in Tables 5.8 to 5.11.

5. Develop the question wording:

The question content and wording was developed in consultation with, or with feedback from the industry and academic experts.[46]. Special thanks is extended to Stephen Viederman, Immediate Past President of the Jessie Smith Noyes Foundation and Dr Raj Thamotheram, Consultant and previous Chief Responsible Investment Officer, AXA for the significant time and thought applied to the development of the survey.

6. Put questions into a meaningful order and format
7. Check the length of the questionnaire
8. Pre-test the questionnaire.

Feedback on the survey was provided by the professionals and academics in Table 5.4.

Table 5.4 Respondents piloting the survey prior to deployment

| NAME | DATE SENT | DATE RECEIVED | FEEDBACK INCORPORATED |
|---|---|---|---|
| **Round 1** | | | |
| Prof. Janet Haddock-Fraser | 23/10/2014 | 31/10/2014 | ✓ |
| Dr. Richard McManus | 23/10/2014 | 31/10/2014 | ✓ |
| Merran Graff | 16/10/2014 | 16/10/2014 | ✓ |
| **Round 2** | | | |

[46]
1. Will Pomroy, Corporate Governance Policy Lead, The National Association of Pension Funds
2. Prof. David Blake, Director, Pensions Institute, Cass Business School
3. Dr. Debbie Hutton, Visiting Professor, The Pensions Institute , Cass Business School
4. Prof. Kathryn Haynes, Professor of Accounting and Finance, University of Newcastle
5. Prof. Laura Spira, Professor of Corporate Governance, Oxford Brookes University
6. Prof. John Hoffman, Professor of Private Equity, Said Business School, Oxford University
7. Mark Hedges, Chief Investment Officer, Nationwide

|  |  |  |  |
|---|---|---|---|
| Dr. Zoe Davies | 1/11/2014 | 4/11/2014 | ✓ |
| Dr. Janna Steadman | 1/11/2014 | 6/11/2014 | ✓ |
| Dr. Sarah Tetley | 1/11/2014 | 5/11/2014 | ✓ |
| **Round 3** |  |  |  |
| Dr. Raj Thamotheram | 6/11/2014 | 12/11/2014 | ✓ |
| Steve Viederman | 6/11/2014 | 1/12/2014 | ✓ |
| Dr. Danny Santamaria | 6/11/2014 | N/A | No feedback |
| **Round 4** |  |  |  |
| Richard Keery (Strathclyde Pension Fund) | 1/12/14 | 7/12/2014 | ✓ |
| Ian McKnight (Royal Mail Pension Fund) | 1/12/14 | N/A | No feedback |
| Martina MacPherson (SRI Partners) | 6/11/2014 | 10/12/2014 | ✓ |

9. Develop the final survey form.

Table 5.9 describes the methodological underpinning of the survey from the foundations established in the literature of Chapter 3. The purpose is to convert the two objectives in the previous section into a set of testable characteristics to explore pension fund trustee decision making. Specifically, whether trustees use any agency theory traits of corporate governance in their decision making in acknowledgement that fund managers exhibit institutional behaviour, and are not agency cost free. Table 5.5 compares agency theory and finance theory to examine which more closely represents 1) that institutional behaviour; and 2) the decision making criteria prioritised by trustees.

Table 5.5 Finance theory or agency theory? The predictor of fund management behaviour in the perceptions of pension trustees

| | **FINANCE THEORY** | **AGENCY THEORY** | **FUND MANAGEMENT RELATIONSHIP** |
|---|---|---|---|
| **GOAL INCONGRUITY** | [1] Parties meet as equals and will only contract when both goals are met by the contract.<br>(Mehran and Stulz, 2007) | [2] The principal must incentivise and monitor the agent to align their effort with the principal's interests. The contract will be either behavioural based (professional fee) or outcome based (performance pay).<br>(Eisenhardt, 1989) | [3] The outcome based contract (for passive or active management) incentivises the agent to invest assets to attain performance at an agreed benchmark for an annual percentage of assets under management.<br>(Whitwell, 2013) |
| **INFORMATION ASYMMETRY** | [4] Both parties are perfectly informed and the market is instantly updated with any new price-sensitive information.<br>(Chan, 1983) | [5] Information asymmetry benefits the agent, leaving the principal vulnerable to adverse selection and moral hazard.<br>(Walter, 2004) | [6] The pension trustees are unsophisticated investors, reliant on the financial expertise of the agent yet with little ability to monitor or evaluate the actions of this agent.<br>(Clark, 2004) |
| **RISK ALIGNMENT** | [7] Risk is fully anticipated and born by the party with less risk aversion, and yet prepared for that risk to have downside (loss) implications.<br>(Kolb, 2011) | [8] The agent is assumed to be more risk adverse than the principal and must be incentivised to accept risk they would otherwise shirk.<br>(Caprio and Levine, 2002) | [9] The fund manager takes on no risk; the contracted fee provides for a percentage of the assets. The pension fund is exposed to downside risk to the full amount of the assets managed.<br>(Eichberger et al., 1999) |
| **FAIR PRICE** | [10] The price is that which equal parties agree for the contract to take place, and is distributively neutral.<br>(Allen and Santomero, 2001) | [11] The problem of multiple principals incentivising and monitoring the agent (one principal is attempting to wealth capture off the other).<br>(Bogle, 2009) | [12] Publicly listed fund managers have stock market scrutiny over their share performance while others are owner-managed. Legislative and economic power benefits the shareholder.<br>(Boatright, 2000) |

| | | | |
|---|---|---|---|
| **OWNERSHIP STRUCTURE** | [13] No institutions (or institutional effects) exist in financial transactions. The markets are a seamless veil used by the counterparties.<br>(Allen, 2001) | [14] Agency theory analyses the impact of governance on the equity of the contract commanded by the principal. It assumes one agent and one principal.<br>(Bratton, 2001) | [15] The governance of fund managers and the relationship between CEO and shareholders has shifted from “bureaucrats or technocrats to shareholder partisans.”<br>(Boatright, 2009; p417) |
| **FIDUCIARY DUTY** | [16] “The fiduciary relationship which exists between two parties must conform to the terms of any contract which they sign.”<br>(Carvalho, 2008; p.406) | [17] Managers have fiduciary duties to shareholders. Firms have no legislated fiduciary duties to clients.<br>(Boatright, 1994) | [18] Fund managers have codified governance duties to shareholders. The Law Commission Review (2013) alludes to a fiduciary flavour in the fund management contract that despite recommendation, has not been legislated or tested in the courts. See Chapter 8. |

Table 5.6 takes the literature’s three competing theoretical implications in the fund management relationship from Table 5.8 (Column 3) and assigns the survey questions that operationalise these observations when first examining the agency theory of funds management. The results of the survey are reported in Chapter 7.

Table 5.6 Agency theory and finance theory constructs for the survey

| | **FUND MANAGEMENT RELATIONSHIP** | **SURVEY QUESTIONS** |
|---|---|---|
| **GOAL INCONGRUITY** | The outcome based contract (for passive or active management) incentivises the agent to invest assets to attain performance at an agreed benchmark for an annual percentage of assets under management.<br>(Whitwell, 2013) | Q1: Does the trust as a whole have a preference for active (Alpha) or passive (Index) fund management? |
| **INFORMATION ASYMMETRY** | The pension trustees are unsophisticated investors, reliant on the financial expertise of the agent yet with little ability to monitor or evaluate the actions of this agent.<br>(Clark, 2004) | Q2: Does the trust have a preference for single or multiple fund manager appointments<br>Q2a: What is the rationale for multiple fund manager appointment? What could be the major disadvantage in multiple fund manager appointments?<br>Q2b: What is the rationale for engaging a single fund manager? What could be the major disadvantage of single fund manager appointment? |
| **RISK ALIGNMENT** | The fund manager takes on no risk; the contracted fee provides for a percentage of the assets. The pension fund is exposed to downside risk to the full amount of the assets managed.<br>(Eichberger et al., 1999) | Q4: How many years has the fund manager with the largest mandate been appointed for?<br>Q5: What was the trust's rationale for selecting this fund manager? |
| **FAIR PRICE** | Publicly listed fund managers have stock market scrutiny over their share performance while others are owner-managed. Legislative and economic power benefits the shareholder.<br>(Boatright, 2000) | Q5: What was the trust's rationale for selecting this fund manager?<br>Q6: Which metric is of key importance when the trust rates financial performance of this fund manager? |

| | | |
|---|---|---|
| **OWNERSHIP STRUCTURE** | The governance of fund managers and the relationship between CEO and shareholders has shifted from “bureaucrats or technocrats to shareholder partisans.”<br>(Boatright 2009; p417) | Q7: Who owns the fund manager with the largest mandate?<br>Q8: Where are the headquarters of this fund manager’s holding company?<br>Q9: Were the two corporate governance characteristics of the fund manager in Q7&8 explicitly considered in the decision to engage them?<br>Q10: Does the trust as a whole believe any of the following corporate governance issues are important to the financial performance less fees of the fund manager?<br>Q11: Was information on any of the corporate governance issues provided to the trust by the fund manager?<br>Q12: Do you think the trust believes that the corporate governance profile of the fund manager helps them manage any of the following challenges? |
| **FIDUCIARY DUTY** | Fund managers have codified governance duties to shareholders. The Law Commission Review (2013) alludes to a fiduciary flavour in the fund management contract that despite recommendation, has not been legislated or tested in the courts. See Chapter 8. | Q13: Please indicate if you agree with the following statements on fiduciary duties:<br>Fund managers should have fiduciary duties to Pension Trusts<br>• Fund managers do have fiduciary duties to Pension Trusts<br>• This duty should override fiduciary duties to their own shareholders/owners<br>• This duty does override fiduciary duties to their own shareholders/owners<br>• Governance analysis is available on fund managers<br>• Governance analysis should be available on fund managers |

| | | |
|---|---|---|
| **TRUST SAMPLE DEMOGRAPHIC CONSTRUCTS** | | |
| Q14: NUMBER OF TRUSTEES (SCALE) | Q15: Assets Under Management (scale) | Q15: Number of members (scale) |
| Q15: NUMBER OF PENSIONERS (SCALE) | Q15: Establishment date (scale) | Q15: Scheme sector (categorical) |

Table 5.7 Survey questions translated into predictive theory testing

| | FUND MANAGEMENT RELATIONSHIP | SURVEY QUESTIONS | PREDICTIVE THEORY TESTING |
|---|---|---|---|
| **GOAL INCONGRUITY** | The outcome based contract (for passive or active management) incentivises the agent to invest assets to attain performance at an agreed benchmark for an annual percentage of assets under management.<br>(Whitwell, 2013) | Q1: Does the trust as a whole have a preference for active (Alpha) or passive (Index) fund management? | Finance theory predicts passive management. Intermediary agency costs are not modelled.<br>Agency theory predicts active management. Intermediary agency costs are borne to incentivise and monitor the agent. |
| **INFORMATION ASYMMETRY** | The pension trustees are unsophisticated investors, reliant on the financial expertise of the agent yet with little ability to monitor or evaluate the actions of this agent.<br>(Clark, 2004) | Q2: Does the trust have a preference for single or multiple fund manager appointments?<br>Q2a: What is the rationale for multiple fund manager appointment? What could be the major disadvantage in multiple fund manager appointments?<br>Q2b: What is the rationale for engaging a single fund manager? What could be the major disadvantage of single fund manager appointment? | Agency theory predicts multiple fund management appointments as a method of reducing the information asymmetry leading to an adverse selection.<br>Finance (intermediation) theory predicts single fund manager as the transaction cost of entering the market.<br>See Table 5.12. |
| **RISK ALIGNMENT** | The fund manager takes on no risk; the contracted fee provides for a percentage of the assets. The pension fund is exposed to downside risk to the full amount of the assets managed.<br>(Eichberger et al., 1999) | Q4: How many years has the fund manager with the largest mandate been appointed for?<br>Q5: What was the trust's rationale for selecting this fund manager? | Agency theory insurance against moral hazard (risk alignment through incentivising) through relationship fostering.<br>See Table 5.13. |

| | | | |
|---|---|---|---|
| **FAIR PRICE** | Publicly listed fund managers have stock market scrutiny over their share performance while others are owner-managed. Legislative and economic power benefits the shareholder.<br>(Boatright, 2000) | Q5: What was the trust's rationale for selecting this fund manager?<br>Q6: Which metric is of key importance when the trust rates financial performance of this fund manager? | Agency theory suggests that the principal aligns their (fiduciary) interests with the agent through monitoring and incentivising. Value for fees is the key metric for alignment of fiduciary duties.<br>See Table 5.14. |
| **OWNERSHIP STRUCTURE** | The governance of fund managers and the relationship between CEO and shareholders has shifted from "bureaucrats or technocrats to shareholder partisans."<br>(Boatright, 2009; p417) | Q7: Who owns the fund manager with the largest mandate?<br>Q8: Where are the headquarters of this fund manager's holding company?<br>Q9: Were the two corporate governance characteristics of the fund manager in Q7&8 explicitly considered in the decision to engage them?<br>Q10: Does the trust as a whole believe any of the following corporate governance issues are important to the financial performance less fees of the fund manager?<br>Q11: Was information on any of the corporate governance issues provided to the trust by the fund manager?<br>Q12: Do you think the trust believes that the corporate governance profile of the fund manager helps them manage any of the following challenges? | Agency theory predicts that the corporate governance of the agent will influence their institutional behaviour.<br>Finance theory predicts that financial transactions are not subject to governance influence.<br>See Table 5.15 |
| **FIDUCIARY DUTY** | Fund managers have codified governance duties to shareholders. The Law Commission Review (2013) alludes to a fiduciary flavour in the fund management contract that despite recommendation, has not been legislated or tested in the courts. See Chapter 8. | Q13: Please indicate if you agree with the following statements on fiduciary duties:<br>• Fund managers should have fiduciary duties to Pension Trusts<br>• Fund managers do have fiduciary duties to Pension Trusts<br>• This duty should override fiduciary duties to their own shareholders/owners<br>• This duty does override fiduciary duties to their own shareholders/owners<br>• Governance analysis is available on fund managers<br>• Governance analysis should be available on fund managers | Agency theory predicts principals monitor and incentivise agents to align with their best interests. This implies that the fiduciary duties owed by the principal should be passed to the agent.<br>Finance theory predicts the counterparties act as equals in possession of perfect information in frictionless markets, making fiduciary agency irrelevant. |

Table 5.8 Information asymmetry as a test of fund manager engagement rationales

| SURVEY QUESTION | RATIONALE FOR APPOINTMENT STRATEGY (AND POTENTIAL DISADVANTAGES) | PREDICTIVE THEORY TESTING |
|---|---|---|
| Q2a: What is the rationale for multiple fund manager appointment? What could be the major disadvantage in multiple fund manager appointments? | 1. Hedging risk of under-performance in one fund manager with outperformance in another<br>2. Benchmarking relative performance across fund managers<br>3. Providing competition incentives between appointed fund managers<br>4. Providing multiple sources of fund management comparison for the buy/sell decision<br>5. Other*<br>6. Professional consulting advice | 1. Agency theory predicts insurance against adverse selection.<br>2. Agency theory insurance against moral hazard.<br>3. Agency theory insurance against moral hazard (shirking).<br>4. Agency theory insurance against information asymmetry (general).<br>5. Open ended question.<br>6. Agency theory insurance against information asymmetry (general) |
| Q2a. What could be the major disadvantage in multiple fund manager appointments? | 1. Administrative burden on the Trust<br>2. Transactions costs inefficiency<br>3. Other*<br>4. None encountered | 1. Finance theory predicts transactions costs do not exist.<br>2. Intermediation theory predicts transactions costs should be minimised. |
| Q2b: What is the rationale for engaging a single fund manager? What could be the major disadvantage of single fund manager appointment? | 1. Minimising fund transactions costs<br>2. Fostering long term relationship<br>3. Minimising administrative complexity<br>4. Simplifies the fund manager buy/sell decision<br>5. Other*<br>6. Professional consulting advice | 1. Intermediation theory predicts transactions costs should be minimised.<br>2. Agency theory predicts relationships minimise moral hazard.<br>3. Intermediation theory predicts agents add value to market transactions. |
| Q2b. What could be the major disadvantage of single fund manager appointment? | 1. Key client reliance risk<br>2. Difficulty with relative performance benchmarking<br>3. Other*<br>4. None encountered | Agency theory insurance against moral hazard. |

Table 5.9 Risk alignment as a test of fund manager engagement rationales

| SURVEY QUESTION | RATIONALE FOR APPOINTMENT STRATEGY | PREDICTIVE THEORY TESTING |
|---|---|---|
| Q5: What was the trust's rationale for selecting this fund manager? | 1. asset class expertise<br>2. reputation<br>3. past performance data<br>4. lowest overall fees<br>5. provision of useful information<br>6. managing unease<br>7. transparency of fee structure<br>8. Risk sharing (including downside risk)<br>9. ESG and engagement strategies<br>10. value for fees<br>11. other criteria were applied*<br>12. consultant recommendation<br>13. other industry recommendation | 1. Finance theory (portfolio construction).<br>2. Finance theory (portfolio construction).<br>3. Finance theory (portfolio construction).<br>4. Intermediation theory (transaction cost minimisation).<br>5. Agency theory (insurance against information asymmetry).<br>6. Agency theory (insurance against moral hazard).<br>7. Agency theory (insurance against information asymmetry).<br>8. Agency theory (incentivising alignment).<br>9. Agency theory (directing agent activity).<br>10. Agency theory (incentivising alignment through fiduciary duty passed to the agent).<br>11. Agency theory (insurance against adverse selection). |

Table 5.10 Fair price as a test of fund manager engagement rationales

| | | |
|---|---|---|
| Q6: Which metric is of key importance when the trust rates financial performance of this fund manager? | 1. Nominal financial returns generated in the last financial year of engagement<br>2. Nominal returns compared to the requisite benchmark<br>3. Nominal returns compared to verbal undertaking (promises)<br>4. Value added performance (above market)<br>5. Value for Annual Management Cost (AMC)<br>6. Value for Total Expense Ratio (TER) | 1. Finance theory (portfolio analysis).<br>2. Finance theory (portfolio analysis).<br>3. Agency theory (institutional behaviour).<br>4. Intermediation theory (intermediaries add value to transactions).<br>5. Agency theory (fiduciary alignment).<br>6. Agency theory (fiduciary alignment). |

Table 5.11 Ownership structure as a test of fund manager engagement rationales

| | | |
|---|---|---|
| Who owns the fund manager discussed in the last section? | 1. Publicly traded corporation<br>2. Privately owned corporation<br>3. Conglomerate owned<br>4. Employee owned corporation<br>5. Partnership | Agency theory (irrelevant to finance theory) |
| Q8: Where are the headquarters of this fund manager's holding company? | 1. United Kingdom<br>2. United States<br>3. European Union<br>4. Other European country<br>5. Asia Pacific<br>6. Africa | Agency theory (irrelevant to finance theory) |
| Q9: Were the two corporate governance characteristics of the fund manager in Q7&8 explicitly considered in the decision to engage them? | Binary response | Agency theory (irrelevant to finance theory) |
| Q10: Does the trust as a whole believe any of the following corporate governance issues are important to the financial performance less fees of the fund manager? | 1. CEO/Chairman separation<br>2. Gender equality<br>3. Employee engagement<br>4. Corporate social responsibility<br>5. Say on pay<br>6. Board composition | Agency theory (irrelevant to finance theory) |

| | | |
|---|---|---|
| Q11: Was information on any of the corporate governance issues provided to the trust by the fund manager? | Binary response | Agency theory (irrelevant to finance theory) |
| Q12: Do you think the trust believes that the corporate governance profile of the fund manager helps them manage any of the following challenges? | 1. Managing pressure from their own shareholders<br>2. Prioritising the client relationship<br>3. Prioritising value for money<br>4. Prioritising transparency<br>5. Prioritising spending on expertise<br>6. Prioritising outperformance<br>7. Sharing risk | Agency theory (irrelevant to finance theory) |

These tables (Tables 5.9 to 5.12) are translated into statistical analysis of the survey responses in Chapter 7. This analysis provides the comparative result between what is observed in the historical accounting record of the Wilmington Directory (2013) and the perceptions of the survey respondents. The last analysis chapter triangulates these observations with the actual and reported state of fiduciary duties in funds management to discuss whether: 1) fiduciary agency exists in the pension supply chain; and 2) corporate governance has any perceived or recorded impact on the fund manager selection process give the burdensome duty placed on trustees to ensure beneficiary best interest.

### 5.9 Applying caution when interpreting results

The current empirical studies of agency theory in management have produced mixed predictive results (for commentary on this, see Foss and Stea, 2014;

Ghoshal, 2005; Daily et al., 2003) and there is little empirical evidence of the effect the governance of professional funds managers has on the interactions with their clients. While arguing for more plurality in research paradigms Crane (1999) concedes that empirical business ethics research, the philosophical home of corporate governance, has also been overwhelmingly positivist, bringing large quantities of data and a natural sciences epistemology to the exploration of these social phenomena. Ghoshal (2005; p86) describes this as the "hubris of physics envy", having led us to adopt narrow versions of positivism together with relatively unsophisticated scientific methods to develop "causal and testable theories." Despite this criticism positivism continues to dominate empirical enquiries into agency theory effects (Howorth and Moro, 2012; Drobetz et al., 2010; Fogarty et al., 2009; Goergen and Renneboog, 2008; Hutchison and Gul, 2003; Jacobides and Croson, 2001; Ogden and Watson, 1999). In order to acknowledge the social nature of the research and the lack of experimental control, a post-positive position (rather than positivism described in Table 5.1) is closely applied when constructing the research design. This is specifically to ensure both the internal validity (triangulation) and external validity (representativeness) of the sample frame are tested.

### 5.10 Conclusion

The conceptual framework orders the objectives of the thesis into quadrants of power and dependence for the two principals under investigation. This logical organisation of the overarching question of whether an agent can (or does) have two fiduciary principals in pension funds management allows the research design to mechanise its measurement.

The chapters of analysis present different information gathering techniques from which to analyse the aim of the thesis; to investigate whether the corporate governance of professional fund managers with pension clients affects asset management outcomes for the UK pensions industry.  In a multi-principal environment in the funds management industry there is misconception over the fiduciary duties the agent owes two principals.  The first analysis chapter explores the relationships between the agent and the pension principal evident empirically (published economic data) that may suggest a relationship between the pension assets of the client beneficiaries correlating with different governance characteristics in the fund manager.  The second analysis chapter explores the perceptions the trustees of pension schemes held of the fiduciary responsibility owed to the trust by the agent, and how they selected and monitored the agent to foster this responsibility.  It also explores the perceptions they hold of the importance of fund manager corporate governance in influencing this.  These analyses alongside the exploration of the literature form the foundation of the discussion chapter (Chapter 8) on the actual economic and legal status of the fiduciary agent alongside the individual and aggregate perceptions of the pensions industry itself.

# Chapter 6
# Analysis Part 1: Empirical examination of the relationship between fund manager corporate governance and pension assets

## 6.1 Introduction

This chapter analyses the Wilmington Directory of Pension Funds and their Advisors (2013) spatial data for the fund managers engaged managing UK pension scheme assets for the year 2013. Described in Chapter 5, this data was transcribed into a database in order to address the first two objectives of the thesis research design: 1) to describe the various corporate governance structures of the professional fund managers with UK pension clients; and 2) to investigate whether different corporate governance characteristics of professional fund managers relate with characteristics of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations.

The first section re-establishes the conceptual framework and describes some of the challenges and consequent strategies employed with the analytical constructs for the research design. The second section presents the descriptive statistics defining the fund management industry involved in pension asset management, augmented by an explicit list of each fund manager along with their characteristics in Appendix III. This provides the elementary industry depiction upon which the second objective relies. The third section then explores the database as a systematic test of the potential relationships between the fund manager corporate governance constructs and the pension scheme population, to determine whether the constructs of fund managers affect (or are affected by) pension scheme in meeting the second objective in the research design. The sensitivity of the results is checked, controlling for several challenges with the data, and their implications for the next stage of the research design (objectives three and four) are discussed in Section 6.9.

## 6.2 The conceptual framework supporting objectives one and two of the research design

The conceptual framework in Chapter 4 proposed the following interactions between the fund manager and pension client: 1) that publicly listed fund managers with shareholder oriented governance compliance in Anglo-American economies will appropriate pension client fees for shareholder benefit; and 2) the pension client characteristics of size and risk spreading (engaging multiple fund managers) can reduce moral hazard and adverse selection to counteract this appropriation through coercion, monitoring and incentives. According to Mantere and Ketokivi's (2013) systematic social science research objectives, if an observation has been predicted, the rule and the explanation of a theory can continue to be inferred. If publicly incorporated Anglo-American fund managers are statistically observed to share a relationship with fewer assets for the clients they manage, the rule of a theory of multiple agency can be cautiously acknowledged as exhibiting a trend worthy of further investigation[47].

[47] Cautiously as the direction of any correlation cannot be inferred, as pension schemes with smaller asset bases may believe publicly quoted Anglo-American fund managers have reputational superiority, assisting fiduciary compliance.

### 6.3 The creation of the proprietary data

As previously noted, the data for this analysis chapter were created and aggregated from various sources, and thereby representing a unique contribution to the thesis. The result is two databases that separately register 502 fund managers servicing 2,154 UK pension schemes. The Directory documented each pension scheme separately including their size by total members and assets under management. It further documented the fund managers they had engaged to manage these assets at the time of the Directory's publication. The value of the Directory is that this engagement information is not publicly disclosed, and required the purchase and aggregation of its surveyed information to illuminate the contractual interconnection between the pension scheme principal and the fund manager agent. The Directory did not provide information on the governance characteristics of the fund managers themselves, such as the legal incorporation status of their "owners" as competing principal. The ownership structure, assets under management, and governance compliance regimes were retrieved from the websites of the individual fund managers.

### 6.4 The contribution of the proprietary database to the literature of financial intermediation

This time-consuming collation process has produced the valuable contribution to the field of fiduciary conflict in financial intermediation of results observed in a proprietary database. It brings hitherto uncollected information about the relationship between the pension scheme principal and the corporate governed agent for novel empirical review.  The characteristics of fund managers were documented in a separate database to the characteristics of the pension schemes.  The pension scheme database included the identity(ies) of the fund managers they engaged as a list attached to each individual pension scheme case.

The theory of financial intermediation assumes that no agency effects are reflected in the transactions between the principal and the underlying equity purchases (the agent brings the parties together in a mutually beneficial transaction that benefits the transacting parties: Allen, 2001).  The thesis contributes to the assumption that this is not necessarily the case. Intermediaries, as discussed in Chapter 3 are corporations in their own right, disavowed by the theory, to smooth or increase the efficiency of transaction costs (Williamson, 1980).  The hypothesis that this is not necessarily the case it examined in the Chapter.  Financial intermediary intentions are to maximise their own business proposition (Holland, 2011).  Exploring this hypothesis is a major contribution of the thesis.

The Directory had missing assets under management data in 14 (0.65%) cases and missing fund manager data in 796 (37%) of cases, retaining 1,358 valid cases.  The UK Registered Occupational Pension Scheme survey (2011) deployed annually by the Office of National Statistics (ONS) plays a mediating role in the verifying the validity of the sample by lending its methodology to the identification of constructs that affect pension performance and providing assurance that the dataset is representative of the ONS population (see Appendix I). The relatively high number of missing fund manager cases suffers from the self-reporting bias observed by the methodology section of the ONS Annual Survey of Pension Schemes (2008).[48] Smaller schemes provide little information about their activity other than statutory disclosure.

The challenge in combining the two datasets was how to capture the individual characteristics of each fund manager when the list of fund managers engaged by a single pension scheme is as numerous as 67 unique entities. This was resolved by converting the single pension scheme case into multiple cases, each attached to one of the fund managers engaged, followed by that particular fund manager's governance characteristics from the second database (this conversion is illustrated by example in Figure 6.1). There were challenges in maintaining the consistency between databases as the number of observations increased from 2,154 pension schemes and 502 fund managers to 5,982 unique observations of a pension scheme matched to a single fund manager with schemes engaging multiple managers now over-represented (in Figure 6.1 3i PLC Pension now has four cases in the dataset rather than the original single case).

[48] "The review has improved the methodology for weighting estimates of scheme numbers, but the problem of sampling variability which produced a set of unusual results in 2008 has not been solved by the new methodology. The only way to solve this problem would be to allocate additional resources to the survey so that sample size could be increased, particularly for very small schemes. ONS does not consider this to be a priority in terms of resource allocation at a time of tight budgets. It is important to note, therefore, that the estimates of numbers of very small schemes continue to be subject to considerable uncertainty" (OPSAR 2011; p6).

Figure 6.1  The process of combining the fund manager and pension scheme data
(A+B=C) (A) Original database design (pension schemes n=2,154)

| Pension scheme | Total members | AUM (£) | AUM per member (£) | No. FM engaged | FM1 | FM2 | FM3 | FM4 |
|---|---|---|---|---|---|---|---|---|
| 3i PLC Pension | 1,658 | 687,000,000 | 414,355 | 4 | BLK | PRU | STD | L&G |

+

(B) Original database design (fund managers n=502)

| Fund manager | FM Code | Assets under management ($US) [FMAUM] | FM Ownership [FMOS] | FM Headquarters [FMRR] | # UK clients |
|---|---|---|---|---|---|
| BlackRock | BLK | 3, 792, 000, 000, 000 | PLC | USA | 430 |
| Prudential | PRU | 753, 000 ,000, 000 | PLC | UK | 24 |
| Standard Life | STD | 280,016,100,000 | LLC | APAC | 155 |
| Legal & General | L&G | 608, 400, 000, 000 | PLC | UK | 539 |

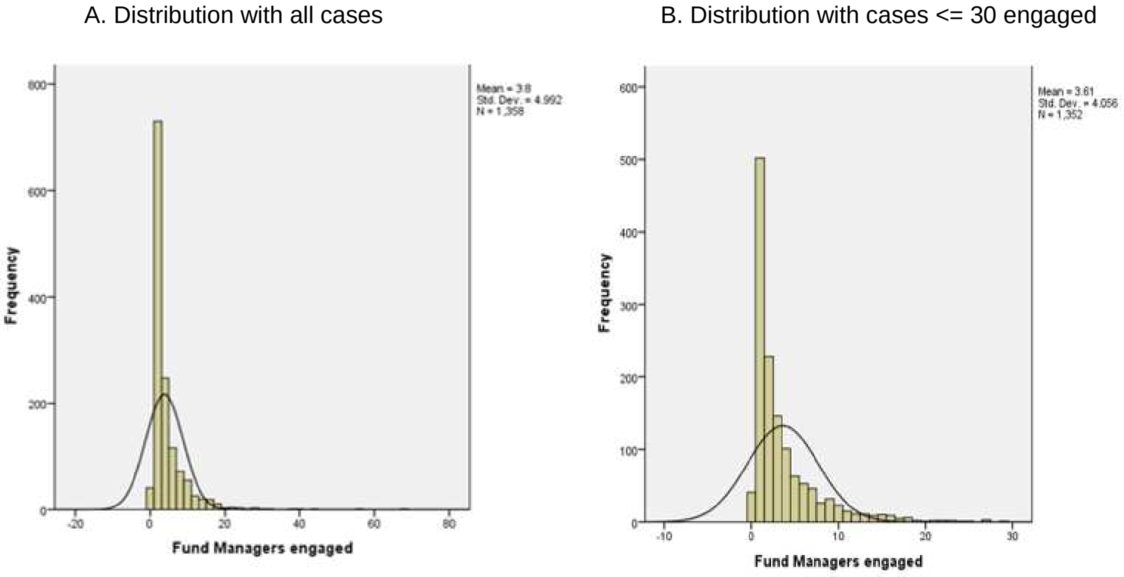
=

(C) Convergence of the databases (n=5,982)

| Pension scheme | Total members | AUM (£) | AUM per member (£) | No. FM engaged | FM code | FMAUM (USD Billion) | FMOS | FMRR |
|---|---|---|---|---|---|---|---|---|
| 3i PLC Pension | 1,658 | 687,000,000 | 414,355 | 4 | BLK | $3,792 | PLC | US |
| 3i PLC Pension | 1,658 | 687,000,000 | 414,355 | 4 | PRU | $753 | LLP | UK |
| 3i PLC Pension | 1,658 | 687,000,000 | 414,355 | 4 | STD | $280 | LLC | APAC |
| 3i PLC Pension | 1,658 | 687,000,000 | 414,355 | 4 | L&G | $608 | PLC | UK |

The implications of this data merge are illustrated by the distribution of engagement in Figure 6.2(A) (n=1,358: mean 3.80 standard deviation (SD) ± 4.99).  From no external fund manager to a single fund manager engaged, to multiple engagements (the majority of pension schemes (n=502:  37%) engage a single fund manager). However, larger schemes by assets under management tend to engage multiple fund managers (n=1,353, r=0.414, p=0.0001), skewing the mean number engaged to (a rounded) 4 fund managers.

Figure 6.2 Distribution of the number of fund managers engaged



A. Distribution with all cases

B. Distribution with cases <= 30 engaged

In Figure 6.2(A) the histogram aggregates pension schemes engaging 1-2 fund managers (n=730) to accommodate the tail (schemes engaging >=30 fund managers). In Figure 6.2(B) the X axis range is reduced from 80 to 30, with the number of schemes engaging a single fund manager now visible (n=502). The effect that pension schemes with larger assets will be over represented in the converged database was central to the decision to remove the extreme outliers above 30 engagements.

The challenge of large scheme over-representation in cases with multiple fund manager engagement was to acknowledge the altered relationship between the assets under management per individual member and the actual assets under management of the pension scheme as a whole.

The analysis draws on the separate databases when describing both the pension schemes population and the fund manager population, to isolate the effect the multiple engagements have over the combined data.  It then explores the interaction between fund manager governance constructs and the assets under management per member (AUMPM) of a pension scheme in the converged database, described as the proxy variable in Section 6.6.1.1.  The origins of the datasets used are made explicit in the analysis.

With these data particulars considered explicitly throughout the chapter, the first objective of the research design, to describe the various corporate governance structures of the professional fund managers with UK pension clients, is the subject of Section 6.4.  The second objective of the research design, to investigate whether different corporate governance characteristics of professional fund managers correlate with the total asset outcomes of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations follows in Section 6.5.

## 6.5 Research objective one: Description of pension schemes and fund managers managing UK pension funds

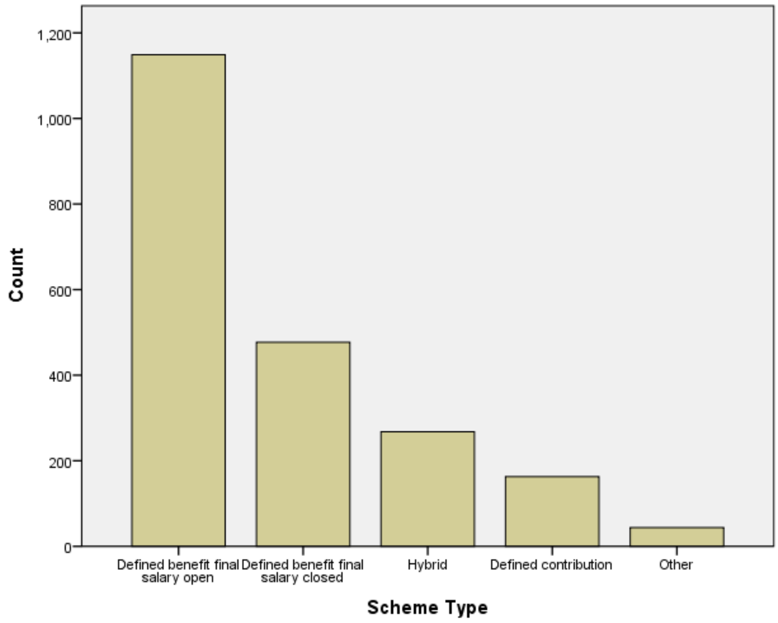
The following two subsections observe the descriptive statistics for both the pensions scheme population and the fund manager population to contextualise how these two populations interact. The thesis hypothesises that the fund manager has an acquisitive influence over pension assets, but pension characteristics may resist this. To explore the premise, the two populations are described.

### 6.5.1 Descriptive statistics: Pension schemes in the UK

The total registered occupational pension schemes (n=2154) had missing assets under management data in 14 cases and missing fund manager data in 796 (37%) of cases, retaining 1358 valid cases. The average pension scheme's assets under management were £529 million (± £2,033 million) and the average member base was 10,616 (± 30,722) allowing for an average of funds per member of £87,000 (maximum £2,319,000; minimum £2,000: ± £135,000). The majority of schemes were Defined Benefit final salary open to new members (55% or 49% in the combined database) and Defined Benefit final salary closed to new members (23% or 26% in the converged database), with the remaining schemes (Defined Contribution, Hybrid, Stakeholder and PPP) accounting for the remaining 22%, or 25% in the converged database (see Figure 6.3 and for comparison of representativeness with the ONS data see Appendix I).

The majority of pension schemes outsource their assets to fund managers (86%), with many outsourcing to multiple fund managers.  Defined Benefit Open schemes outsourced in 2,898 schemes, Defined Benefit Closed in 1551 schemes, Hybrid in 970 schemes and Defined contribution in 401 schemes with the average number of fund managers engaged across all schemes being 8.91 (±11.27).

Figure 6.3.  Frequencies of pension scheme type in the independent database



As discussed in Chapter 4, the Office of National Statistics (ONS) has identified Defined Benefit schemes as a separate population from Defined Contribution and other schemes in their methodology.  The logic for consistent handling in line with their methodology is borne out by the significant size differences between them in both by both assets under management (F=91.598, df4, p=0.0001) and membership size (F=84.461, df4, p=0.0001) (see Table 6.1).

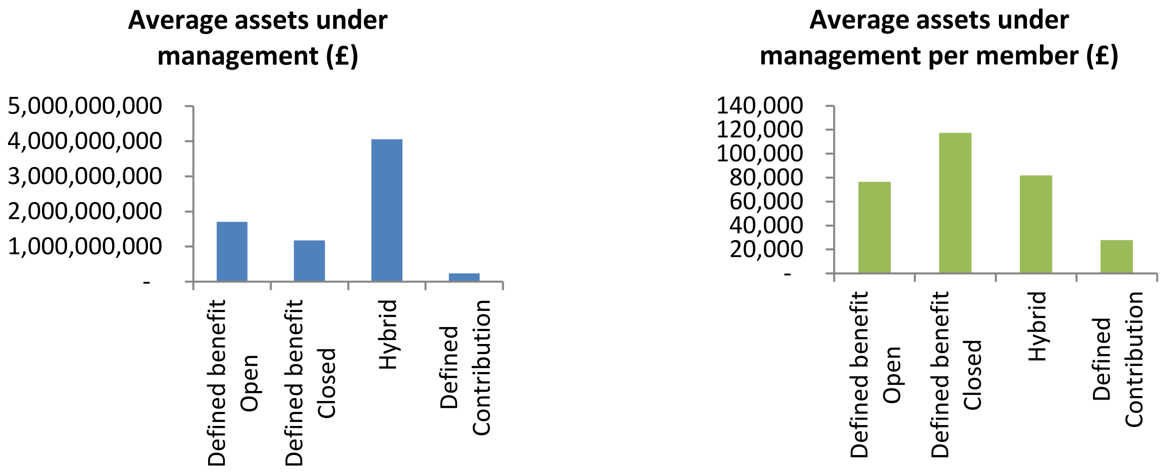
Table 6.1. Schemes by assets under management and total membership

| **Pension Scheme** | **Assets under management mean and SD (£ million)** | **Total membership mean and SD (retired and current participants)** |
|---|---|---|
| Defined benefit open (n=1146) | 477 ± 1,770 | 13,013 ± 31,974 |
| Defined benefit closed (n=477) | 567 ± 2,141 | 7,757 ± 24,467 |
| Hybrid (n=267) | 911 ± 3,147 | 13,251 ± 44,144 |
| Defined contribution (n=160) | 105 ± 228 | 5,186 ± 9,823 |

The large disparity in size of both assets and members, particularly in hybrid schemes possibly reflects the complexity and resource intensity of running these multiple schemes for different parts of a large workforce.

To evaluate whether any attributes of the fund manager affect the sustainability of a scheme when the size of schemes are heterogeneous, the unit of measurement should be the amount of the assets each member is entitled to, allowing a member of a small scheme to be applicably compared to a member of a large scheme. This also allows cross-scheme comparisons to determine whether their size itself has any mediating effect on the size of the assets of a single member. Illustrated in Figure 6.4, when total assets under management are divided by total members for the different scheme categories, the comparison between schemes flattens from very significant differences in asset size (F=119.664, df3, p=0.0001) to still significant, but less so (F=91.598, df4, p=0.0001). Section 6.6 explores this phenomenon of pension scheme size as a potential determinant of the size of assets apportioned to a single member.

Figure 6.4. Categorical differences in average asset allocations across schemes by assets under management and assets under management per member respectively



**Average assets under management (£)**

**Average assets under management per member (£)**

(3%) schemes managing funds internally, 502 (37%) engaging a single funds manager and 120 (7%) engaging over 10 fund managers (average 3.4 ± 5.0), illustrated in Figure 6.3.

Given 86% of pension schemes outsource their assets under management to one or more fund managers, the characteristics of these managers have important implications to the sustainability of pension assets for any given member. These characteristics form the alternative variables in the analysis.

### 6.5.2 Description of the fund managers managing UK pension funds

The 502 fund management firms have aggregated assets under management of USD83.5 trillion, averaging $147,000 billion (standard deviation ± $1,303,000 billion),[49] representing some of the largest corporations globally. Figure 6.5 depicts the ownership categorisation of the fund managers, 239 with external shareholders / owners and 219 with internal owners.

Figure 6.5 The ownership structures of fund managers with UK pension clients in line with the rationale for this external variable.

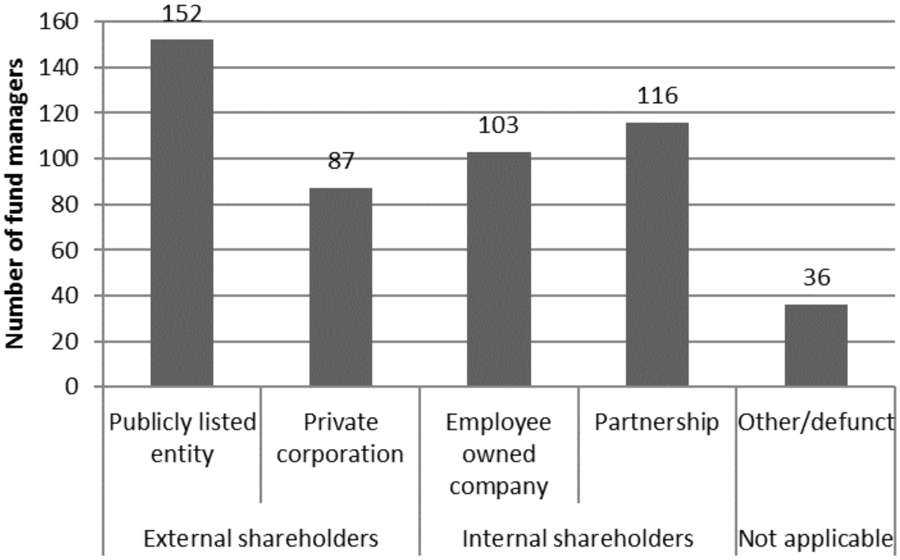


Table 6.2 outlines the frequency of entity ownership structures in each geographic location. Anglo-American governance is described in Chapter 2 as comparatively more shareholder oriented (n=398) than that stakeholder oriented governance regimes of Europe and Asia (n=96). These shareholder primacy regimes dominate the management of UK pension assets (80.6%).

[49] A full list of fund managers and their governance characteristics can be found in Appendix IIII

Table 6.2 Frequency of observations of entity type in each geo-political reporting regime

| | Publicly traded entity | Private corporation | Employee owned corporation | Partnership | Other/ defunct | Total | Total (%) |
|---|---|---|---|---|---|---|---|
| **USA** | 49 | 35 | 47 | 34 | 13 | 178 | 36.0 |
| **UK** | 59 | 30 | 36 | 75 | 20 | 220 | 44.5 |
| **Asia Pac** | 20 | 9 | 9 | 2 | 2 | 42 | 8.5 |
| **Europe** | 8 | 10 | 9 | 3 | 0 | 30 | 6.1 |
| **EU** | 16 | 3 | 2 | 2 | 1 | 24 | 4.9 |
| **Total** | 152 | 87 | 103 | 116 | 36 | 494 | 100 |
| **Total (%)** | 30.8 | 17.6 | 20.8 | 23.5 | 7.3 | 100 | |

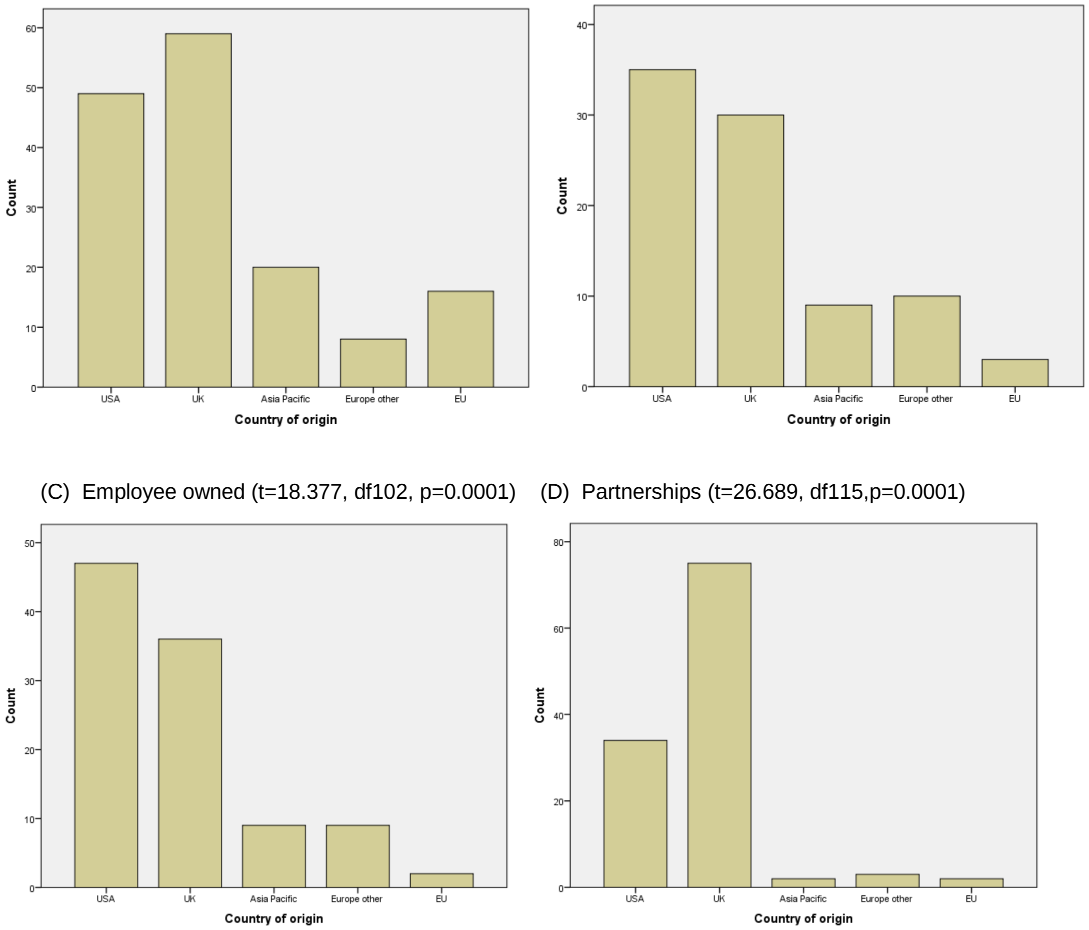
With the three governance constructs described, there is a reasonable spread of fund managers across ownership structures, however the industry is dominated by fund managers from the USA (36%) and the UK (45%).

### 6.5.3 The inter-relationship between the three fund manager governance variables and pension variables

Collinearity between variables has important implications for the second objective of the research. Should the variables prove interrelated (where no statistical difference is detectable between them), one characteristic's influence over the assets of a pension member cannot be viewed as independent of the related variable's influence. For instance, the sample is dominated by publicly traded companies in the UK and USA. If they relate to each other (it is likely that you are a PLC in the UK), then which is the characteristic that the pension client correlating with. Isolating a particular governance influence over the member would be internally invalid.

The UK and USA dominate UK pension asset management averaging 82.4% of UK funds management globally.  The UK is dominant over the territories in the use of partnership structures (64.7% of partnerships are UK based), while the USA utilises more private sector entities.  Figure 6.6 illustrates the compliance regions by each organisational structure.  In each corporate structure category, the predominance of Anglo-America over the remaining territories is statistically significant, with partnerships proving the most disparate.

Figure 6.6  Ownership structure variance of the fund managers in each geo-political compliance regime



(A) Publicly traded entities (t=21.951, df151, p=0.0001)    (B) Private corporations (t=16.711, df86, p=0.0001)

(C)  Employee owned (t=18.377, df102, p=0.0001)    (D)  Partnerships (t=26.689, df115,p=0.0001)

Anglo-American difference in assets per member between public and private ownership is not statistically significant (t=0.8966, df4,273, p=0.3700). The difference in assets per member in stakeholder governance regimes between public and private ownership is also insignificant (t=0.1254, df435, p=0.9002). However, the difference between partnerships and the three other categories is significant (t=2.0711, df4710, p=0.0384) (See Table 6.3).

Table 6.3 Assets per member by alternative ownership structures in shareholder and stakeholder oriented governance regimes

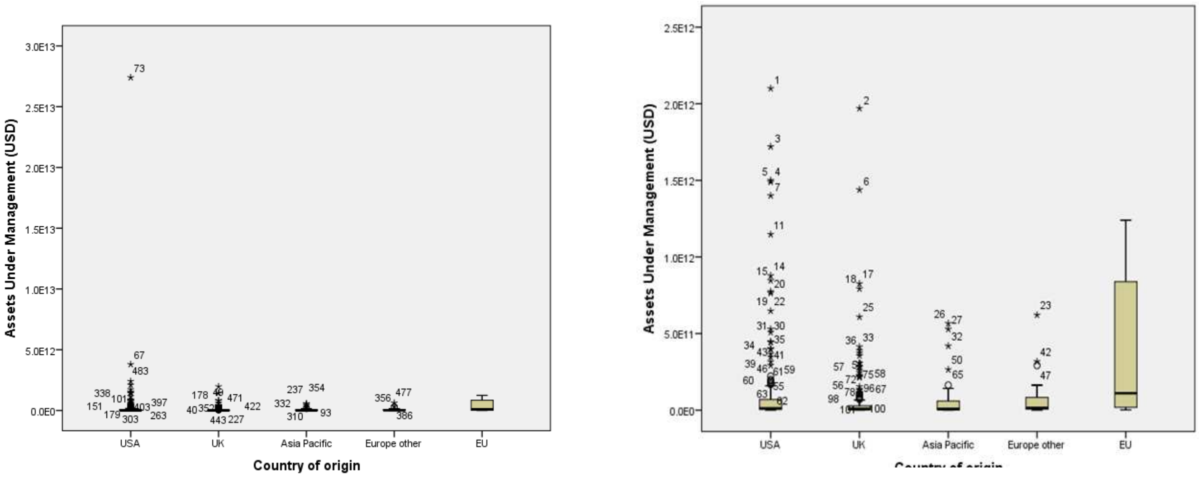
| **Ownership Structure** | **Anglo- American governance** | **Stakeholder governance** |
|---|---|---|
| | Mean and standard deviation | Mean and standard deviation |
| Public corporation | £84,311 ± 140,962 (n=2,892) | £87,687 ± 154,289 (n=282) |
| Private corporation | £83,969 ± 116,358 (n=459) | £105,759 ± 203,984 (n=78) |
| Employee owned | £85,877 ± 136,109 (n=334) | £74,134 ± 69,692 (n=62) |
| Partnership | £95,354 ± 156,616 (n=590) | £77,789 ± 81,494 (n=15) |

While the third variable, the size by assets of the fund managers [FMAUM], differs significantly between organisational structures (F=2.634, df4, p=0.034), it does not by geographical location (F=0.924, df4, p=0.450). Any reporting regime has big and small fund managers.

While the observed economies of scale in larger assets under management are not preferred by a particular reporting regime, they do share a statistically significant relationship to ownership structures. These ownership structures do share a statistically significant relationship with reporting regimes. The apparent contradiction in this result is exacerbated by two factors: 1) the over-weighting of

US and UK representation in the reporting regime category evident in Figure 6.5; and 2) the fact that partnership structures are proportionally popular in the UK compared with publicly listed corporations in the US (75/59, or 127.1% in the UK and 34/49, or 69.4% in the US: $x^2$=57.692, df6, p=0.0001). However, it is important to note the cases identified as anomalies for the size of their assets under management (BNY Mellon, BlackRock and Vanguard) being ten to twenty times the size of the mean, are publicly quoted corporations in the USA. Removing their effect, highlighted in Figure 6.7, helps to normalise this distribution.

Figure 6.7 Box plots of fund manager assets under management by reporting regime before and after the removal of outlier cases



Fund manager assets under management (AUM)

Fund manager AUM with outliers removed

Larger fund managers (assets under management) tend to be publicly listed companies with more UK pension clients[50]. With regard to the herding hypothesis[51] that pension schemes gravitate towards certain fund manager

[50] It is important to note that there is no category exclusivity implied. A pension fund engaging multiple fund managers can conceivably engage the smallest and the largest of them.
[51] The industry conjecture that small schemes gravitate to large fund managers is explored in Chapter 3, yet rarely empirically tested in the literature (Williams, 2014).

characteristics (particularly ownership structure) there is a significant difference in the mean number of clients managed by legal entity type (F=5.651, df4, p=0.001), biased towards publicly listed entities (illustrated in Table 6.4[52]). The causal direction of this relationship is undetermined. FMOS biasing publicly trading entities have more clients and AUM, so it seems logical is that more clients create more assets under management. The question of interest is whether particular clients share relationships marque brands.

Table 6.4 Number of reported UK pension clients managed by fund manager legal entity[53]

| FMOS | Public listed (n=149) | Private corporation (n=87) | Employee owned (n=103) | Partnership (n=116) | Other (n=41) |
|---|---|---|---|---|---|
| Mean ± SD | 18.26 ± 52.07 | 7.07 ± 15.94 | 4.21 ± 10.69 | 4.06 ± 5.51 | 2.98 ± 5.49 |

The profile of the pension client for each fund manager is a significant inquiry for the following section addressing research objective two, assessing whether smaller pension schemes are gravitating to larger fund managers given that larger fund managers have more clients. This potentially creates two types of herding in the fund management industry: 1) small schemes are over-represented in the public listed fund manager category; and 2) large schemes are over-represented in the more boutique ownership structures of fund managers.

[52] Given the influence that the two publicly quoted companies with the most clients BlackRock (n=430) and Legal & General (n=538) will have over this result they cannot be excluded as anomalies. When explored individually, the BlackRock pension client profile (£1,228,580,615 ± £3,519,636,508) and Legal & General client profile is (£981,879,030 ± £3,064,614,273) both smaller than the general client profile (£1,844,630,998 ± 4,331,160,454).

[53] According to the pension self-reported fund managers engaged in the Wilmington Directory

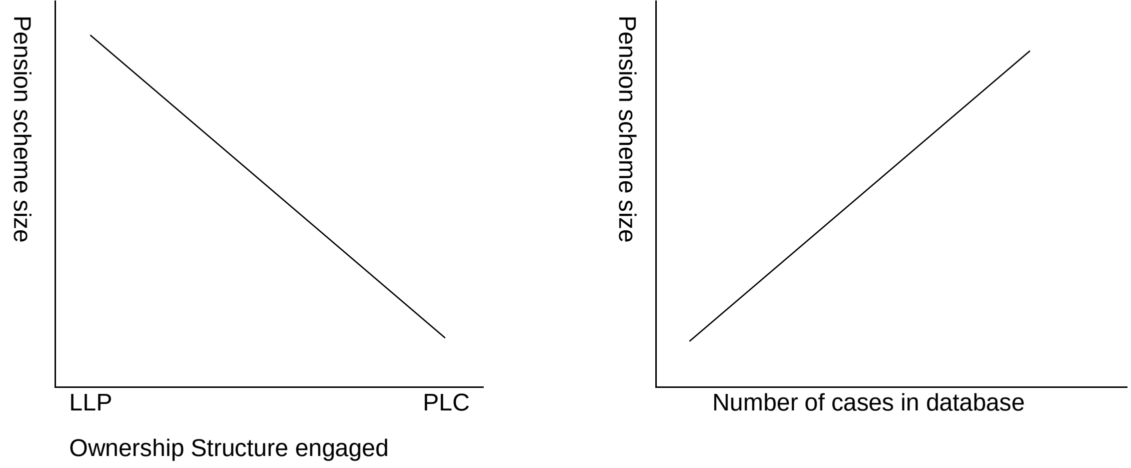
### 6.5.4 Implications for objective two

There are three main implications of these findings for the research design of objective two; investigating whether different corporate governance characteristics of fund managers correlate with the total asset outcomes of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations. Firstly, the difference in mean size between the ownership structures. Secondly, the herding of small UK pension scheme clients towards large fund managers. Thirdly, the over-represented large schemes in privately held ownership structures.

The implications for the second objective are that while each variable will be explored individually for a direct relationship with assets under management per member, they are not independent of each other. When interpreting results for the relative effect each shares with assets under management per member, acknowledgement must be made that they are not necessarily independent corporate governance effects over pension wealth capture and other pension variables may be responsible for greater effects.

The implication for objective two of the over-representativeness of UK pension schemes by publicly listed corporations is that the two publicly listed companies managing a high percentage of clients (45% of pension schemes in the sample) have both recorded mean and standard deviations significantly lower assets per member than the general client population.[54] While this will not always be an exclusive client relationship, the tendency for small pension funds to gravitate towards marque firms and engage fewer fund managers will exacerbate their governance profile influence over the results. Conversely, large pension schemes have statistically more fund managers engaged, and therefore more cases recorded in the converged database. Their assets per member will account for a large part of any governance effect of the more boutique fund manager entities. These two effects are depicted in Figure 6.8.

Figure 6.8 Pension scheme size effect on results for objective two



The implications for an analysis framework for objective two are:

a) The dominance of the UK and USA over the geography of origin for governance compliance. The three smaller categories (Asia Pacific, European Union and Europe Other) will be combined to represent the stakeholder oriented regimes in governance. This emphasises a rank,

[54] Legal and General t=2.0356, df7014, p=0.0356*, BlackRock t = 2.8868, df6906, p=0.0039**.

rather than categorical construct useful for interpreting the relationship with the conceptual framework;

b) Large fund managers are engaged by smaller pension schemes. While this may prove a legitimate and interesting finding, the category is dominated by two publicly listed corporations. A sensitivity analysis with BlackRock and Legal & General included then excluded from analysis will make their influence transparent;

c) Inversely to the previous point, large pension schemes are over-represented in privately held (smaller) fund management entities. Larger schemes are positively correlated with assets per member and smaller schemes are negatively correlated (although neither significantly). As with point (a), combining the category into the binary external owner / internal owner will be useful for interpreting the relationship with the conceptual framework; and

d) Large pension schemes engage more fund managers, and hence have more individual cases in the combined database. Their assets per member results will be over-represented in the analysis. A sensitivity analysis with cases engaging less than 30 fund managers will make their influence transparent.

These issues are explicitly considered in the next section where the conceptual framework is used to interpret the relationships the governance constructs share with the pension scheme assets of a member to meet the second objective of the research design.

### 6.6 Research objective two: First analysis of the conceptual framework

Objective two of the research design is to investigate whether different corporate governance characteristics of professional fund managers correlate with the total asset outcomes of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations. The conceptual framework (Figure 4.3) has postulated a relationship between the corporate governance characteristics of a fund manager and the sustainability of pension scheme assets from the literature in Chapters 2, 3 and 4. The contributing workforce has little control over fund manager selection, nor the ability to interact with the fund manager directly regarding their savings. The framework proposes that certain characteristics of the pension scheme the member belongs to should have some mediating effect on the wealth capture from the assets of the member. These include the ability to negotiate efficient fund management contracts and sufficient resources to monitor and manage their agents effectively.

### 6.6.1 Analysis plan: Description of the relationships in the conceptual framework

The conceptual framework imagined four quadrants of corporate governance behaviour, manifesting in relation to the governance traits of the firm (Section 6.4). The four quadrants suggest that management decision making discretion and external decision controlling (governance compliance) influence will cause different fiduciary agent protections. The interpretation of the four quadrants:

1. Investor oriented decision-making and shareholder oriented decision control

   The publicly listed fund manager will make decisions in favour of shareholders in the shareholder decision-controlling Anglo-American corporate governance regime (market oriented governance).

2. Manager oriented decision-making and shareholder oriented decision control

   The privately owned fund manager will have discretion to make decisions in favour of pension clients despite the shareholder decision-controlling Anglo-American corporate governance regime.

3. Investor oriented decision-making and stakeholder oriented decision control

The publicly listed fund manager will make decisions in favour of shareholders despite the stakeholder decision-controlling European corporate governance regimes.

4. Manager oriented decision-making and stakeholder oriented decision control

   The privately owned fund manager will have discretion to make decisions in favour of pension clients in the stakeholder decision-controlling European corporate governance regime (polity oriented governance).

According to the theory of agency in corporate governance, illustrated by the conceptual framework (Figure 4.3), Quadrants one and four should be unambiguous representations of shareholder primacy (Quadrant 1) and director primacy (Quadrant 4). In quadrant one both the constructs of external firm ownership and shareholder primacy governance regimes work in unity to wealth capture the pension assets. In quadrant four both the constructs of internal ownership in stakeholder oriented governance regimes work in unity to provide management with discretionary decision-making power to protect the pension from wealth capture. Conversely, the conceptual framework suggests that in quadrants two and three the corporate governance constructs conflict with each other. In Quadrant 2 internal firm owners should not be pressured by governance compliance favouring the shareholder. The firm has the decision-making discretion to set their own tolerance for wealth capture. Similarly, for Quadrant 3 where externally owned corporations are managed in stakeholder oriented compliance regimes, they should be capable of establishing their own wealth capture strategies, free from market oriented pressure. Should the results reflect these propositions the agency theory of corporate governance cannot be rejected.

Chapter 4 (Section 4.4.6) discussed the rationale for using Assets Under Management Per Member as the proxy dependent variable. Given the thesis aims to examine the corporate governance effects of fund manages on the distribution of wealth back to the pension principal, the only way to compare pension schemes that differ to orders of magnitude in both member base and assets under management is to isolate the total assets attributable to a single member. Chapter 5 discusses this concept of fungibility.

### 6.6.2 The advantages and disadvantages of the dependent variable: Assets Under Management per Member

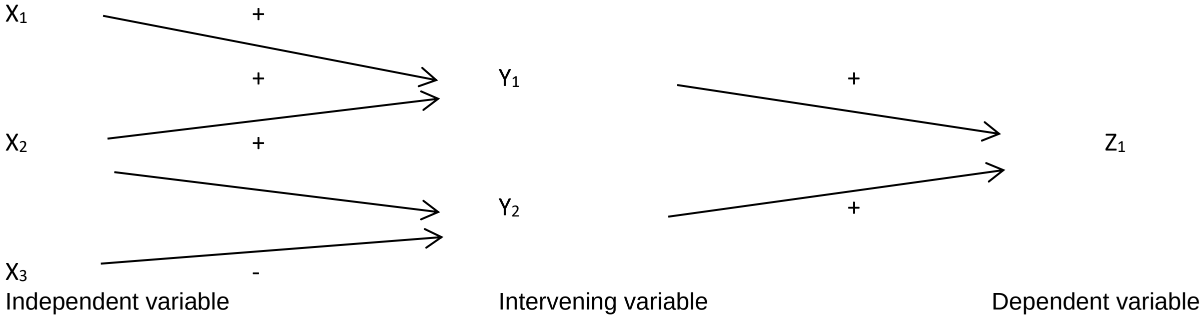
The construction of this variable was discussed in Section 4.4.6. There are several advantages and disadvantages for using this proxy as the dependent variable. Addressed in Section 4.4.6 was the need for fungibility between pension schemes for accurate comparison. There are 2,154 pension schemes in the sample data in a range of sizes, both by assets under management (AUM) and total membership base. While it is acknowledged in the research that these pension schemes are influenced by different factors, from an exogenous viewpoint the size of the schemes by these two different measures leads to a lack of compatibility. The research design needed to establish an independent measure of participant wealth to contribute to an opinion on the effect fund management may or may not have on member wealth. If Member X is assigned to a £100 million AUM scheme with 10,000 members and Member Y is assigned to a £100 million AUM scheme with 20.000 members, Member X is worth £1 million in their own right and Member Y is only worth £500, 000 in their own right. The schemes are identical in size of assets; however, the member experience is not equitable. For instance, in the Wilmington data two schemes have £3,683 million in assets under management. Pharmaceutical company Astra Zeneca has 29,500 members, whereas National Rail has 35,287 members. The difference in assets under management per member (£124,847 to £104,373) is 20%. The private property fortunes of the members are not comparable, even where the schemes purport the same mediating power of negotiation [PSAUM]. This influenced the decision to create the proxy variable of the members' own asset allocation being the appropriate fungible variable to control for the sample variance.

The funds per member can be affected by many characteristics of the scheme relationships (not only those relating to fund manager governance). This is explored in the ONS data analysed in Appendix I. For instance, in the previous example it could be assumed that the average salary of an Astra Zeneca employee is higher than that of a National Rail employee. It might also be that the National Rail pension scheme is older than the Astra Zeneca scheme. At present these assumptions are untested. However, for the purpose of the research while acknowledging it is challenging to control for undetectable variables, under the a priori propositions the research design seeks to establish whether particular fund manager governance variables may account for part of the variance in the assets under management per member as the proxy dependent variable. This is a limitation of the research, but certainly an indicator of future control variables for studies aiming to continue insight into the findings of the thesis that explain pension member asset growth.

### 6.6.3 Analysing the governing and mediating principal variables

Creswell (2009) portrays the measurement of a multiple agent environment as a set of constructs representing the principal of interest's characteristics being mediated or intervened by the effect the second principal's characteristics (see Figure 6.9). This depiction of the analysis is an accurate reflection of the conceptual framework proposal. However, it implies a cause and effect relationship that cannot be ascertained with the data at hand.

Figure 6.9 Three independent constructs influencing a single dependent variable mediated by two intervening constructs



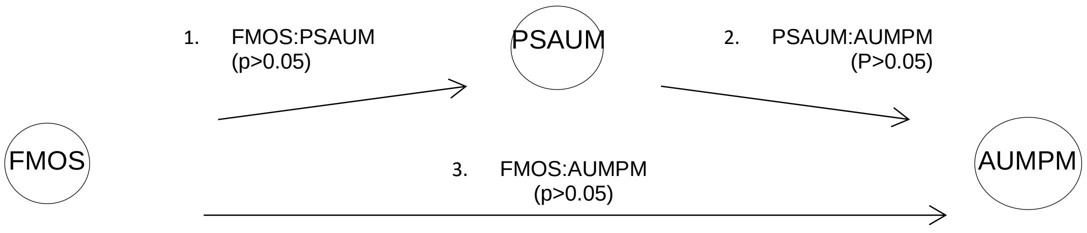
Source: Creswell (2009; p122)

Certain characteristics of both principals should be capable of affecting their ability to monitor and incentivise the agent, such as the relative size of each principal. In this analysis, these characteristics of the principal, the owners of fund management institutions have been hypothesised as corporate governance characteristics, specifically 1) the ownership structure of the fund manager [FMOS]; the headquarters for reporting corporate governance of the fund manager [FMRR]; and 3) the size of the fund manager and their ability to resist monitoring or encourage incentivising, measured by their own assets under management [FMAUM].

However the fund manager has another principal, the pension client whose assets they manage. This alternative principal should also possess characteristics that allow them to monitor and incentivise agent, that may mediate or intervene in the owner's ability to demand exclusive best interest from the fund manager. These may include, but will not be limited to: 1) the pension scheme's own size, measured by assets under management, assisting them in resisting the moral hazard of too few resources to monitor and influence the efficiency of the contract; and 2) the decision to have multiple fund managers engaged in managing their assets, assisting them in avoiding the adverse selection of a single under-performing fund manager, and resisting the problems of information asymmetry through cross fund manager bench-marking.

A mediating variable is a variable used to explain causal links between other variables. According to Wuensch (2014) "[c]onsider a model that proposes that some independent variable (X) is correlated with some dependent variable (Y) not because it exerts some direct effect upon the dependent variable, but because it causes changes in an intervening or mediating variable (M), and then the mediating variable causes changes in the dependent variable." For the pension scheme variables to be considered mediating the corporate governance effects on the assets of a single member, they must share a significant relationship with both the dependent and independent variables (see Figure 6.10).

Figure 6.10. Analysing the relationships between the independent, mediating and dependant variables*. An example relationship [FMOS→PSAUM → AUMPM]*



Adapted from Wuensch (2014)

In this example, for PSAUM to be considered a mediating variable, both FMOS:PSAUM (1.) and PSAUM:AUMPM (2.) must be significantly related alongside the relationship between FMOS:AUMPM (3.).

## 6.7 Testing the analysis plan

The analysis plan commences with a regression of the five relationships between the fund manager agent, the pension principal and the unit of measurement; the assets of a single member in any given pension scheme. In order for that regression to be valid, the collinearity between the variables is tested (see Table 6.6).

Collinearity was tested in the following methods: 1) With the converged database testing all Members separately (Total Members, Deferred Members and Pensioners); 2) With the converged database using Total Members only; 3) With the converged database on both member variable iterations where the three Fund Manager governance variables were converted to dummy variables.

The dummy variables were constructed in the database by converting fund management ownership structure (FMOS) and fund management reporting regime (FMRR). These were converted to FMOS (0=Publicly listed entity and 1=Privately held entity) and FMRR (0=Anglo-American registered entity and 1= Stakeholder oriented entity). Fund manager Assets Under Management were retained as a controlling governance variable. With no significant differences between the tests the second (dummy) iteration is displayed in Table 6.5. Total members include deferred members and pensioners, but also current contributors so portray the full view of current and previously contributing pension scheme membership.

Table 6.5 The relationships between the variables (Converged database with Total Members only)

| Correlation | | Assets Under Management | AUM per Member | Scheme Type | Sponsor type | FMs engaged | Fund Manager Country | FM Ownership | FM AUM |
|---|---|---|---|---|---|---|---|---|---|
| **Total Members** | r | .862** | -.067** | .020 | .173** | .653** | .100** | -.059** | -.043** |
| | Sig | .000 | .000 | .120 | .000 | .000 | .000 | .000 | .001 |
| | N | 5982 | 5237 | 5915 | 5974 | 5982 | 5809 | 5838 | 5982 |
| **Assets Under Management** | r | | .105** | .043** | .153** | .640** | .082** | -.052** | -.042** |
| | Sig | | .000 | .001 | .000 | .000 | .000 | .000 | .001 |
| | N | | 5237 | 5915 | 5974 | 5982 | 5809 | 5838 | 5982 |
| **AUM per Member** | r | | | -.033* | .022 | .018 | .009 | .014 | -.012 |
| | Sig | | | .017 | .108 | .181 | .527 | .319 | .399 |
| | N | | | 5197 | 5235 | 5237 | 5070 | 5098 | 5237 |
| **Scheme Type** | r | | | | -.237** | .123** | .107** | -.142** | .040** |
| | Sig | | | | .000 | .000 | .000 | .000 | .002 |
| | N | | | | 5915 | 5915 | 5742 | 5771 | 5915 |
| **Sponsor type** | r | | | | | .141** | -.094** | .163** | -.064** |
| | Sig | | | | | .000 | .000 | .000 | .000 |
| | N | | | | | 5974 | 5801 | 5830 | 5974 |
| **Fund Managers engaged** | r | | | | | | .170** | -.132** | -.061** |
| | Sig | | | | | | .000 | .000 | .000 |
| | N | | | | | | 5809 | 5838 | 5982 |
| **Fund Manager Country** | r | | | | | | | -.586** | .095** |
| | Sig | | | | | | | .000 | .000 |
| | N | | | | | | | 5808 | 5809 |
| **FM Ownership** | r | | | | | | | | -.306** |
| | Sig | | | | | | | | .000 |
| | N | | | | | | | | 5838 |

There is no collinearity between AUM per Member and the three governance (independent) variables (FMRR p=0.527; FMOS p=0.319; FMAUM p=0.399). There is significant collinearity between all independent variables and mediating variables (PSAUM and PSMFM) with low r scores. The r score of note is between the two mediating variables (r=0.640, p=0.000). Large schemes employ more fund managers. The other r score of note is the relationship between independent variables FMOS and FMRR (r= -586, p=0.000). The USA has the majority of listed fund managers and the UK the majority of partnerships. These results are accommodated through weighting in the regression by individual variable in the following subsections:

### 6.7.1 Fund manager ownership structure

Proposition 1: Total pension funds per member will be lower when managed by fund managers with external shareholders (Berle and Means, 1932) ownership structures.

The fund manager ownership structure relationship with assets per member is significant between ownership categories (F=24.678, df5, p=0.000) with a trend in higher assets per member relating to more internalised ownership structures. Table 6.6 illustrates the dominance of PLC ownership structures that will impact the interpretation of the regression. There is a significant difference between publicly listed corporations (PLC) and partnerships (t=2.1241, df3777, p=0.034). However, uncertainty exists in the means between partnerships (higher) and employee owned corporations (lower), both having internal ownership structures (although the difference is insignificant: t=1.4279, df999, p=0.154).

Table 6.6 Ownership relationship with assets per member

| Ownership structure | Percentage of sample | Mean assets per member (£) | Standard deviation (£) |
|---|---|---|---|
| Publicly listed corporation (n=3,174) | 67.4 | 81,455 | 140,415 |
| Private owned corporation (n=537) | 11.4 | 84,920 | 131,703 |
| Employee owned corporation (n=396) | 8.4 | 81,566 | 126,907 |
| Partnership<br>(n=605) | 12.8 | 94,918 | 155,180 |

The conceptual framework proposed that internal versus external ownership structures encouraging wealth capture may be exacerbated when the entity is based in a shareholder primacy governance regime. This agency proposition, exhibited in the descriptive statistics (Table 6.8), is not consistently supported by the empirical observations.

### 6.7.2 Fund manager reporting regime

Proposition 2: Total pension funds per member will be lower when managed by fund managers located in dominant (Anglo-American) shareholder-agency economic environments.

The fund manager reporting regime effect on assets per member is statistically significant (F=24.265, df5, p=0.0001). Table 6.7 illustrates the change in assets per member as the reporting regime moves from stakeholder to shareholder oriented compliance structures, with the exception of Asia Pacific.

Table 6.7 Reporting regime relationship with assets per member

| Reporting regime | Percentage of total | Mean assets per member (£) | Standard deviation (£) |
|---|---|---|---|
| United States (n=1,324) | 26.6 | 82,106 | 132,254 |
| United Kingdom (n=3,193) | 64.2 | 82,953 | 139,962 |
| Asia Pacific (n=135) | 2.7 | 77,952 | 120,939 |
| Europe Other (n=227) | 4.6 | 83,685 | 141,772 |
| European Union (n=92) | 1.9 | 103,657 | 206,793 |

As with the ownership structure previously the sample is dominated by UK based fund managers. There is no statistically significant difference between the poles of stakeholder and shareholder governance (USA to EU: t=1.4456, df1,414, p=0.149), however the category variance will be addressed in the regression following.

The conceptual framework proposed that comparing shareholder versus stakeholder corporate governance reporting regimes, shareholder primacy regimes where shareholder wealth maximisation is the perceived goal of the corporation would encourage wealth capture through fees from pension clients. This agency proposition is the basis of the dummy variable for the regression.

### 6.7.3 Fund manager assets under management

Proposition 3: Total pension funds per member will be lower when managed by larger fund managers.

The fund manager assets under management relationship with assets per member is not significant (r=0.016, p=0.213). While there is no discernible statistical relationship between the fund manager's assets under management and the assets of the member, removing the outliers from the fund manager AUM increases visibility into the smaller fund managers. When reanalysed with fund manager AUM above £3 trillion removed, the result evidences no further relationship (r=0.003, p=0.847).

## 6.8 The corporate governance variables relationship with the pension scheme mediating variables

The pension scheme variables are tested in the regression to determine their mediating qualities (the rationale described in Section 6.6.2). The propositions explored by the regression below are that:

Proposition 4: Total pension funds per member will be higher when pension clients are larger, avoiding wealth capture by the agent;

The conceptual framework posited that larger pension schemes would be capable of greater levels of measurement and monitoring of their agent’s behaviour in order to protect their members against the information asymmetry problem of moral hazard.

Proposition 5: Total pension funds per member will be higher when pension clients have more agents, avoiding adverse selection of an underperforming agent.

In the original pensions data the pensions’ scheme engagement behaviour shares a negative and statistically significant relationship with the assets of the member (p=0.020), implying that the pension principal decision to engage multiple fund managers has a negative bearing over the benefit accruing to their members.

### 6.9 The regression analysis between the independent, mediating and dependent variables

The regression testing was carried out iteratively to isolate the effect the independent variables have over the dependent variable and whether this is reduced once mediating variables are introduced (Baron and Kenny, 1986). From a mediating hypothesis, the independent variables must be significant predictors of the mediating variables to establish that they are indeed mediating something in the model. This is the case in both the test for collinearity and linear regression. The regression analysis was carried out on both the independent variables as their original categorisations and as dummy variables. There was no significant difference in the results for either variation. The results displayed are with dummy variables for the three fund manager governance characteristics. Total members only is the variable employed as it will include deferred members and pensioners, but also current contributors. Where possible, the results have been weighted by fund managers engage variable to reduce the impact of multiple cases discussed in Section 6.3.

The first test was a linear regression of the relationship between the governance variables and the dependent variable (Table 6.8). There is no significant relationship between the independent variables and the dependent variable. When the regression is weighted for multiple cases of fund manager engagement, this statistical insignificance still stands, if slightly altered to Fund Manager Country increasing in significance (p=0.096) and Fund Manager Ownership declining (p=0.659). This result is interesting given the weighting of Fund Manager Country to multiple engagement strategies among pension schemes, where the weighting should be controlling for this phenomenon.

Table 6.8 Regression coefficients for three governance variables on the assets per member

| | **Standardized Coefficients** | | |
|---|---|---|---|
| | **Beta** | **t** | **Sig.** |
| **(Constant)** | | 11.824 | .000 |
| **Fund Manager Country** | .016 | 1.030 | .303 |
| **FM Ownership** | .018 | 1.155 | .248 |
| **FM AUM** | -.008 | -.565 | .572 |

Dependent Variable: AUM per Member

Table 6.9 tests the first pension scheme variable against three independent variables. Fund Manager Country and Fund Manager AUM are both significant predictors, with the fund managers AUM being negatively associated. This is consistent with the previous findings that small pension schemes gravitate to large fund managers in the UK. It is important for the mediating hypothesis that this pension scheme variable is associated with the independent variables. The characteristics of the pension scheme are predictors of the fund manager traits most likely engaged by that scheme. This has important implications for the survey analysis in Chapter 7 involving what selection techniques are employed by pension schemes with different profiles.

Table 6.9 Regression coefficients for three governance variables on the pension scheme assets

| | **Standardized Coefficients** | | |
|---|---|---|---|
| | **Beta** | **t** | **Sig.** |
| **(Constant)** | | 7.809 | .000 |
| **Fund Manager Country** | .071 | 4.406 | .000 |
| **FM Ownership** | -.027 | -1.598 | .110 |
| **FM AUM** | -.055 | -3.962 | .000 |

Dependent Variable: Assets Under Management

Table 6.10 examines the independent variable relationship with pension schemes engaging multiple fund managers. All relationships are significant, with Fund Manager Ownership and Fund Manager AUM being negatively related. Engaging multiple fund managers encourages a strategy of selecting smaller fund managers, as previously reported in the descriptive statistics. The most predictive variable is that pension schemes engaging multiple fund managers will trend towards engagement outside the UK. This is again observed in the descriptive statistics and described in more detail in Appendix IV.

Table 6.10 Regression coefficients for three governance variables on the pension scheme fund manager engagement

| | Standardized Coefficients | | |
|---|---|---|---|
| | **Beta** | **t** | **Sig.** |
| **(Constant)** | | 15.859 | .000 |
| **Fund Manager Country** | .128 | 7.992 | .000 |
| **FM Ownership** | -.087 | -5.227 | .000 |
| **FM AUM** | -.095 | -6.964 | .000 |

Dependent Variable: Fund Managers engaged

In five of six relationships between the mediating and independent variables the results are significant. While the mediating variables are predictors of fund management characteristics, as suggested in Table 6.11 they are also influencing the relationship with the dependent variable. The size of the pension scheme has a positive and strong influence over the dependent variable and multiple fund manager engagement has a negative yet less predictive relationship with the assets of a single member. This observation is in keeping with the qualitative results reported in Chapter 7 (Section 7.5.4) in the motivations for and against multiple fund manager engagement.

Table 6.11 Regression coefficients for two mediating variables on the assets per member

| | Standardized Coefficients | | |
|---|---|---|---|
| | **Beta** | **t** | **Sig.** |
| **(Constant)** | | 34.056 | .000 |
| **Assets Under Management** | .156 | 8.795 | .000 |
| **Fund Managers engaged** | -.081 | -4.552 | .000 |

Dependent Variable: AUM per Member

When all variables are regressed together, they are consistent with the narrative of these results (see Table 6.12). The relationships have been examined for predictive qualities in three capacities: 1) independent variables predicting the dependent variable; 2) independent variables predicting the mediating variables; and 3) mediating variables predicting the dependent variable. The lack of predictive power in the direct relationship between independent and dependent variable becomes altered at the insertion of the mediating variables. The size of a pension scheme (highly correlated with scheme type: p=0.001; see Appendix IV for detail) is the largest and strong predictor of member assets, with the model in total predicting 43% of the asset per member outcome (r=0.430)

Table 6.12 Regression coefficients for all variables on the assets per member (dependent variable)

| | **Standardized Coefficients** | | |
|---|---|---|---|
| | **Beta** | **t** | **Sig.** |
| **(Constant)** | | 10.489 | .000 |
| **Assets Under Management** | .664 | 24.370 | .000 |
| **Scheme Type** | -.056 | -4.075 | .000 |
| **Sponsor type** | .026 | 1.859 | .063 |
| **Fund Managers engaged** | .019 | 1.067 | .286 |
| **Fund Manager Country** | .022 | 1.552 | .121 |
| **FM Ownership** | .027 | 1.807 | .071 |
| **FM AUM** | -.007 | -.471 | .638 |

The corporate governance characteristics proposed by the conceptual framework have provided very little predictive power. The corresponding relationship between the assets per member and the mediating pension scheme variable of multiple fund manager engagement has fallen away to insignificance. Assets under management (size) of the pension scheme to which the member is attached has the largest influence over the assets of the member. This result is important as it indicates that there is a strong mediating influence by the pension scheme, implying that the proposition that the moral hazard of agent appropriation is avoided by the scheme’s ability to monitor and control the relationship. The test fails to satisfy the proposition that this pension scheme trait protects the member from adverse selection.

From a post-positive perspective, agency theory does not appear to perfectly model the principal-agent relationship as it was proposed a priori from the literature. However, there is a strong indication that the a priori agency assumption that large (powerful) principals share a more positive relationship with outcomes for their beneficiaries. Appendix IV provides further detail of the categorical breakdown of each variable, such as scheme type, to provide further insight into the data supporting these results. The results conclude that different pension scheme traits lead to different asset outcomes for the member. This, alongside the observation that small schemes gravitate towards publicly listed corporations provides important guidance for further sense-checking analysis and the survey design and construction for Chapter 7.

### 6.9.1 Sense-checking the initial regression analysis

Discussed in Section 6.3 were the challenges in analysis created by the merge of two databases creating a weighting bias towards pension schemes that engage multiple fund managers. A pension scheme that engages one fund manager will generate one case in the combined database. A pension scheme that engages 67 fund managers will generate 67 cases. The following section controls for this by weighting multiple fund management engagement cases by a factor of their contribution to the data, bringing their weight over the data down to their equivalent pension scheme companion of n=1. The data will also be considered in the light of the conceptual framework assertion that an Anglo-American PLC fund manager will provide a different outcome for members to their Stakeholder economy based privately owned fund manager competitors. This polar comparison provides an important contribution to any trends suggesting lines of further enquiry into pension governance practice and policy.

#### 6.9.1.1 Weighted versus unweighted regression results

The results of the analysis of the independent and mediating variables were weighted by number of fund managers engaged to ensure that the pension schemes engaging multiple fund managers were not skewing the interpretation of the impact that pension and fund manager principals were having over the beneficiary outcomes. The weighting variable (Pension Scheme Multiple Fund Managers) was used as the control to sense-check the previous Section results. In the dataset where the fund manager variables were not converted to dummy variables the following results were observed (See Table 6.13):

Table 6.13 Weighted versus unweighted regression results for assets under management per member (by regression significance)

| **Results** | **Unweighted (Sig.)** | | **Weighted (Sig.)** | |
|---|---|---|---|---|
| **Independent variable influence over dependent variable results** | | | | |
| | Original | Dummy | Original | Dummy |
| **Fund manager Country** | p=0.303 | p=0.303 | p=0.096 | p=0.096 |
| **Fund manager Ownership** | p=0.248 | p=0.248 | p=0.659 | p=0.659 |
| **Fund manager AUM** | p=0.572 | p=0.572 | p=0.397 | p=0.397 |

| **Independent variable influence over mediating variable [PSAUM]** | | | | |
|---|---|---|---|---|
| **Fund manager Country** | p=0.000 | p=0.000 | p=0.000 | p=0.000 |
| **Fund manager Ownership** | p=0.110 | p=0.110 | p=0.110 | p=0.110 |
| **Fund manager AUM** | p=0.000 | p=0.000 | p=0.000 | p=0.000 |
| **Independent variable influence over mediating variable [PMFM]** | | | | |
| **Fund manager Country** | p=0.000 (+ve) | | N/A | |
| **Fund manager Ownership** | p=0.000(-ve) | | N/A | |
| **Fund manager AUM** | p=0.000 (-ve) | | N/A | |

There is no significant difference between the weighted and unweighted results for cases in either the normal or governance dummy variable databases. The previous results are reflected in this. The next important sense-checking test is to measure them against the conceptual framework (Section 4.3) assumptions of the different beneficiary outcomes between a Quadrant 1 result of an Anglo-American PLC beneficiary outcome compared with a Quadrant 4 stakeholder privately owned fund manager providing benefit to their pension client members.

#### 6.9.1.2 Conceptual framework assumptions: Quadrant 1 versus Quadrant 4

The database was converted into two sections: 1) Fund managers incorporated in stakeholder based reporting regimes (Europe, European Union, Asia Pacific); and 2) Fund managers incorporated in Anglo-American economies (USA and UK). In-house fund management was removed from this test to make direct comparison possible. The results are reported in Table 6.14.

Table 6.14 Comparison between shareholder dominant and management dominant reporting regimes

| | Stakeholder FMRR | | | Anglo-American FMRR | | |
|---|---|---|---|---|---|---|
| | **Beta** | **t** | **Sig.** | **Beta** | **t** | **Sig.** |
| **(Constant)** | | 4.190 | .000 | | 7.836 | .000 |
| **Total Members** | -.212 | -3.405 | .001 | -.673 | -22.523 | .000 |
| **Scheme Type** | -.042 | -.858 | .391 | .671 | 22.703 | .000 |
| **Sponsor type** | .057 | 1.150 | .251 | -.049 | -3.306 | .001 |
| **FM Ownership** | -.106 | -1.888 | .060 | .039 | 2.541 | .011 |
| **FM AUM** | -.140 | -2.409 | .016 | .009 | .632 | .528 |
| **Fund Managers engaged** | .142 | 2.178 | .030 | .029 | 1.928 | .054 |
| **Pension Scheme AUM** | .737 | 8.537 | .000 | .671 | 22.724 | .000 |

Dependent Variable: AUM per Member

The conceptual framework proposed that corporate reporting regimes that support managerial discretion over shareholder decision-making priority would benefit the pension principal. The regression controlled for scheme (such as Defined Benefit versus Defined Contribution) and sponsor type (such as private versus governmental and NGO organisations). There are significantly more Defined Benefit pension schemes invested in the Anglo-American reporting regimes and more private sponsored pension schemes engaging fund managers in Anglo-American reporting regimes. Fund manager ownership structures are significantly more likely to be publicly listed companies in Anglo-American regimes; however, the fund managers are significantly more likely to be larger in Stakeholder reporting regimes.

Pension scheme size is a significant mediating factor in both reporting regimes, however they are more effective in Anglo-American economies. These results are consistent with the conceptual framework. The ability of a larger pension scheme to influence fund manager beneficial outcomes is more pronounced in

Anglo-American economies. The interpretation of this is that these economies require more powerful pension principals to influence beneficiary outcomes to members whereas the stakeholder economies provide more equitable outcomes to members regardless of pension scheme size. This is juxtaposed by results that Fund Manager ownership of publicly listed companies in Anglo-American structures supports better outcomes for members than in Stakeholder oriented reporting regimes.

## 6.10 Conclusion

This chapter contributes to the research by describing the various corporate governance characteristics of the professional fund managers with UK pension clients. It investigates whether the different corporate governance characteristics of professional fund managers correlated with the wealth management outcomes for their pension clients, and whether particular pension client attributes moderate any possible corporate governance relationships. When the rules of agency theory are tested in the empirical data of pension fund manager engagement, it looked at whether observations infer that agency theory is predicting a proxy variable being the assets of a single pension scheme member.

The funds management industry described found that 152 of the 502 fund managers in the Wilmington Directory (2013: 30.8%) were publicly listed corporations, providing the ability to compare public versus private organisational traits proposed by the conceptual framework to conclude on any organisational phenomena in fund managers interacting with the proxy variable. This is important to the industry understanding of the nature of corporations that manage pension funds and whether they affect asset outcomes.

Not any of the three independent variables provided a significant relationship with the dependent variable, and so superficially there is no relationship for the pension variables to mediate. However, the relationships between the pension variables and the independent variables were strong, as was their relationship with the dependent variable, disavowing this simple assumption. In the final regression, pension scheme assets under management was a significant predictor of the assets per member alongside fund manager selection criteria (with scheme type also describing or predicting the assets per member in a controlling capacity. This variable does affect (or is affected by) both the independent variables and dependent variable and so must bear some mediating relationship. The result is significant to the thesis proposition that agency theory is predictive of the empirical outcomes of pension governance analysis; large pension principals share a relationship with member outcomes regardless of fund manager selection choices, suggesting that their influence is important even while indicating that they share collective fund manager selection trends.

The UK and USA dominate asset management in the UK, with 82.4% of the total funds under management. The descriptive statistics illustrated the change in assets per member as the reporting regime moves from stakeholder to shareholder oriented compliance structures (with the exception of Asia Pacific). However, regardless of the proportional difference in means, there is no statistically significant difference between the poles of shareholder (lowest mean) and stakeholder (highest mean) governance. However, when compared at a macro-level between stakeholder and Anglo-American reporting regimes, fund manager selections by larger schemes trended towards smaller fund managers and away from publicly listed corporations. While this did not adversely affect assets per member as hypothesised conceptually, it is an interesting pattern of selection that warrants further investigation.

The dominance of Anglo-American firms in funds management is an interesting finding in its own right, raising the question of why European fund management markets are not more represented given the UK's subscription to the Markets in Financial Instruments Directive (MiFID). Watching for this trend as Brexit finalises has important ramification for the future management of pension funds.

Pension scheme size proved the most challenging result of the research. It proposed that total pension funds per member will be higher when pension clients are larger, avoiding wealth capture by the agent under the agency theory of moral hazard, with the pension principal able to appropriately manage the performance effort of the agent. In the original pensions data (prior to converging with the fund management governance data), the pensions scheme assets share no statistical relationship with the assets of the member, implying this pension principal characteristic is not influencing the members' assets, however in the later regression it was the single most predictive result. This mediation of the relationship suggests there is an indirect mediation in action as the complete set of variables are read together and the interactions are comparatively viewed.

Size matters to the contracted results in a way that suggests collective bargaining is a future area of policy enquiry.

The second pension scheme variable proposed was that total pension funds per member will be higher when pension clients have more agents, avoiding adverse selection of an underperforming agent. Multiple fund manager engagement has statistically significant and negative association with the assets per member. Rather than avoiding adverse selection, multiple engagement shares a relationship with fewer pension assets per member. The direction of this relationship is indeterminate but of important interest to the efficacy of pension fund management. The phenomenon is important, and retested in the attitudinal survey results with pension trustees in Chapter 7. The administrative burden of managing multiple agents is qualitatively suggested as overriding the advantage of competition between vying agents.

It is important to highlight that the traits of the pension scheme were statistically related to the three governance characteristics in five of the six relationships, with pension scheme assets under management and fund manager ownership structures being the only not to. This is possibly because large pension schemes engage across the spectrum of ownership structures and this nuance will be lost in the regression with the use of the dummy variable. Smaller pension schemes gravitating towards public fund managers, while larger pension schemes share a relationship with internally owned fund managers. Given the relationship between large pension schemes and multiple fund managers, they are simply engaging across a fuller spectrum of fund manager organisational types that are consistent with the implications of larger schemes who engage more fund managers are more likely to spread their assets with geographic diversity. Conversely, the smaller the pension scheme, the fewer fund managers engaged, and those fund managers will be large and predominantly based in the UK. As these relationships, do not improve the statistical significance of the asset per member, the expedience of engaging particular ownership structures, large fund managers or portfolio diversification requires further investigation.

While it is important to note that there is a potential limitation in the interrelatedness of the fund manager variables and the limits of spatial rather than time series data, these results provide a compelling first and second step in the research design. In the pension scheme population, as a whole, pension schemes were engaging fund managers in a consistent manner. Given the direction of the relationship (cause and effect) is unknown the chapter cannot contribute to the thesis on whether large fund managers with external shareholders are making schemes smaller through appropriation, or whether small schemes naturally seek fiduciary comfort in large, publicly listed fund managers. This has important implications for fund manager selection decisions, and contributes to the Chapter 7 survey design, exploring the reason for this phenomenon.

The failure of the propositions to observe any relationship between these governance characteristics of the pension scheme and fund management agent, and the assets of the member raises two interesting possibilities: 1) the characteristics selected are immaterial to fund management selection benefits to members, in which case an agency theory observation of the phenomenon does not hold predictive merit; and 2) pension schemes bring no benefits to members and the likelihood of a positive outcome to member assets is a product of chance. Either way, the empirical contributions to the study of agency theory  and what it brings to the management study of pensions has important contributions to the Academy in its search for meaningful predictive theory.

The contribution to agency theory is the production of another empirical study to add to the business study of theory paradigm testing.  The unique contribution of this study is its multi-agency nature.  Agency theory has been historically tested in dyadic environments with a closed system assumption.  While there have been concept contributions to the theory of multi-agency, and the development of stakeholder theory has been important to this development, a body of empirical work on multi-principal agency is yet to appear in the literature.

The most important point to move forward with from this chapter is to the practice of fund manager selection in the execution of pension asset outsourcing.  As the UK pension industry moves away from Defined Benefit Open schemes, where member benefits are guaranteed and liability lies with the sponsoring employer, the implications of the findings have a contribution to make in the non-financial performance assessment of fund managers in pension scheme selection frameworks.  Non-financial performance assessments (such as environmental, social and governance performance) are widespread in the pensions industry in the process of underlying asset and portfolio selection.  Yet they have been conspicuously absent in fund manager selection criteria in both the academic and practitioner literature. The hypothesis moving into the next chapter is that fund manager selection is grounded in finance theory, yet more appropriately embodied by agency theory.

# Chapter 7
# Analysis Part 2: Survey examination of the perceptions of pension trustees

## 7.1 Introduction

A survey of pension trustees was developed in July 2014 with the assistance of numerous pension industry practitioners and academic input from both pension governance and traditional corporate governance expertise. Objectives 1 and 2 were addressed in Chapter 6. The purpose of the survey in contributing to the subsequent research objectives are twofold:

1. To investigate whether pension clients perceive that the corporate governance of the fund manager matters to the fiduciary governance of asset management for their beneficiaries; and

2. To determine whether pension clients believe the fiduciary duties of professional fund managers conflict with the delivery of fiduciary asset management.

It was deployed to the list of trustee contacts by emails that were published in the Wilmington Directory of Pension Funds and their Advisors (2013) totalling 1,243 potential respondents. Respondents were emailed individually with an invitation to complete the survey using the software package Qualtrics. The response rate achieved over two months was 112 completed surveys (representing 9.01% of potential respondents). The detailed description of the design and construction of the survey is outlined in Chapter 5 (Section 5.8).

In brief, the respondents reported with some uniformity that the corporate governance characteristics of the fund manager were not considered important to the selection decision compared with the financial considerations of historical returns on investment achieved and the perception of asset class expertise. The perceptions held of the fiduciary duty that fund managers owed their shareholders were that in reality they were greater than those owed to the assets they managed for pension clients. It was also suggested that this should not be the case.

These results are in keeping with the findings of the Kay Review (2012; p13): "The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers," and subsequently the Law Commission Review (2013; p4):

> *"A number of submissions* – in particular, powerful argument from FairPensions – suggested that some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact. Lawyers who participated in our discussions, however, suggested that the law allowed a more robust interpretation. Several commented that pension fund trustees who insisted on a narrow view of fiduciary duty were often hiding behind risk-averse legal advice, designed to protect the adviser and client

> rather than to provide guidance as to the proper discharge of fiduciary *duty."*

This chapter commences with a review of the theoretical foundations establishing the objectives.  It revisits the contention made in Chapter 3 that finance theory, and the heuristic assumptions of the risk/reward relationship are still the basis for fund manager selection decisions.  The chapter continues with a comparison of the demographics of the cases to both the Wilmington Directory (2013) where the sample originated, and the Office of National Statistics (ONS, 2014), being an approximation of the pension population.  The research acknowledges a large pension scheme self-selection bias raised by the ONS.  The chapter finally reports the results separately for each of the objectives and discusses the methodological challenges and the issues of secrecy and sensitivity around the fees contract for asset management endemic to the industry.

## 7.2 A post-positivist analysis of fund management governance

The survey is a perceptions based analysis of pension trustees and as such can only look for patterns of stated observations made by respondents rather than any revealed preference through their market based transactions.  Market based data is widely available on the absolute investment performance of all fund managers, such as MorningStar.com, discussed in Chapter 5.  However, given the comprehensive absence of market based data on the cost of investment performance to the pension trust, these perceptions are the only information available on its value for money after all fees and charges have been appropriated. The first section of the survey elicited the agency characteristics (if any) that were used in the fund manager selection process (in fulfilment of the research Objective 3) and how these relate to the perception of fiduciary duties owed to the trust by the fund manager (in fulfilment of Objective 4). The survey construction was described in Section 5.8.1. The demography in the second section of the survey ensures the sample is representative of both the sample frame in Chapter 6 and the pension population according to the Office of National Statistics. The next section tests the sample against these previous populations before Sections 7.4 and 7.5 present the analysis in exploration of Objectives 3 and 4 respectively.

## 7.3 Descriptive statistics: Analysis of the representativeness of the sample

According to the Occupational Pension Schemes Annual Report for 2010 (OPSAR, 2011), the most recent time the ONS survey sought scheme information, there were 44,380 schemes registered in the UK, 21,730 of these still functioning unclosed to new business. The majority of registered schemes (80%) have only 2-11 members and the largest schemes (5,000+ members) account for only 1% of the population (see Table 7.1 for further detail).

Table 7.1 Number of private sector occupational pension schemes by size and operational status, 2010

| Members | Open | Closed | Frozen | Winding up | Total |
|---|---|---|---|---|---|
| **5,000+** | 250 | 180 | 40 | 10 | 480 |
| **1,000 to 4,999** | 430 | 400 | 160 | 70 | 1,060 |
| **100 to 999** | 760 | 1,220 | 1,180 | 410 | 3,570 |
| **12 to 99** | 1,020 | 960 | 1,460 | 510 | 3,950 |
| **2 to 11** | 19,270 | 10,240 | 5,560 | 250 | 35,320 |
| **Total** | 21,730 | 12,990 | 8,400 | 1,250 | 44,380 |

Source: Occupational Pension Schemes Survey 2010

This skewed distribution of members (mean 8,876 ± 14,860: see Figure A1.9 in Appendix III) has provided the ONS with a methodological challenge of large scheme self-selection bias, unsolved by a methodology review post the unsatisfactory results of the 2008 survey:

> *"The review has improved the methodology for weighting estimates of* scheme numbers, but the problem of sampling variability which produced a set of unusual results in 2008 has not been solved by the new methodology. The only way to solve this problem would be to allocate additional resources to the survey so that sample size could be increased, particularly for very small schemes. ONS does not consider this to be a priority in terms of resource allocation at a time of tight budgets. It is important to note, therefore, that the estimates of numbers of very small schemes continue to be subject to considerable *uncertainty." (OPSAR, 2011; p6).*

The total registered occupational pension schemes in the Wilmington Directory (2013: n=2,154) represent the pension assets of 15,987,000 members. This accounts for 57.3% of the membership population recorded by the ONS in 2013 (Table 7.2). Total members were reported by 1,506 (70%) of schemes, distributed around the mean as 10,616 ± 30,722 (Range: 10 – 425,823). Categorising total members into scheme size using the ONS methodology enables the sample frame to be compared to the population for representativeness. Noting the ONS concerns regarding self-deselection in the category of 2-11 members, supported by the single case in the Wilmington (2013) sample frame, the single observation in this category was disregarded on strength of the ONS observation for the Chapter 6 analysis yet the two survey respondents were included in analysis in this chapter.

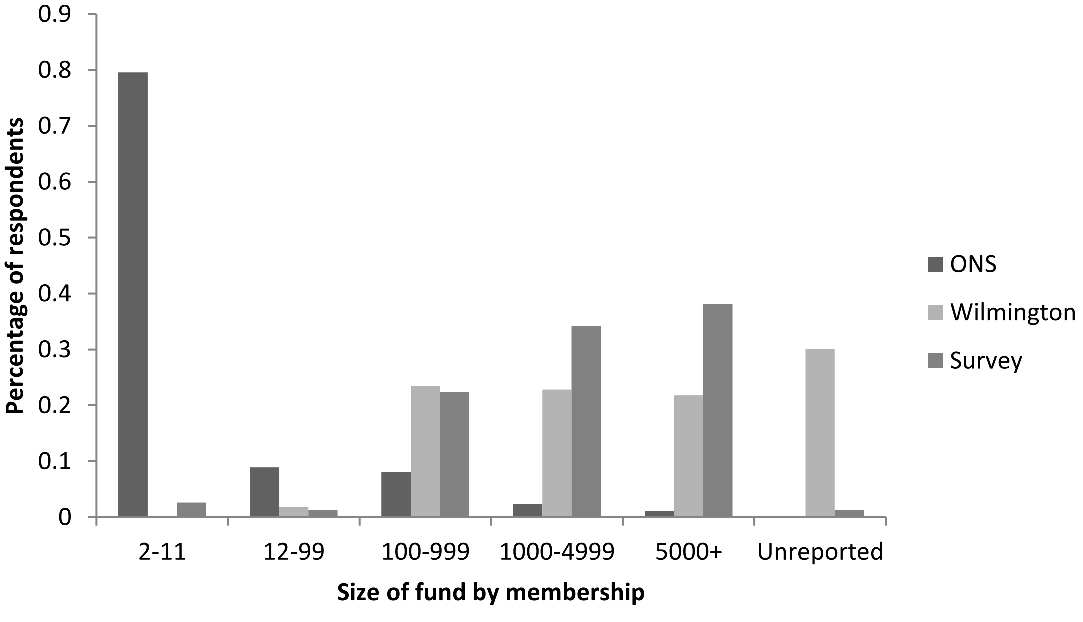
Table 7.2 Total number of registered occupational pension schemes by membership size

| **Membership size categories** | **ONS reported (A)** | **Wilmington reported (B)** | **Survey respondents (C)** | **Percentage of sample[1]** | | |
|---|---|---|---|---|---|---|
| **-** | - | - | - | **A** | **B** | **C** |
| **2-11** | 35,320 | 1 | 2 | 80 | 0 | 3 |
| **12-99** | 3,950 | 39 | 1 | 9 | 2 | 1 |
| **100-999** | 3,570 | 505 | 17 | 8 | 23 | 22 |
| **1000-4999** | 1,060 | 492 | 26 | 2 | 23 | 34 |
| **5000+** | 480 | 469 | 29 | 1 | 22 | 38 |
| **Unreported** | - | 647 | 1 | 0 | 30 | 1 |
| **Total** | 44,380 | 2,154 | 76 | 100 | 100 | 100 |

Source: Office of National Statistics (ONS2013) and Wilmington Pension Directory (Wilmington, 2013)
1. Rounded to 0 decimal points, comparing ONS/Wilmington/Survey results (See Figure 7.1)

When comparing the distribution of the ONS population and the Wilmington sample (described in Chapter 6) with the sample of respondents there is a consistent trend towards larger pension schemes responding to the three surveys (Figure 7.1). This self-selection trend is supported by the distribution of membership of the Wilmington Directory of 10,616 ± 30,722 members per fund compared with the larger member base of survey recipients at 26,407 ± 65,868. This is discussed in Chapter 8 as a methodological challenge of smaller pension funds self-exclude that has been met through limiting any interpretations as only relevant to large funds with more sophisticated fund management capability (and resources to complete surveys). As member size increases, Wilmington data and survey respondents become less representative of the ONS data. The fault observed in the ONS methodology is heightened in the following Wilmington dependent data.

Figure 7.1 The trend towards large scheme self-selection through the three surveys: Graphic representation of the membership categories in Table 7.2.



The types of schemes considered by the two surveys in Chapter 6 (Wilmington Directory and ONS) and the survey are compared as Defined Benefit Open, Defined Benefit Closed, Defined Contribution and Other. Table 7.3 compares the survey demographics to the Wilmington sample. It is important to note that the survey represents 12.6% of the total members in the Wilmington Directory, despite the survey being completed by only 112 pension schemes. In this the sample well represents members of occupational pension schemes in the UK.

Table 7.3 Total members per pension benefit structure

| Benefit structure | Total members Wilmington Directory | Percentage of Directory total (%) | Total members Survey | Percentage of Survey total (%) |
|---|---|---|---|---|
| **Defined Benefit Open** | 8,315,595 | 52 | 1,612,665 | 80 |
| **Defined Benefit Closed** | 3,125,892 | 20 | 339,480 | 17 |
| **Defined Contribution** | 788,269 | 5 | 54,804 | 3 |
| **Other** | 3,671,927 | 22.5 | 0 | 0 |
| **Unreported** | 85,317 | 0.5 | | 0 |
| **Total** | 15,987,000 | 100 | 2,006,949 | 100 |

Source: Wilmington Pensions Directory (Wilmington 2013) and survey respondents

There is a statistical difference between the number of survey respondents from Defined Benefit Open schemes and the Wilmington Directory ($\chi^2$=5.939, df1, p=0.0148). This is the only significant difference in scheme taxa between the sample and survey respondents. The category of "other" for the Wilmington sample includes the designation "hybrid", as a fund that is running multiple schemes. Given the dominance of Defined Benefit schemes in both samples, (and the dominance Defined Benefit schemes have over large funds; see Chapter 6) the interpretation of any results are limited to large Defined Benefit schemes.

This analysis illustrates that the survey attracts the same methodological issues that both the ONS and Wilmington Directory in Chapter 6 have been challenged by, it is easier to extract information on the specifics of operations from larger, more resourced schemes. While acknowledging this limitation in the scope of the results, it is important to note that these survey respondents have an important contribution to make to the understanding of pension governance for three reasons: 1) they represent a vast number of UK contributing members (2 million); 2) they have influence over the industry and regulators generally that the smaller schemes do not (Aubrey, 2015); and 3) they have the resources and profile to be thought leaders for smaller schemes (Aubrey, 2015), so are a legitimate place to begin contemplation of how pension trusts view the fund management relationship. Section 7.5 will draw on this caveat when interpreting the responses to the questions supporting Objective 3 of the research design.

### 7.4 Anomalies in the reporting on fund managers engaged

The fund managers named in Question 3 as the bearer of the survey respondent's largest mandate are heavily weighted to PLC ownership structures

(80% of respondents). The predominance of UK engagement (56%)[55] is followed by the USA (24%) then EU (7%) and Europe Other (5%) and Africa (2%), with 6% of the respondents managing funds in house. These results differ from the Chapter 6 findings, where UK engagement was higher (64.2%: $\chi^2$=14.682, df4, p=0.0054). Table 7.4 illustrates the diversity of these characteristics (or lack thereof), with the 71 respondents engaging only 22 fund managers. Very large, publicly listed UK based fund managers are predominant in the sample (50.7%), with PLC and privately owned corporations being the only indicated as owning the mandate (this is significantly different to the expected findings from Chapter 6, where more diversity was in evidence: $\chi^2$=25.699, df2, p=0.0001). This is in keeping with the self-selection bias discussed in the previous section. Legal & General Investment Management account for 27% of the respondents' mandate (n=19: see Box 7.1 for a description of Legal & General).

[55] See the change in sample demographics between respondents. Chapter 6 (Section 6.5.2) theorised that larger pension schemes have diversified fund managers outside the UL reporting regime. This accounts for the statistical difference between the 56% of UK engagement in the survey results compared with the 64.2% in the revealed data results. The Chapter discusses the selection bias towards larger schemes that supports this conclusion.

Table 7.4 Diversity in the fund managers with largest mandate

| Fund manager | Ownership structure | Geographical headquarters | Number of respondents |
|---|---|---|---|
| **Legal & General** | PLC | UK | 19 |
| **BlackRock** | PLC | USA | 10 |
| **Insight** | PLC | UK | 8 |
| **In house** | N/A | N/A | 4 |
| **Standard Life** | PLC | UK | 4 |
| **State Street** | PLC | USA | 4 |
| **Cardano** | Private Ownership | EU | 3 |
| **Cazenove** | PLC | UK | 3 |
| **Grosvenor Capital** | Private Ownership | UK | 2 |
| **UBS** | PLC | Europe Other | 2 |
| **AllianceBernstein** | PLC | USA | 1 |
| **AXA Rosenberg** | PLC | EU | 1 |
| **Baillie Gifford** | Private Ownership | UK | 1 |
| **Credit Suisse** | PLC | UK | 1 |
| **Investec** | PLC | Africa | 1 |
| **IPM (Sweden)** | Private Ownership | Europe Other | 1 |
| **J P Morgan** | PLC | USA | 1 |
| **Lazard** | Private Ownership | USA | 1 |
| **Lothbury** | Private Ownership | UK | 1 |
| **Russell Investments** | Private Ownership | UK | 1 |
| **SEI** | PLC | USA | 1 |
| **Threadneedle** | PLC | UK | 1 |
| **Total (n=22)** | 57 PLC /10 PO | 6 USA / 10 UK / 5 Other | 71 |

There are twelve fund managers in the FTSE100, with a combined market capitalisation of £124.25 billion (FTSE, 2015). Table 7.5 compares the shareholder's asset contribution to their agent (shareholder equity in the form of market capitalisation) with the asset contribution made by the pension principal to their agent.

Table 7.5 Market capitalisation of FTSE100 fund managers compared with the size of assets managed

| Fund manager | Market capitalisation in £ billions | Assets under management in £ billions |
|---|---|---|
| **Prudential** | 31.63 | 753.00 |
| **Aviva** | 17.69 | 374.17 |
| **Standard Chartered** | 13.52 | 725.90 |
| **Legal & General** | 13.21 | 608.40 |
| **Old Mutual** | 8.45 | 319.40 |
| **Schroders** | 6.63 | 390.44 |
| **Standard Life** | 6.63 | 280.02 |
| **Hargreaves Lansdown** | 5.87 | 55.20 |
| **Provident Financial** | 4.74 | 6.50 |
| **St. James's Place** | 4.68 | 62.67 |
| **Aberdeen Asset Management** | 3.14 | 304.81 |
| **Total** | 109.66 | 3,880.51 |

Sources: London Stock Exchange (2016) and Wilmington (2013). Currency conversion xe.com at 2 March 2016

This represents an average market capitalisation of (volume of shares on issue multiplied by current share price) £10.35 billion per institution, and 1.1% of the total company capitalisation on the London Stock Exchange FTSI100 (Russell, 2015). This proxy for shareholder perceptions of share value makes them important institutions to the investment market; finance theory suggesting this is because their returns on investment are adequate to attract and retain equity capital (Levine, 2005; Allen and Santomero, 1997). The contribution of the shareholder principal is not correlated with the size of the pension assets the fund manager manages, the latter being three orders of magnitude more (35.4 times), yet the direction of the fiduciary duty is reported by trustees as due to the comparatively modest shareholder assets. Pressure to maintain market capitalisation through year-on-year profit improvement is a strong corporate objective for publicly traded entities (Bainbridge, 1993). Box 1 illustrates this point using Legal & General, the most prevalent fund manager elicited by the survey sample. The survey examines whether this was a consideration for the trustees engaging PLCs compared with alternatively owned fund managers.

## Box 1. Case study description of Legal & General: The dominant fund manager amongst survey respondents.

Organisational name: Legal & General Group PLC (LSE: LGEN)

Legal & General Group Plc, commonly known as Legal & General, is a British multinational financial services company headquartered in London, United Kingdom. Its products include life insurance, general insurance, pensions and investments. Legal & General is listed on the London Stock Exchange and is a constituent of the FTSE 100 Index[1].

Profile: £709bn in total assets and 9,000 employees worldwide, established in 1836. It has 10m customers worldwide and a £16.5 billion market capitalisation as at 31 March 2015[1]. This makes it the 35th largest PLC listed on the London Stock Exchange[3].

- Asset expertise: Legal and General manages fixed income, equity, multi-asset, liability-driven investment, property and alternative solutions on behalf of its clients[4]
- Share price: £214.10 on 12-May-2016[5] increasing 33.3% since May 2013
- Dividends[6]

"The Board has confidence in the strength and growth prospects for the business. This underpins the Board's recommendation of a final dividend of 9.95p, giving a full year dividend of 13.40p, 19% higher than 2014."

| 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| 6.40p | 7.65p | 9.30p | 11.25p | 13.40p |

- Investment performance for pension principals

2013 Worst-performing funds: Managers who've lost investors the most ground – Legal and General 7th at 26.67% underperformance on sector average[7]

"2015 We recently reviewed 54 Legal & General unit trust and OEIC funds. The review found that 70% of the total money invested with Legal & General is held in consistently poor performing funds. Our analysis found that only 2 or (3.7%) of the 54 funds managed to consistently maintain top quartile performance over the most recent 5 year period.

These 2 funds hold a combined £494 million. Therefore, only 2% of the money invested within the 54 Legal & General funds are actually placed within consistently top performing funds.

Sources:
1. www.legalandgeneralgroup.com
2. http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB0005603997GBGBXSET1.html
3. http://www.ftse.com/products/indices/uk
4. http://www.lgim.com/global/about-us/
5.http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB0005603997GBGBXSET1.html
6. http://www.legalandgeneralgroup.com/investors/dividend.html
7. http://www.thisismoney.co.uk/money/investing/article-2348068/The-10-worst-performing-investment-funds-2010.html#ixzz48WGE2sPy

The question of whether ownership structure is an important attribute to pension schemes was elicited in the survey. This was to ascertain whether the conflicted agency duty to shareholders highlighted above matters to the pension trustees engaging PLC fund managers.

In Question 7 (see Appendix II) of the survey only 65% (n=44) of respondents labelled the fund manager they had described in Question 3 as a PLC. This is 15% lower than actual number of PLCs in the fund managers according to the Chapter 6 database. This suggests that ownership structure was not considered important by some of the respondents in the selection process, given the proportion of mislabelling. Conversely, 55% designated their fund manager of UK origin and 28% of USA origin, an accurate reflection of the fund manager governance regime provided in the Question 3 list (Table 7.5), suggesting geographic origins may be more deliberated. Given the differences in response to these two governance characteristics, the survey does not later delineate between the two. The response to Question 9 was that 53% of participants thought that these origin and ownership characteristics were not considered in the selection process (with 27% responding it was only implicitly considered). This observation leads directly into consideration of the third objective of the thesis.

## 7.5 Analysis of objective three of the thesis

The aim of this section is to analyse the survey data in accomplishing the following objective:

> To investigate whether pension clients perceive that the corporate governance of the fund manager matters to the fiduciary governance of asset management for their beneficiaries.

Where fiduciary governance is defined as avoided wealth capture; or value for money in the outsourcing of funds management. According to the Chapter 6 findings, external ownership structures did not disadvantage pension members in terms of wealth capture. The assets under management per member of the survey group was £95,450 ± £74,739. This is statistically equivalent to the Chapter 6 sample (t=0.4699, df2202, p=0.6385). The survey respondents were proportionally likely to select a PLC fund manager as the manager of their largest mandate (see Table 7.4). The difference in the assets per member between the group of respondents that engaged a PLC and those who engaged alternative fund managers was statistically insignificant (t=0.0994, df64, p=0.9212). This corresponds with the Chapter 6 proposition that the agency characteristic of governance structure is not predictive of pension asset allocation.

When respondents were asked whether corporate governance information had been provided by the fund manager (n=66), 55% (36) responded that it either had been, 32% (21) responded that they were unaware and 14% (9) responded no.

While approximately half the respondents were aware of the provision of information, the other half had not sought any. This does not rule out the possibility that information was sought from other resources (for example, consultants or industry publications).

The three main questions on whether, once governance information was known, it was used in a decision making capacity creates the early impression that the importance of governance in selection criteria was not high. This lends weight to the proposal that financial information is a priority in selection decisions, rather than agency information. Question 9 of the survey asks whether ownership structure or geographical headquarters for compliance played a part in fund manager selection, with 53% of responses a definitive no (n=66) or 27% the more ambiguous “implicitly only” (leaving only 20% of the sample a definitive “yes”). Question 10 supports the notion that financial criteria are prioritised over agency criteria, asking specifically whether corporate governance is relevant to the funds management contract (agreed performance less fees). It finds most governance traits congregate around the lower end of a Likert range (1 is not important, 7 is very important). With the exception of “Corporate Social Responsibility” and “Board Composition” in Table 7.6, typical corporate governance criteria applied by the governance codes to the shareholder principal are not prioritised by the pension principal.

Table 7.6 *Trustees' beliefs on the importance of corporate governance on the management* of the fund management contract (agreed performance less fees n=67)

| Governance assistance in managing net performance | Mean and median | Total responses ≤ "3" on Likert scale (n / %) |
|---|---|---|
| **CEO/Chairman separation** | 3.22 and 3 | 34 (51%) |
| **Gender equality** | 2.66 and 2 | 46 (69%) |
| **Employee engagement** | 3.76 and 3 | 34 (51%) |
| **Corporate social responsibility** | 3.70 and 4 | 32 (48%) |
| **Say on pay** | 3.09  and 3 | 37 (55%) |
| **Board composition** | 3.75 and 4 | 29 (43%) |

"Say on pay" (senior management and Board directors' remuneration) is interesting as a corporate governance trait of low importance (Likert median score 3). There is pressure for fund managers to increase and disguise the client fee base alluded to by the Kay Review (2012; also see Chapter 3). This is a key concern to current pension governance dialogue, described as the effort shareholders should expend to curb run-away increases in executive remuneration that decrease investor value (or as Jensen (2001b; p2) more emotively expresses, "steals from investors") in the form of perquisites. This issue has become central to concerns for corporate value retention, and active ownership proponents suggest it should by compulsory to proxy vote on this issue alone (Karmel, 2010). Many pension schemes instruct their fund managers to operate active ownership mandates on this issue, to vote on board remuneration on their behalf. Yet the survey responses have not supported the notion that the respondents entertain a duty to contain perquisites within their own financial intermediaries, despite having a fiduciary duty to defray costs facing contributors.

While Question 10 of the survey asked “does the trust as a whole believe any of the following corporate governance issues are important to the financial performance less fees of the fund manager?”, Question 5 asks “what was the Trust’s rationale for selecting this fund / manager?” The question moves the respondent from reflecting on the importance of specific governance criteria to asking about fund manager selection criteria that includes agency and finance theory constructs. Table 7.7 proposes that the three highest performing key metrics for selecting a fund manager (asset class expertise 71%, reputation 56% and past performance data 48%) are all market facing financial performance criteria.

Table 7.7 Question 5: W*hat was the Trust’s rationale f*or selecting this fund / manager?

| **Criteria*** | **Answer** | **Response** | **%** |
|---|---|---|---|
| **1** | Asset class expertise | 52 | 71% |
| **2** | Reputation | 41 | 56% |
| **3** | Past performance data | 35 | 48% |
| **4** | Lowest overall fees | 25 | 34% |
| **5** | Provision of useful information | 12 | 16% |
| **6** | Managing unease | 2 | 3% |
| **7** | Transparency of fee structure | 23 | 32% |
| **8** | Risk sharing (including downside risk) | 4 | 5% |
| **9** | ESG and engagement strategies | 6 | 8% |
| **10** | Value for fees | 28 | 38% |
| **11** | Other criteria were applied* | 7 | 10% |
| **12** | Consultant recommendation | 34 | 47% |
| **13** | Other industry recommendation | 3 | 4% |
| **Total respondents** | | 73 | |

*Where any number of criteria could be selected

The next key metric is by consultant recommendation (47%), an observation also made in the Kay Review (2012) as a method for fulfilling the trust's fiduciary duty through the purchase of external advice (or cynically viewed as outsourcing fiduciary responsibility). These four metrics outweighed low fees (34%) and value of fees (38%). The tepid result for value for fees is interesting regardless of other selection rationale, or portfolio management preferences. From a fiduciary perspective achieving value for money would be the minimum duty assigned to the trustees in responding to a question where any number of criteria could be selected.

Analysing the 73 responses individually reinforces these observations. In the 71% of the respondents selecting asset class expertise, only two selected it as their sole criterion. Other respondents selecting only one criterion (therefore a more definitive representation of their decision methodology) elected consultant recommendation (n=3), past performance (n=1) and reputation (n=1). These criteria are not as oriented to fiduciary agency as value for fees, selected by only 38% of respondents. These respondents selected value for fees in a bundle of an average of 4.2 criteria compared with the average of 3.2 criteria selected by the remaining responses. Table 7.8 illustrates the criteria also selected by the value for fees group.

Table 7.8 *Additional criteria selected by "value for fees" respons*es

| Criteria | Answer | Response | % |
|---|---|---|---|
| **1** | Asset class expertise | 22 | 26% |
| **2** | Reputation | 14 | 17% |
| **3** | Past performance data | 14 | 17% |
| **4** | Lowest overall fees | 11 | 13% |
| **5** | Provision of useful information | 5 | 6% |
| **6** | Managing unease | 0 | 0 |
| **7** | Transparency of fee structure | 9 | 11% |
| **8** | Risk sharing (including downside risk) | 0 | 0 |
| **9** | ESG and engagement strategies | 1 | 1% |
| **11** | Value for fees | 1 | 1% |
| **12** | Other criteria were applied* | 7 | 8% |
| **13** | Consultant recommendation | 0 | 0 |
| **Total** | | 84 | |

Asset class expertise is dominating the additional criteria selected by the group. Value for fees is one characteristic of a larger decision bundle where the remaining criteria are market facing. This intimation of the preference for market facing rather than governance key performance indicators can also be observed in Question 12 of the survey. The question asks "Do you think the Trust believes that the corporate governance profile of the find manager helps them manage any of the following challenges (1 is not important, 7 is very important)". This question, when interpreted next to the analysis of Questions 5 and 10 provides an indication for the third research objective that pension principals do not see corporate governance as influencing their fiduciary asset management decisions. The responses to Question 12 are displayed in Table 7.9.

Table 7.9 *Trustees' beliefs on the importance of corporate governance on the management* of the fund manager

| **Governance assistance in managing the pension principal** | **Mean and median** | **"Not important" response (% of total)*** |
|---|---|---|
| Managing pressure from their own shareholders | 3.29 and 4 | 22 (34%) |
| Prioritising the client relationship | 3.98 and 4 | 13 (20%) |
| Prioritising value for money | 4.06 and 4 | 12 (18%) |
| Prioritising transparency | 4.57 and 5 | 8 (12%) |
| Prioritising spending on expertise | 4.11 and 4 | 10 (15%) |
| Prioritising outperformance | 4.23 and 5 | 11 (17%) |
| Sharing risk | 3.57 and 4 | 11 (17%) |

*"Not important" being defined as a Likert score of less than or equal to 3 where 1 is not important and 7 is very important.

The interesting observation in this result is the two lowest mean scores are on the aspects of the fund manager governance that are central to the thesis: 1) that shareholders necessarily matter to the governance of a PLC fund manager; and 2) that a lack of interest in risk sharing is aligned with Boatright's (2009; p471) observation of governance in the finance industry, that CEOs have shifted from "bureaucrats or technocrats to partisan shareholders". This would imply that fund managers are agents for their shareholders, incentivised through ownership (shares or options) of the organisation itself and potentially motivated to appropriate fees from the risk free environment of the pension client contract to the self-incentivised environment of shareholder wealth maximisation.

### 7.5.1 Combining the selection criteria results

Combining the results from Questions 5 and 10 implies that governance characteristics are not viewed as canaries in the mines in the fiduciary pursuit of net value for pension contributors. This general speculation cannot be inferred from the aggregate survey results. However, each individual case can be examined to observe whether prioritised governance characteristics share any relationship with the key performance indicators of assessed fund managers. Sixteen respondents rated all Question 10 governance criteria as ≤ 3 on the Likert scale (unimportant). Conversely twenty respondents valued all governance criteria ≥ 4. Table 7.10 compares the key performance selection criteria indicated by these groups.

Table 7.10 Key fund manager performance indicators selected by respondents prioritising and deprioritising corporate governance characteristics on the Likert scale

| Criteria | Answer | Importance ≤ 3 | | Importance ≥ 4 | |
|---|---|---|---|---|---|
| | | Response | % | Response | % |
| **1** | Asset class expertise | 5 | 15% | 17 | 17% |
| **2** | Reputation | 6 | 18% | 17 | 17% |
| **3** | Past performance data | 5 | 15% | 14 | 14% |
| **4** | Lowest overall fees | 6 | 18% | 10 | 10% |
| **5** | Provision of useful information | 1 | 3% | 3 | 3% |
| **6** | Managing unease | 0 | 0 | 2 | 2% |
| **7** | Transparency of fee structure | 2 | 6% | 7 | 7% |
| **8** | Risk sharing (including downside risk) | 0 | 0 | 3 | 3% |
| **9** | ESG and engagement strategies | 0 | 0 | 5 | 5% |
| **10** | Value for fees | 4 | 12% | 10 | 10% |
| **11** | Other criteria were applied | 1 | 3% | 5 | 5% |
| **12** | Consultant recommendation | 3 | 9% | 6 | 6% |
| **13** | Other industry recommendation | 1 | 3% | 0 | 0 |
| **Total** | | 34 | | 99 | |

Acknowledging the limited sample size, the results are consistent with the previous analysis section. Respondents either prioritising or deprioritising corporate governance agency traits prioritised selection alternative criteria in equal measure ($\chi^2$=17.516, df12, p=0.131). The three finance oriented characteristics of asset class expertise, reputation and past performance data comprise 48% in both categories.

Table 7.11 compares this result with Question 12 ("Do you think the Trust believes that the corporate governance profile of the find manager helps them manage any of the following challenges (1 is not important, 7 is very important)". It takes the responses to each of the of the governance criteria and compares these to the aggregate Likert score for the importance of selection criteria from Question 10.

Table 7.11 Responses to governance assistance in assuring fiduciary agency over the pension relationship compared with key fund manager performance indicators (KPIs) from Table 7.10

| Governance assistance in managing the pension principal | Likert score ≥ 4 | KPIs ≥ 4 | KPIs ≤ 3 |
|---|---|---|---|
| Managing pressure from their own shareholders | 33 | 14 | 8 |
| Prioritising the client relationship | 42 | 10 | 8 |
| Prioritising value for money | 42 | 13 | 10 |
| Prioritising transparency | 47 | 18 | 10 |
| Prioritising spending on expertise | 43 | 15 | 11 |
| Prioritising outperformance | 42 | 14 | 9 |
| Sharing risk | 35 | 12 | 8 |

There is no significant difference in the scores between governance assistance responses and either an aggregate KPI score ≥ 4 from Question 10, ($\chi^2$=2.286, df5, p=0.683) or KPI score ≤ 3 ($\chi^2$=1.571, df6, p=0.666). Transparency is the highest correlating characteristic chosen by respondents who scored all KPIs over four in importance, despite not being prioritised as a criterion in the KPI list in Question 10. Conversely, outperformance scores above four were equal with value for money, despite past performance rating higher as a KPI than value for money in Question 10. This results in a mixed message as to whether the agency characteristic of transparency (alleviating information asymmetry) and the traditional finance characteristic of performance are the true reflection of trustee behaviour being oriented towards agency theory predictability.

Central to interpreting these results, highlighted in Chapter 6, is distinguishing between pension trustees who have their largest mandate with PLC owned fund managers and those engaged with alternative ownership structures. This will provide further detail for discussion on whether alternative ownership structures point to any trend in this conundrum between agency and finance theory in the following sections, and is an important avenue for future research.

### 7.5.2 Individual cases engaging PLC owned fund managers

There is a predominance of UK based PLC entities appointed as pension fund managers in the sample. To analyse any differences between PLC and other entities, the size of assets under management and scheme designation of the individual trust is examined to ask two questions: 1) Who chose to engage a UK PLC?; and 2) Does this group choose governance characteristics in the fund manager differently? Table 7.12 addresses the first question; the respondents choosing a UK PLC fund manager.

Table 7.12 Total Assets Under Management and percentage of respondents engaging UK PLC fund managers and alternative fund managers

| Total Assets Under Management | All cases (£000) | UK PLC cases (£000) (% of total) | Other cases (£000) (% of total) |
|---|---|---|---|
| Defined Benefit Open (n=20) | 134,754,472 | 84,403,375 (63%) | 50,351,097 (37%) |
| Defined Benefit Closed (n=34) | 68,648,174 | 49,450,000 (72%) | 19,198,174 (28%) |
| Defined Contribution (n=26) | 3,760,329 | 2,861,939 (76%) | 898,390 (24%) |
| Total | 207,162,975 | | |

Twenty respondents reported operating Defined Benefit Open schemes, six of them engaging UK PLC fund managers. The six, however, account for 63% of the total assets under management in this scheme type among survey respondents. They are individually significantly larger than the schemes appointing alternative fund manager entities (£14.1 billion ± £9.9 billion compared with £6.7 billion ± £4.8 billion for all cases: t=2.5350, df24, p=0.018). However, the assets per member for this scheme are £105,850 ± £95,384. This is consistent with the assets per member in Chapter 6 (£86,457 ± 134,820: t=0.6411, df1527, p=0.521)

Defined Benefit Closed schemes were reported by 34 respondents, with the 12 appointing UK PLC, again accounting for a large proportion of the total assets under management (72%: See Table 7.10). They are also larger at individual level than the schemes appointing alternative structures (£4.1 billion ± £2.9 billion compared with £2.0 billion ± £1.4 billion: t=2.3868, df44, p=0.021).

In the Defined Contribution responses 11 of the 26 schemes engaged a UK PLC, yet this represents 76% of the assets under management for this scheme type (illustrated in Table 7.10). As with the Defined Benefit schemes, larger pension schemes are engaging UK PLC fund managers (£260,176 ± £183,965 compared with £144,628 ± £102,249: t=2.4540, df35, p=0.019). Larger schemes in the range of all scheme types are engaging UK PLCs. However, no particular scheme type is doing this more than any other ($\chi^2$=2.140, df2, p=0.343). No schemes were reported in the category “Other” among respondents.

Viewing the three scheme types in aggregate, the difference in assets under management between PLC respondents (n=29) and all other fund manager ownership types (n=26) increases in significance (£18.4 billion ± £13.0 billion compared with £8.2 billion ± 5.8 billion: t=3.7036, df53, p=0.0001). This contradicts the Chapter 6 findings of an inverse relationship between the size of the pension scheme and the size of the fund manager. However, given the survey sample consists solely of large pension schemes, this is a within-category observation of a group of pension schemes who are statistically likely to engage multiple fund managers and have only been asked to comment on one (the fund manager carrying their largest mandate). Given Chapter 6 does not identify the fund manager with the largest scheme mandate when multiple managers are engaged in most cases, no comparison can be drawn between the two sets of analysis on this particular test.

The second question addresses whether these different groups respond differently to the governance characteristics questions in the survey. From the 29 PLC engaging respondents, only 22% considered ownership structure and governance compliance headquarters in their fund manager selection processes. Table 7.13 demonstrates how as the responses to Question 5 (the rationale for selecting the fund manager) become less frequent in number (less important selection criteria) they are likely to be considered important by the PLC engaging group. Asset class expertise is the most important key metric in general, but disproportionately more so to PLC respondents. This disproportion is observed more keenly with consultant recommendations, with 81% of respondents to this criterion engaging PLCs.

Table 7.13 What was the T*rust's rationale for selecting this fund manager ranked by number* of res*pondents (percentage of PLC versus "Other" respondents)*

| **Selection criteria** | **Number of responses** | **Percentage of PLC respondents nominating KPI** | **Percentage of PLC respondents in total** |
|---|---|---|---|
| Asset class expertise | 52 | 70 | 58 |
| Reputation | 41 | 72 | 75 |
| Past performance | 35 | 72 | 57 |
| Consultant recommendation | 34 | 81 | 62 |
| Value for fees | 28 | 76 | 57 |
| Lowest overall fees | 25 | 75 | 68 |
| Transparency of fee structure | 23 | 73 | 70 |
| Provision of useful information | 12 | 55 | 67 |
| Other criteria were applied | 7 | 43 | 43 |
| ESG and engagement strategies | 6 | 50 | 100 |
| Risk sharing (inc. downside risk) | 4 | 50 | 50 |
| Other industry recommendation | 3 | 0 | 33 |
| Managing unease | 2 | 0 | 0 |

Taking the market facing (finance oriented) criteria alone (Asset class expertise, Reputation and Past performance) the difference between the groups favouring these KPIs is only pronounced for reputation ($\chi^2$=10.000, df1, p=0.0016). This is consistent with the Chapter 6 proposition that trustees select PLC marque brands to create the appearance of fiduciary care through brand association. As Table 7.14 illustrates, this difference between groups is further found in Question 6 (Which metric is of key importance when the Trust rates the financial performance of this fund manager?). The key criteria were market and benchmark oriented to the respondents as a whole, yet disproportionately selected by the PLC engaging respondents. The further fiduciary key metrics of fund management cost and promise keeping are undervalued by the PLC group (Value for Annual Management Cost 29% of responses, Value for Total Expense Ratio 29% of responses, and Nominal returns compared to verbal undertaking (promises) 27% of responses). Having acknowledged that Legal & General is the fund manager dominating PLC engagement, the nominal returns to the benchmark criterion was the key metric to the majority of this group (68%).

Table 7.14 Metrics of key importance for PLC fund manager engaging Trust funds (% frequency for UK PLC versus total respondents)

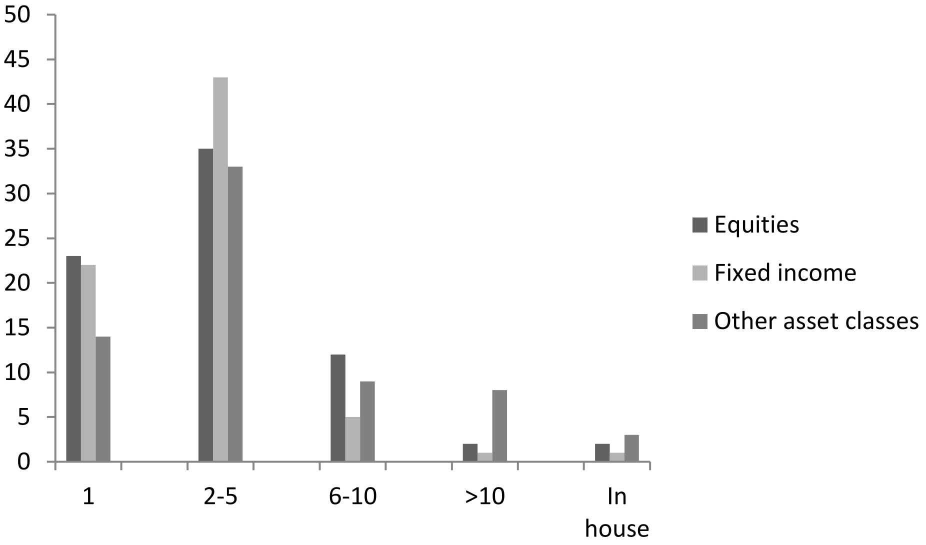
| Key metric | % of PLC respondents nominating the key metric | % of PLC respondents in total respondents |
|---|---|---|
| Nominal returns compared to the requisite benchmark | 76 | 86 |
| Value added performance (above market) | 38 | 57 |
| Value for Annual Management Cost (AMC) | 37 | 29 |
| Nominal financial returns generated in the last financial year of engagement | 31 | 25 |
| Value for Total Expense Ratio (TER) | 22 | 29 |
| Nominal returns compared to verbal undertaking (promises) | 14 | 27 |

In summary, when analysed on a case-by-case basis the criteria for asset manager selection are predominantly market based. These criteria become even more important to the respondents engaging a PLC fund manager. Fiduciary agency characteristics, including value for fees have not been assigned the same importance by either category of respondent. Yet the importance of the fiduciary characteristics is further underrated in the PLC engagement category ($\chi^2$=17.640, df1, p=0.0001 in both categories of value for annual management cost and value for total expense ratio). The survey results have corroborated the Chapter 6 findings that PLC fund manager engagement dominates pension scheme selection in the UK (Chapter 6 recording 56.5% of PLC engagements out of six entity types). However, the individual cases selecting PLC fund managers by pension scheme type are lower in the survey same than the Chapter 6 results (DBO survey 30%: Wilmington 52%; DBC survey 35%: Wilmington 60%; DC survey 42%: Wilmington 70%). Furthermore, the size of the pension schemes selecting PLC fund managers has inverted between the two sets of results. The implications of these a contradictions are discussed in Section 7.8.

### 7.5.3 Moral hazard and adverse selection

Question 2 of the survey asked respondents' preferences for single or multiple fund manager appointments to determine whether multiple fund manager engagement may be seen as means of avoiding the adverse selection of a single, non-performing manager. However, the converse of this strategy is the moral hazard of expensive monitoring and incentivising of multiple agents. The question was split into three asset classes (equities, fixed income and other), acknowledging that asset classes (such as property) will each be managed differently depending on the propensity for active management and bespoke asset class expertise in the fund manager. Figure 7.2 describes the response to a preference for fund managers in each asset category.

Figure 7.2 Preferences for single or multiple fund manager appointments by asset class



Removing in-house results from the responses (as cases with no agent), the majority of respondents advocate multiple appointments, with 2-5 engagements being the largest category ($\chi^2$=113.754, df3, p=0.0001 between all engagement categories and $\chi^2$=15.906, df1, p=0.0001 between 1 engagement and 2-5 engagements). The stated rationale for multiple fund manager appointments (49% of responses) was to hedge against under-performance in one fund manager with outperformance in another. This implies a strategy to avoid deleterious effects from adverse selection. The second rationale (22% of responses) was on the recommendation of professional consulting advice. As discussed previously, the purchase of external advice may be for the purpose of fiduciary auditability. The majority of respondents (58%) saw the administrative burden on the trust as the main disadvantage of a multiple appointment strategy.

Conversely, the single appointment advantage was perceived by the majority of respondents as minimising transaction costs (63.6%), with the disadvantage perceived as (40%) key client risk. These results are consistent with the tension in agency theory between avoiding adverse selection (key client risk) and minimising costs (cost of monitoring). This may not be consistent with the market facing criteria for individual fund manager selection. The finance theory characteristics applied to the appointment of each individual fund manager are now contradicted by agency characteristics associated with information asymmetry, or the need for fiduciary protection from the consequences of single multiple fund management engagement.

Whether this is empirically observed in the size of the assets under management correlating with a multiple engagement strategy is illustrated in Table 7.15.

Table 7.15 Relationship between assets under management per member and multiple fund manager engagement strategies (one manager versus multiple engagement t-test)

| **Number of FMS engaged** | **Scheme type / asset class** | **Defined benefit open** | **Defined benefit closed** | **Defined contribution** |
|---|---|---|---|---|
| **1 v. >1** | Equities | (n=4 v. n=16)<br>p=0.0312** (S) | (n=9 v. n=22)<br>p=0.0973 | (n=7 v. n=13)<br>p=0.5401 |
| **1 v. >1** | Fixed income | (n=8 v. n=12)<br>p=0.6039 | (n=9 v. n=22)<br>p=0.0001*** (M) | (n=7 v. n=16)<br>p=0.4760 |
| **1 v. >1** | Alternative | (n=5 v. n=15)<br>p=4174 | (n=6 v. n=25)<br>p=9137 | (n=3 v. n=20)<br>p=4142 |

S= in favour of single fund manager engagement
M= in favour of multiple fund manager engagement

The Table 7.15 results do not meet the predicted agency theory results of multiple fund manager engagement allowing adverse selection to be avoided except in one case (fixed income assets in Defined Benefit Closed schemes). In Defined Benefit Open schemes, single fund manager engagement shares a positive relationship with assets per member in the equities asset class. The general lack of a relationship is consistent with the Chapter 6 results; the relationship is not revealing itself as a hedging strategy to advance the size of assets per member. However, the motivations for these strategies were reflected in the text responses supplied and meet the agency theory expectations of the desire to avoid adverse selection of an underperforming fund manager:

- Advantages of single fund manager appointments: No comments were forthcoming.
- Disadvantages of single fund manager appointments:
    - Exposure to single manager style
    - Missing out on other better performing funds
    - At any given time the manager's style may be suboptimal for current market conditions
    - Fee arrangement can limit fund investment options within a particular asset class

These comments reflect the agency theory of adverse selection and moral hazard, with the disadvantage of no hedging strategy against underperformance in the agent. They differ from the motivations for multiple fund manager appointments in a manner consistent with agency theory.

- Advantages of multiple fund manager appointments:
    - Different styles of management [which, to a degree, covers the 1st point] (hedging risk of underperformance in one fund manager with outperformance in another).
    - Fund managers with different strategies/who target different sectors of the market can complement one another, and aim to achieve steady returns by hedging the risk of one managers' *underperformance against another's overperformance (different* sectors of the market may flourish/shrink at different times)
- Disadvantages of multiple fund manager appointments:
    - Increased costs ie higher manager fee in total for multiple vs single manager
    - Less purchasing power to negotiate fees
    - Governance burden
    - Over diversification
    - More likely to result in index performance and defeat the object of active management.

The concept of hedging one manager's underperformance against another manager's outperformance was hypothesised in Chapter 4 as a motivation for multiple fund manager engagement. This is consistent with the observations of disadvantages to multiple fund manager appointments. Specifically the principal's ability to monitor (governance burden) and incentivise (less purchasing power to negotiate fees) the agent to act in the principal's best interest. While hedging and diversification are integral elements to portfolio construction theory, they are consistent with both if they can predict pension trust behaviour. However, finance theory would suggest that the fund manager performs the hedging function in portfolio construction. Observations on the advantages of multiple fund manager engagement that do not reflect agency theory and reflect the market oriented selection criteria prioritised in the previous Section included:

- Diversification of assets
- Our approach to investing within equities includes multiple exposures to various alternative risk premia, which we implement using a variety of different approaches (generally 2 per risk premium).
- Diversification, complementing managers, different equity styles including fundamental indexation and unconstrained selection
- Being able to use different manager styles in each asset class, eg., growth and value in equities
- Different investment processes and philosophies to exploit market inefficiencies
- Opportunity set of more specific activities that require specialist expertise that cannot be obtained from single or small portfolio of managers
- Use different managers for each sub-class of assets eg in equities, have different managers for UK equities (largely passive) and emerging markets (active). Each subclass has a single manager
- Managers/strategies appointed to provide exposure to different risk factors within each asset class, specifically equities
- Property management specialisms

Question 4 of the survey asked how long the largest fund manager elected had been engaged. The majority of responses (62%, n=45) were 5 years or more. Chapter 3 explored the concept of agency theory in financial intermediation as the challenge the principal faces in monitoring agent performance, with the perception in the literature that agents are not re-evaluated often enough for fiduciary compliance (see the findings of the NAPF Engagement Survey, 2014). In the cases responding 5 years or more 47% suggested the rationale for this was asset class expertise (assisting the pursuit of financial performance), 30% believed it was the value for fees charged (the fiduciary requirement to minimise costs) and 23% responded that it was on consultant recommendation (outsourcing fiduciary responsibility). This result cannot interpret whether strong management by the principal (continuous assessment of agent satisfaction) or weak fiduciary management (prolonged moral hazard exposure to the agent).

### 7.5.4 Reflections on the survey responses through finance theory and agency theory

The survey aimed to address two objectives of the thesis. The first objective above was to explore whether trustees of pension schemes viewed corporate governance characteristics of fund managers as important indicators of fund manager value for money (avoiding wealth capture). The fiduciary duty to pension contributors to ensure value for money requires engaging an agent who will act in their exclusive best interest and defray any unreasonable costs of doing so. Yet this section concludes that trustees underrate corporate governance characteristics in favour of selection criteria based on perceived portfolio construction expertise in different asset classes and markets.

As discussed, Question 9 asked whether these two characteristics (the presence of shareholders in shareholder wealth maximising marketplaces) were considered in fund manager selection. The majority did not (53%), with only 20% responding that they did explicitly. Question 12 (Do you think the Trust believes that the corporate governance profile of the find manager helps them manage any of the following challenges) reinforced this impression with 19% of responses stating "value for money" was "not important" and "when managing pressure from their own shareholders", 34% of respondents stated that this was also not important, suggesting that a substantial proportion of the survey base do not consider governance characteristics are relevant to fiduciary pension management.

Conversely, Question 5 (the trust's rationale for selecting the fund manager) earlier discussed that the three highest performing key metrics for selecting a fund manager (asset class expertise 71%, reputation 56% and past performance data 48%) are all market facing financial performance criteria. Only 38% regarded value for fees in the selection criteria. In Question 6 (key metrics for rating fund manager financial performance) 86% of responses rated nominal returns compared to the requisite bench mark as the key metric for selection and evaluation. Given the benchmark is the aggregate of fund manager performance, this is in effect achieving the average. A further 57% rated above market performance as a key metric, yet only 29% rated the annual cost of management and 29% the total expense ratio as a key metric.  Achieving the average of the market with no regard to the cost of this would not be considered a legal discharging of a fiduciary duty.  The Kay Review (2012) intimated that this may be why the next highest performing metric in Question 5 was consultant recommendation (46%) as a means of fulfilling a fiduciary duty through deflecting the selection process onto a purported industry expert.

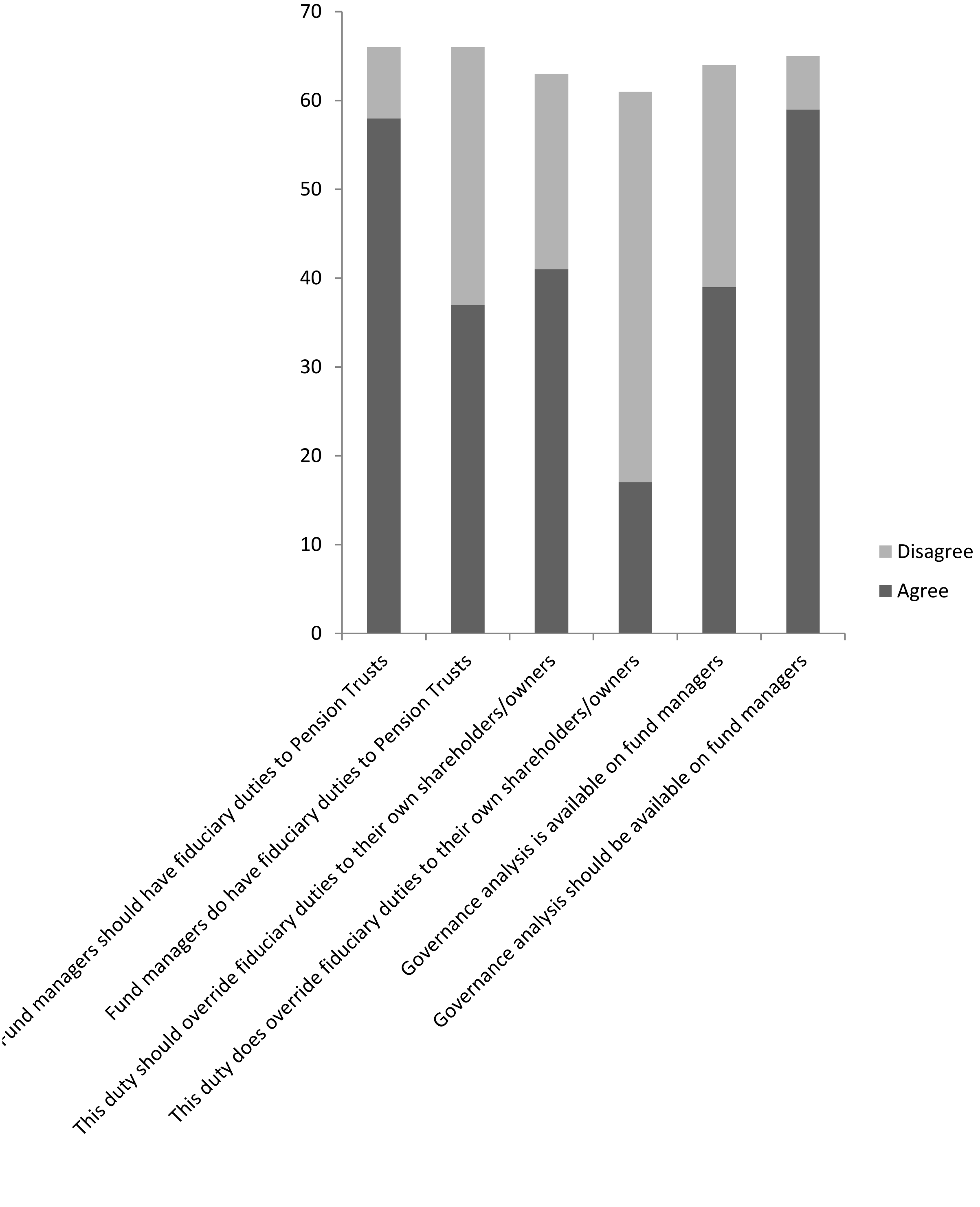
Trustees discussing performing their fiduciary duty in fund manager selection suggested in the open ended response to Question 2 suggested alternative criteria were applied.  In particular, the agency theory prediction of multiple manager engagement for avoiding adverse selection.  However, the data in Section 7.5.3 does not bear this strategy out.  This corresponds with the Chapter 6 findings.

This evidence leaves an impression that the trustees consider market information as more important to their fund manager selection process than governance information.  While market information is in the public domain, with finance theory holding that the market is perfectly informed and instantly updated, governance information is proprietary and leaves the principal vulnerable to information asymmetry.  In the pursuit of fiduciary protection for pension contributors, the initial indication is that trustees participating in the survey prioritise selection criteria based on the principles of finance theory over the principles of agency theory, and consequently may be discounting the importance of the concept that financial intermediaries are not free of agency problems.  Chapter 3 and Chapter 8 both address the problem of secret and proprietary information being controlled by the fund manager surrounding their fee structures as problematic for fiduciaries.  The next Section employs this premise as the basis for analysing the survey data in response to the fourth objective of the thesis, the trustee perceptions of the fiduciary duties arising for fund managers in the management of another's private property.

## 7.6 Analysis of objective four of the thesis

The fourth objective of the thesis was to determine whether pension clients believe the fiduciary duties of professional fund managers conflict with the delivery of fiduciary asset management.  This was accomplished through the question in the survey instrument displayed in Figure 7.3.  The survey question consisted of six statements, three of which were "fund managers should…" and three being "fund managers do…" questions regarding their fiduciary duties.  The only responses were "agree" or "disagree", purposefully providing no opt-out option to elicit an absolute response.

Figure 7.3 Fiduciary duties survey question: *"Please indicate whether you agree or disagree with the following statements"*



Overwhelmingly there is a belief that fund managers should have fiduciary duties to their pension assets but ambiguity over whether they actually do. The feeling that they should override duties to shareholders is strongly perceived, however there is a contradiction in the perception on whether they do.  This is an important indication of the persisting confusion surrounding the allocation of fiduciary duties post the Kay and Law Commission reviews.

As discussed in Chapter 3, the Kay Review (2012) and the Law Commission Review (2013) both determined that while the relationship between the fund manager and the pension client was fiduciary in nature, no fiduciary duties were arising from the funds management contract in either case or statute law.  Both reviews endorsed statutory rectification in their parliamentary recommendations, a recommendation that was rejected in the Parliament's response to the reviews (Clark, 2013).  When looking at the fiduciary responsibilities pension trustees believe fund managers should bear, there is evidence that the trustees also believe the relationship is fiduciary in nature.

There is a strong perception that fiduciary duties should be owed by the agent with 88% (n=58) agreeing with the binary statement.  The results are indicative of the confusion in the industry over the custodial responsibilities of pension assets, with only 45% (n=29) agreeing that the fund manager should but does not have fiduciary responsibility for the assets.  The remaining majority believe the fund manager does have these duties.  There are eight cases that disagree that fund managers should have duties.  The governance characteristics of these cases were unexpectedly diverse; UK PLC (n=3), USA PLC (n=2), UK Partnership (n=1), USA Private (n=1), UK Don't know (n=1).  This does not imply that trustees selecting a particular type of fund manager governance have been influenced into this opinion.  It seems a spurious response to a concept that only causes benefit to the respondent and a curious reflection on their fiduciary discharge. Furthermore, two cases responded that while fund managers shouldn't hold duties, they do. The remaining cases that responded "don't know" to the governance characteristics of their fund manager (n=10) believe that the fund manager should have fiduciary duties to the pension scheme but don't. Acknowledging the small number of cases, this implies that their perception that conflicting governance duties brought by corporate governance codes is not a consideration in the execution of their own duties. This contradicts the overall message of the responses to the questions addressed in the section on Objective 3 where governance was expressly not included in fund management selection frameworks and was continuously underrated in the comparison with other financial (market) metrics.

Within the two constructs, categories were collapsed into "PLC" and "Private" for Ownership Structure of the fund manager engaged, and USA, UK and Other for Governance Reporting Regime. Table 7.16 and 7.17 examine the cases individually to determine if there is any discrepancy in the perceptions of fiduciary duties between the different categories. The two fiduciary statements of relevance were "Fund managers should have fiduciary duties to Pension Trusts" and "Fund managers do have fiduciary duties to Pension Trusts". Both required an agree or disagree response with no opt out alternative. The Tables were converted into percentages to facilitate comparison between the categories.

Table 7.16 Ownership structure of the fund manager collapsed to public verses private

| **Ownership structure** | **Cases (n)** | **Fund managers should have fiduciary duties to pension clients** | | **Fund managers do have fiduciary duties to pension clients** | |
|---|---|---|---|---|---|
| | | Agree | Disagree | Agree | Disagree |
| **PLC** | 43 | 38 | 5 | 22 | 21 |
| **Private** | 15 | 13 | 2 | 13 | 2 |
| **Cases as %** | **Cases (n)** | **Fund managers should have fiduciary duties to pension clients** | | **Fund managers do have fiduciary duties to pension clients** | |
| | | Agree | Disagree | Agree | Disagree |
| **PLC** | 43 | 0.88 | 0.12 | 0.51 | 0.49 |
| **Private** | 15 | 0.87 | 0.13 | 0.87 | 0.15 |

There is general strong agreement between PLC and Private ownership structures that fund managers should have fiduciary duties (87% and 88% respectively). However, there is a divergence between the two on the perception of the duties actually owed to them. Trusts appointing PLC fund managers believe agree and disagree in equal measure that a duty is owed (51% to 49%). However, Trusts engaging privately owned entities perceive a fiduciary duty actually in place (87%). Acknowledging the small sample size, this is a tenuous indication of trustee perception for both objectives three and four. The ownership structure matters to the perception of the status of fiduciary asset management. Engaging fund managers on the managerial discretion end of the conceptual framework X axis and perceptions of fiduciary wealth management in place may show a trend.

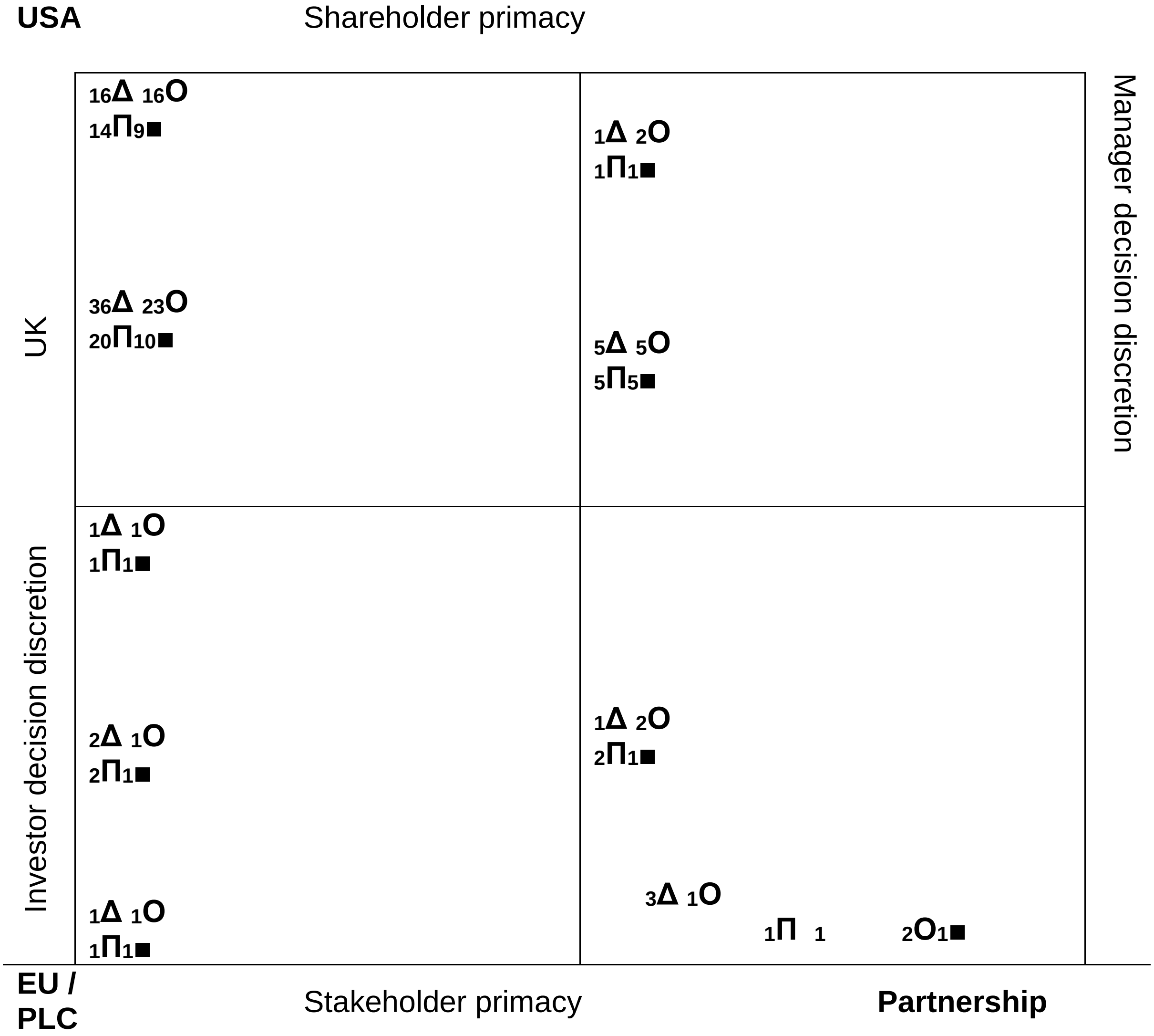
This trend is also observed when reporting regimes are compared between shareholder primacy and stakeholder regimes. Table 7.17 indicates (again, in a small sample size) the broad agreement that fund managers should have fiduciary duties, however trustees with USA based engagements are less likely to agree that they do (56% compared with 61% in the UK and 71% in Europe).

Table 7.17 Governance regime categories of fund managers collapsed to USA, UK and Other

| **Governance regime** | **Cases (n)** | **Fund managers should have fiduciary duties to pension clients** | | **Fund managers do have fiduciary duties to pension clients** | |
|---|---|---|---|---|---|
| | | Agree | Disagree | Agree | Disagree |
| USA | 18 | 15 | 3 | 10 | 8 |
| UK | 33 | 29 | 4 | 20 | 13 |
| Other | 7 | 7 | 0 | 5 | 2 |
| **Cases as %** | **Cases (n)** | **Fund managers should have fiduciary duties to pension clients** | | **Fund managers do have fiduciary duties to pension clients** | |
| | | Agree | Disagree | Agree | Disagree |
| USA | 18 | 0.83 | 0.17 | 0.56 | 0.44 |
| UK | 33 | 0.88 | 0.12 | 0.61 | 0.39 |
| Other | 7 | 1.00 | 0.00 | 0.71 | 0.29 |

Whether respondent knowledge of the corporate governance characteristics is connected to perceptions of fiduciary duty is difficult to assess visually in the populated conceptual framework (Figure 7.4). Many of the categories have returned too few (or no) observations to justify any interpretation.

Figure 7.4 Corporate governance characteristics and Trustee perceptions compared through the conceptual framework


USA
Shareholder primacy
16Δ 16O
14Π9■
1Δ 2O
1Π1■
36Δ 23O
20Π10■
5Δ 5O
5Π5■
UK
Manager decision discretion
1Δ 1O
1Π1■
Investor decision discretion
2Δ 1O
2Π1■
1Δ 2O
2Π1■
1Δ 1O
1Π1■
3Δ 1O
1Π 1
2O1■
EU / PLC
Stakeholder primacy
Partnership

Δ Fund manager with the largest mandate reported by respondents (Question 3: Who is the fund manager managing the most of the trust's assets?): Governance characteristics applied from the Chapter 6 data.

O Respondent answers to Questions 7 and 8 (Fund manager's headquarters and ownership structure). Remaining responses: 1) Other (n=4) and 2) Don't know (n=8).

Π Respondents believing fund managers should have fiduciary duties to pension clients whose assets they manage.

■ Respondents believing fund managers do have fiduciary duties to pension clients whose assets they manage.

When the objectives are read together, the apparent contradiction between what fund manager fiduciary duties should be, and what they are, alongside the contradiction between these governance duties being important yet not considered in the fund manager selection process. This is particularly pronounced in the first quadrant of the conceptual framework, where governance characteristics (de)prioritised in Objective 3 (Figure 7.4) in publicly listed organisations in shareholder primacy regimes depart from trustee perceptions of fiduciary duties owed by the fund manager. These fund managers who have a fiduciary conflict with their shareholders are less likely to be perceived as having or needing a duty to the pension client, and yet they dominate the fund managers selected. The trustees are perceiving fiduciary duties are important, however don’t use this information to alleviate asymmetry in the selection process.

This conundrum forms the basis of the third analysis chapter of the thesis. This content analysis considers the actual state of fund management fiduciary duty discussed by courts and legislators alongside the perceived state of this duty in the industry press. The chapter forms the final connection in the sequential pursuit of a research design aimed at exploring the importance of fund manager corporate governance in the discharge of fiduciary pension asset management.

### 7.7 Asymmetric information implications in the industry

There is a well-documented reluctance to engage in discussions regarding fund management fees in the industry literature (Shah, 2014). This was exacerbated by the dialogue at the time of the survey that fund manager contracts should be subject to non-disclosure agreements (Blake, 2014). This development, alongside the fact that the fee contracts are private domain caused difficulty with the respondent rate and sample size. The methodological problem of self-selection has been discussed in detail alongside the Office of National Statistics observations that larger pension schemes have the resources to partake in surveys that smaller schemes do not. There was also a corresponding issue with incomplete data in some of the completed surveys. As far as possible, this has been accounted for by analysis at case level, rather than taking an overall, or inferential view of the survey for the purpose of deriving a trends based approach to determine where the survey and the literature overlap. It needs to be acknowledged that the survey does not lend itself to exploration of the population as a whole, but rather presents fertile highlights for further investigation.

Herding in the finance industry is not a phenomenon that was captured by the survey. According to the industry and academic literature addressed in Chapter 3 many schemes look to others or industry consultants for the formulation of their fund manager selection criteria, rather than the use of rigorous key performance indicators of their own. If the selection process is a “black box” from which the name of their selected fund manager appears, governance characteristics may have been considered that they are not aware of. The recommendation to follow up on this is proposition with consultants Aon Hewitt, Mercer and Towers Watson is discussed in Chapter 8. This leads to a problem with index benchmarks, as they are a measure of average investment behaviour, rather than an independent metric for accountability. As the sample frame suggested, many of respondents are invested heavily in Legal & General, so the benchmark against which this company's performance is judged influences the survey results. Overcoming this from a research perspective is challenging, as herding behaviour in pension asset management is a phenomenon remarked upon in the industry press, but not easily observed in a research environment as it can be perceived as critical of the fiduciary judgement of individual trustees.

With hindsight, the question "does active management demonstrably increase asset performance?" was not asked which would have been beneficial for the hypothesis on finance theory (if correlated with active management against performance against benchmark and consultant recommendation) to further investigate the potential for a herding phenomenon. Do all pension investors invest the same as their peers as there is fiduciary safety in doing so? This would be a challenging premise for a survey to approach. Further improvements to the survey have been suggested by the respondents in Appendix II. These are reflected upon in the Appendix as a response to feedback and recommendations of the Chapter 8 discussion.

## 7.8 Conclusion and further research

The survey respondents were predominantly pension trusts running large Defined Benefit schemes. Large UK based fund managers dominate the survey sample of pension schemes engaged with the largest mandates over these schemes. This is challenging from a representativeness perspective viewed against the larger pension population.  There are three hypothesised reasons for this: 1) the secret nature of the fund manager contract that is explicit in the literature encouraged frigidity in the less resourced trusts to reveal information that may jeopardise their fiduciary duties; 2) the observations made by the Office of National Statistics in Chapter 3 as a challenge to their methodology that smaller trusts with few resources experience survey fatigue; and 3) the respondent contact information was dependent on the quality of the Wilmington (2013) data and larger trusts have more visible data available to industry bodies.

The challenges to methodology continue to be prevalent in all aspects of research into this industry, and include the sample size of responses and a reluctance to provide data.  The post-positivist objective of the survey was to compare trustee perceptions of fund manager fees with the analysis of Chapter 6, rather than infer or extrapolate anything about the pension population.  To this point, the chapter recognised that the survey can only comment on the perceptions of a limited number of large pension schemes and it is explicit about how respondents skewed against the population in response demographics.  Nevertheless, it represents the start of collecting a proprietary set of data on a notoriously confidential industry to enable exploration of this extremely important issue. These respondents who collectively manage the assets of over 2 million members of the UK investing public believe fund managers should support, and even adopt, their fiduciary obligations yet also believe the fund manager's primary fiduciary obligation to corporate ownership is in conflict with this objective.  The sensitive nature of the subject forced the exploration of the fourth objective to be more elusive than explicit in the survey's examination of whether trusts believe fund managers exploit the fiduciary free nature of the contract for the fulfilment of their own duties to owners, yet yielded interesting findings that are worthy of further examination. Chapter 3 explored much ambiguity in the area as the Kay Review and Law Commission Review highlighted, where the boundaries of the fiduciary need further legal definition. This was reinforced by the survey results.

The two objectives of the thesis that the survey explored were deliberately designed to cause tension for respondents between perceiving whether the corporate governance of fund managers matters in the fiduciary management of their assets, and perceiving whether the fiduciary duties of fund managers themselves lie with the trust or with the owners they govern for. The overall impression given by respondents was that the corporate governance of fund managers is not an urgent or explicit consideration in fund manager selection. Market performance objectives in different asset classes advertised by the fund manager take priority. In the case of trusts engaging PLC fund managers, their responses that the key metric in selection is nominal returns tied to requisite benchmarks proportionately dominated the total respondents, entrenching a market oriented view to trustee decision-making. The concept of value for money in the assets they are placing is not appearing a priority in the (undeniably) fiduciary decision of where to place assets under management. Yet there was strong acknowledgement that while the fiduciary duties of fund managers should lie with pension trusts as the duty to protect they beneficiaries, they in fact lie with the owners of the fund manager (with the fiduciary responsibility to maximise this owner’s return on investment). This represents a conflict in perceptions held by trustees that was observed by the Kay Review (2012) and Law Commission

Review (2013). There is much work needed at policy level to clarify this alarming and material conflict in the purpose of the financial services industry. These issues are reflected on in the following discussion chapter regarding industry reform.

# Chapter 8
# Discussion and Conclusion

## 8.1 Introduction

In his book Paupers' Progress, Joe Harris describes seven centuries of "paternalistic and demeaning attitudes towards older people and the inadequacies of public pensions." (Harris, 2006; foreword). The common belief of Parliament, reflected in centuries of development of the Poor Laws was that poverty was self-inflicted and the provision of relief rendered the poor "indolent and wasteful" (Harris, 2006; p25). By the 19th Century as the UK's population reached 16 million people, 1.6 million of whom were destitute, and only those people "deserving and of good character" were entitled to public purse relief (Harris, 2006; p27). Social momentum was generated between the wars to pass the National Insurance Act 1946, establishing the National Insurance pay-as-you-go system (Bozio et al., 2010). The designation of "pauper", a pejorative term, was dropped from the statute books by this Act of Parliament in effect in 1948. Providing a productive member of society had contributed to National Insurance (the equivalent of 21.3p per week for 44 years for men and 39 years for women matched by 16.3p from the employer) a retired employee (the qualifying age for men at 65 years and women at 60 years) would receive £1.30 a week (£2.10 per couple) from the State (Harris, 2006; p48). Average life expectancy at the time was 60 years (Bernard, 2006). This history is critical to the thesis as the context of the investment proposition for pension funds. They need to be maximised with minimal interference by the finance industry.

The Office of National Statistics estimates that 17.8% of the UK population is aged over 65 (ONS, 2015), projected to rise to 24% by 2032 (Blackburn, 2006).

A new bracket, the over 80’s was inconceivable when the pension apparatus was established and yet it is the most rapidly expanding bracket globally with actuaries now debating whether there actually is a natural human lifespan (Blackburn, 2006). At the same time there are fewer young people contributing to the pension pool as the age bracket 20-64 is projected to continue its decline (Barr, 2006). The projected impact of State pensions on the public purse did not anticipate these major demographic shifts, and Anglo-American governments have reacted with various reforms such as increasing the statutory retirement age, reducing entitlements, decreasing tax incentives and increasing immigration (Dale, 2012; Hannah, 2002). The main reform was to privatise significant proportions of pension provision to the finance industry (McSweeney, 2008; Deakin, 2005; Stephen and Backhous, 2003) and in October 1986 the Thatcher government deregulated the finance industry in the UK to this end (Davies et al., 2010).

While much attention has been paid by governments and researchers to US Social Security and UK National Insurance funding gaps “little or no scrutiny” has been paid to the sustainability of the relatively new welfare capitalists – the private pension sector (Boatright, 2011; Blackburn, 2006). This is why the thesis is important, the industry provides financial products designed to comfort the member (consumer) who requires access to social goods (health care, education, retirement security) which can be purchased out of current salary and will be adequately and assuredly provided above subsistence in the future (Klumps and McCrea, 1999). However, numerous misadventures in the private pension sector, from corporate looting of pension funds (for instance Robert Maxwell in Kutsch and Lizieri, 2005) to product miss-selling (for instance Equitable Life in

Handley-Schachler et al., 2007) or the “fiasco” of Tony Blair’s attempt to revive British pension prospects by means of ‘partnership’ with the financial services industry (Barr, 2006), caused the government’s own Pensions Commission to describe private pension provision as ‘not fit for purpose’ (Blackburn, 2006; Note 23). This lends itself to a reflection on what the role and function of the pension supply chain actually entails.

During a conference on Investing in Responsibility, London in 2011 one of the speakers was the Chief Responsibility Officer for one of the largest Fund Managers globally. He was talking about their product offerings in active ownership and non-financial performance screening over the equities they place and manage for pension funds, saying that these equities have a fiduciary responsibility to their shareholders (in this case pension funds) to maximise returns to pension schemes. When asked “do publicly listed shareholders own companies?” apparently bemused, he said yes. His fund management corporation is publicly listed and talks in its investor relations literature about its responsibility to its own shareholders, and how they have grown their own profitability for shareholder benefit over the last reporting periods. To do this their corporate objective is to charge fees for pension asset management, and presumably maximise these for their shareholders’ wealth growing ambitions. This was the genesis of this thesis. It grew from the desire to know whether shareholders are the owners of corporations, and if so, when those corporations managing the social savings of the general workforce, do their shareholders deserve a higher duty of investment care than the pension funds they manage? Boatright (2011) and Monks (2002a) believe they do not. Maximising the fees and charges they demand for their expertise are the means of providing codified fiduciary care to their shareholders. If that expertise equally benefits the pension contributors with returns over market where the contributors bear "virtually all the [financial] risk," (FCA, 2016; p7), there should be no fiduciary conflict. However, where the fees and charges erode the rightful returns on investment to pension contributors a conflict arises where the fiduciary responsibility to one principal whose assets they manage disadvantages the principal whose assets they also manage, and whether the rightful direction of duties to exercise financial expertise become unclear, or even unjustifiable. The thesis places its foundations in the premise of the academic reasoning for the existence of financial intermediaries (Allen, 2001). From an economic efficiency perspective, financial intermediaries only exist to add benefit to the counteracting parties, and have no role if they bring no benefit to net asset growth for the social sector who comprise their client base.

This is wholly aligned with the observations of the Financial Conduct Authority Interim Report (FCA, 2016; p11): "the evidence suggests there is weak price competition in a number of areas of the asset management industry. This has a material impact on the investment returns of investors through their payments for asset management services." The theory of financial intermediation suggests that the pension supply chain should be naturally competitive (Allen, 2001; Allen and Santomero, 1997; Ramakrishnan and Thakor, 1984), supplying services that aid and abet the efficient exchange operation of the market place. They have no reason for existence if buyers and sellers can find each other and negotiate in light of perfect information without them (Allen, 2001). Yet the funds management business is one of the largest growth businesses in the finance industry (Malkeil, 2011). The FCA investigation into competitiveness in the market concurs with Malkeil and has been critical in its initial assessment of fee pricing (FCA, 2016).

The industry has been criticised for seeking advantage from the boon of compulsory social savings to charge for management (Monks, 2002a; Boatright, 1999), yet little confirmation has been forthcoming into the duties the finance industry has to these savings and whether any duties to protect them are legally owed. Over the time of the thesis, three significant enquiries were enacted: 1) The Kay review (2012); 2) The Law Commission Review (2013); and 3) The Financial Conduct Authority Review (2016). Each had a remit to investigate the operation of the financial services supply chain and how it supports the sustainability of the net investments of the pensions industry. Their joint findings were critical of the operation of the finance supply chain in the efficient management of social savings. The thesis contributes to the continuing investigation into the equity of, and fiduciary responsibility to pension savings governance.

The literature proposed that any analysis of the finance industry requires a fundamental understanding of how the underlying nature and role of the markets have been socially constructed and understood (Ardalan, 2007). Most occupational pension funds are compelled by law to act as trustees for contributing beneficiaries for the “exclusive purpose of providing benefits to them and defraying administrative expenses,” (Greenwood, 1996). In the examination of the purpose of a financial intermediary firm, the thesis initially examined whether shareholders could or should be considered the owners of firms, able to distract from this purpose in the investment supply chain.  There is much evidence in the literature that shareholders are not the owners of firms (Lan and Heracleous, 2010; Verret, 2010; Bainbridge, 2002; Iwai, 1999).  They are the owners of shares traded exclusively on a stock market, and not owners of the underlying corporation or corporate purpose (Anabtawi and Stout, 2008; Ryan and Stout, 2003; Stout, 2003).  This contributes to the importance of the foundation of the thesis, as it raises the question of whether this “principal” has countermanding fiduciary sway over the loyalties of the firm if they do not technically own it.  Comparatively, the pension principals’ assets are important to understand and protect in fiduciary as the fund manager wholly acting for the benefit of their beneficiaries’ private property in any financial management contract they enter.

The aim of the thesis is to investigate whether the corporate governance of professional fund managers with pension clients influences asset management outcomes for the UK pensions industry.  It proposes to achieve this aim through a set of four research objectives.

1) To describe the various corporate governance structures of the professional fund managers with UK pension clients;
2) To investigate whether different corporate governance characteristics of professional fund managers relate with characteristics of their pension clients, and whether particular pension client attributes mitigate any negative corporate governance correlations;

3) To investigate whether pension clients perceive that the corporate governance of the fund manager matters to the governance of asset management for their beneficiaries; and

4) To determine whether pension clients believe the fiduciary duties of professional fund managers conflict with the delivery of outsourced asset management.

## 8.2 Why this was a current imperative

Despite a raft of pension legislative reforms in recent decades, the UK pension system continues to be criticised as overly complex and opaque (Bozio et al., 2007). There are three tiers to the UK pension apparatus, each providing a contributing member of the workforce with different benefits and administrative costs (Barr, 2006). The first is the Basic State Pension (BSP), the stipend paid from the compulsory contributions to the National Insurance Fund. The second is the voluntary Second State Pension (S2P), replacing the State Earnings Related Pension (SERPS) in 2002. The main objective of these two State pension systems when taken together is only to reduce old age poverty (Bozio et al., 2010). The third is the voluntary occupational pension system, administered outside the government fostered system (Bozio et al., 2010). The government has long embraced the idea of privatising pension provision to take advantage of the theoretical efficiency virtues of the market (Dixon and Hyde, 2003). In the markets, theory has it that private pension provision can meet the demographic challenge of the aging population more efficiently than State provision by assuming financial risk and commanding extraordinary financial performance from its pooled assets (Clark, 2004). This requires the academic virtues of market efficiency to translate into empirical reality.

These two material risks are neatly addressed by Clark and Urwin (2007), one a noted pension governance academic, the other a well-known practitioner with Towers Watson, commenting:

> If nation states are to redesign pension and retirement income institutions to cope with twenty-first century imperatives like demographic ageing, the sustainability of plan sponsors, and the increasing premium on (and visibili*ty of) financial performance, issues of structural design must be* considered in relation to institutional governance.

Keith Ambachtsheer of Harvard Business School concurs (Ambachtsheer et al., 2011, Ambachtsheer, 2007) declaring their inherited current form “not fit-for-purpose”. This presents a challenge to the newly conceived finance industry in establishing their responsibility for pension management. Should it be that the industry 1) use their new inter-temporal role as pension custodians to deliver adequate returns on investment to achieve retirement for members today while protecting the savings contributions of future generations (Monks, 2002a); 2) use their new role as institutional investors with vast capital at their disposal to influence the long term sustainable value creation activity of the entities in which they are invested (Sparkes and Cowton, 2004); or 3) fulfil their traditional role as institutions with shareholders of their own, to protect and serve the interests of their shareholders as fiduciaries with duties to the commonly understood owners of the corporation (Bebchuk and Weisbach, 2010).

This is where fiduciary ambiguity enters the new pensions governance environment (Boatright, 2011). Pension trusts have clear and legislated fiduciary responsibility to their trustees. However, few have the financial expertise to adequately discharge this duty. The financial intermediaries that purport to take on numerous ownership structures, from partnerships to global listed corporations (Ingley and van der Walt, 2004). In Anglo-American corporate governance regimes listed corporations have codified fiduciary duties to "the company and its shareholders" (Waring, 2006). Karns (2011) believes these duties are commonly understood to be the requirement to maximise shareholder wealth. Where a fund manager has both shareholders and pension clients their primary fiduciary duty is (but should not be, according to Monks (2002a)) to the shareholder. Juntunen (2007) also believes the landscape is shifting: "…the ownership structure of many consultancies changed from partnerships to corporates where the goal is to boost shareholder assets". This confronts the issue of conflicts of interest central to the academic contribution of the thesis; whether corporations are appropriately nonaligned to be financial intermediaries for pension funds. To determine this, the thesis investigated whether there is a discernible difference between the funds managed by listed corporations and those managed by alternative structures. It also explored whether there was a difference between economies that are more aggressively pro-shareholder and those less inclined to this pursuit.

### 8.3 The nature of the contract between the pension scheme and fund manager

The contractual relationship between the pension scheme and fund manager exhibit typical principal-agent characteristics, where the principal lacks the expertise to carry out a task and enlists the agent with relevant expertise to act on their behalf (Eisenhardt, 1989). The law of agency confers strong commitments on the agent to protect the principal and avoid using their advantageous position to the principal’s detriment (Lan and Heracleous, 2010). Protecting the suppliers of finance needs to acknowledge that managed funds dwarf equity financing on the balance sheet of financial intermediaries (Clark, 1976). Clark (1976) describes shareholders of finance giants as "elite suppliers of capital" typically less numerous, wealthier, and suppliers of a smaller and static proportion of the funds under management. As the 2007 financial crisis demonstrated, it was excessive leveraging in pursuit of shareholder wealth maximisation to the point of illiquidity that led to the socialised rescues of some of the largest banks around the world (Liedekerke, 2013; Graafland, 2011; Shahabian, 2011). Although poor quality macroeconomic policy and economic shocks often play a major part in financial instability, Handley-Schachler et al. (2007) accuse inadequate risk management within the finance industry as the cause of most episodes of financial system distress that wiped trillions of dollars from pensions globally, and view the frequent cause of poor risk management being inadequate corporate governance. Some scholars have suggested that the shocks to the economy of poor risk management are final proof that the social responsibilities of financial intermediaries are special and specific (O’Brien, 2012;

Das and Ghosh, 2004; Green, 1989). They not only have weighty obligations to contributors, they are central to market making in global economies (Macey and O'Hara, 2003). Given the theory of financial intermediation, where intermediaries are compensated for the efficient costs of information aggregation and exchange facilitation, many scholars view finance corporations governed by the shareholder wealth maximisation axiom of the real economy as a threat to market efficiency and stability (Losada, 2013; Macey and O'Hara, 2003; Kangis and Kareklis, 2001).

Academics in both law and economics have paid little specific attention to the corporate governance of financial intermediaries despite the significant amount of attention being paid to the role that the intermediaries themselves play in demanding good governance in the equities under investment (Macey and O'Hara, 2003). In an efficient capital market losses should be borne by the bearers of that risk. If the downside of losses can be outsourced, leveraging to dangerous extremes in pursuit of shareholder value maximisation becomes risk free to shareholders, resulting in the relationship between risk and reward becoming uncoupled. Macey and O'Hara (2003) warn of this moral hazard, where the pension scheme bears the entire loss of poor investment choices yet still mostly pays a performance fee to the fund manager. Kolb (2011) sees this breakdown in the risk/reward relationship as a distributive justice issue where shareholders and executives become handsomely compensated despite the risk borne by pension contributors and society more widely.

Regarding this remuneration arrangement, Chapter 3 of the thesis explored the legal nature of the contract between the pension scheme and fund manager to confirm that the courts consistently find that no fiduciary duties arise between principal and agent. The relationship is wholly determined by the terms of the contract. Contract law assumes that the counterparties meet on equal footing, yet some suggest that this is not always the case between, for instance, that between a small pension fund and large fund manager (Anabtawi and Stout, 2008). Malkiel, 2013 concurs:

> From 1980 to 2006, the financial services sector of the United States economy grew from 4.9 percent to 8.3 percent of GDP. A substantial share of that increase was comprised of increases in the fees paid for asset management. This paper examines the significant increase in asset management fees charged to both individual and institutional investors. Despite the economies of scale that should be realizable in the asset management business, the asset-weighted expense ratios charged to both individual and institutional investors have actually risen *over time…*fees have risen substantially as a percentage of assets managed.

## 8.4 Exploring the agency of the relationship: Are fund managers delivering value for money?

The role of the financial intermediary is to direct the flow of pension capital to the real economy for a return on investment to the capital they are placing (Walter, 2004). The price they charge to do this should theoretically be the point at which supply equals demand where substitution is readily available (Spithoven, 2005). The theory of intermediation implies that the buyer and seller will not require an intermediary if that function adds no value to a transaction (Allen and Santomero, 1997). One of the main roles of intermediary is that of overseer to provide accountability that firms are efficiently using society's resources to the end investor (Liedekerke, 2013).

Analysing value for money is crucial to understanding whether pension funds management is currently appropriate. In the behavioural analysis of capital channelling Franklin Allen (2001, p1165) asked "do financial institutions matter?" He continues (Allen, 2001, p1166) argues "how can it be that when you give your money to a financial institution there is no agency problem, but when you give it to a firm there is?" The narrow focus of corporate governance theory remains on traditional corporations, and financial intermediation theory assumes an institution-free finance industry, so these phenomena have not been analysed together (Bogle, 2009). Agency theory has been rarely used to examine whether financial intermediaries deliver value for money. The analysis of financial performance has been dominated by finance theory, and the comparison of risk adjusted returns compared with an agreed industry benchmark.  Again, Malkiel (2013) makes an important observation in this regard:

> One could argue that the increase in fees charged by actively managed funds could prove to be socially useful, if it reflected increasing returns for investors from active management or if it was necessary to improve the efficiency of the market for investors who availed themselves of low-cost passive (index) funds. But neither of these arguments can be supported by the data. Actively managed funds of publicly traded securities have consistently underperformed index funds, and the amount of the underperformance is well approximated by the difference in the fees charged by the two types of funds.

This was a challenge for the research in an industry Harrison (2012) describes as rife with an absence of transparency.  The FCA (2016; p16) again concurs in their interim findings: “The transparency of charges has been under scrutiny and debate for some time.”  The thesis propositions were established from the literature a priori to the investigation.  It established there was reason to explore whether fund managers with external shareholders potentially charged higher fees and charges or provided less value for money than fund managers with internal ownership structures for the purpose of the corporate governance rubric of shareholder wealth maximisation.  This is consistent with the FCA (2016; p13) interim findings:

> We have found considerable price clustering for active equity funds, with many funds priced at 1% and 0.75%, particularly once assets under *management are greater than £100 million. This is consistent with firms’* reluctance to undercut each other by offering lower charges. We also note that as fund size increases, price does not fall, suggesting the economies of scale are captured by the fund managers rather than being passed onto investors in these funds.

If the theory of financial intermediation were to hold true, these economies of scale would exist and investors should not seek inefficient intermediation. However, under agency theory it could be hypothesised that the principal with little financial expertise needs to incentives the agent to apply their own expertise to growing the pension assets. With no access to research information on the fees and charges embedded in the contracts between the fund manager and pension scheme, the relationship had to be discerned by alternative means in the research. By comparing the pension scheme assets with the corporate governance traits of the fund manager, observations could be made of any evident trend. In the first analysis of the relationship there was no direct connection between the corporate governance traits and the size of the assets of a single member. These were the result of the direct relationship proposed in the a priori set-up of the agency theory hypothesis, suggesting agency theory was neither predictive nor prescriptive in analysing pension governance behaviour. However it is observed in this analysis that the average assets per member, at £87,000 represent an insignificant sum of money to support to support an average of 15 years life expectancy post retirement. This raised the need for further research addressing leakage through the entire pension supply chain, not only through funds management, but also other services such as custodial services, consulting advice, actuarial services, etc.  It also concurs with the findings of Malkiel (2013) and Sharpe (2015; 2014; 2013) supporting the observation that risk-adjusted **net** returns flowing from the schemes are not currently academically or practically justifiable in the pensions management industry.

The interesting and exceedingly relevant finding from this analysis was in pension scheme behaviour (the interaction between the fund manager agent and pension scheme principal).  Small pension schemes (by assets under management) gravitated towards large, publicly listed fund managers, mostly in the UK and typically a smaller number of managers engaged (the majority with just one). However, large pension schemes were overly represent among fund managers with internal ownership structures and were far more likely to invest abroad and with multiple fund manager engagement.  This finding had important ramifications for the survey of trustees.  The thesis proposed that pension scheme size would ameliorate the moral hazard of overpayment for management services by negotiating from a position of power (See Section 8.4 for a discussion of the relevance of power in the theories of business).  Again, this is in keeping with the FCA (2016; p19) interim report, noting “[t]he amount of assets also affects oversight committees’ bargaining position, with smaller schemes being less able to secure discounts from asset managers.”  However, the direction of the relationship is indeterminate - do smaller schemes gravitate towards large fund managers, or do large fund managers, who tend to be listed entities, make schemes smaller through appropriation - and so the rationale for selection needed clarification from the trustees themselves. The thesis also proposed that engaging multiple fund managers would avoid the adverse selection of an underperforming fund manager. Under this proposition it is the principal's problem when entering the relationship at being unable to properly estimate potential for performance through lack of information (Mande et al., 2012; Cormier et al., 2011). Reflecting previous observations on a lack of transparency, comparison between managers should be more available when the pension scheme has two or more management contracts to contrast, rather than relying on third party or anecdotal information. However the findings suggest that not only do multiple fund managers fail to be reflected by more assets per member, they are negatively (however not significantly) related to the member's assets. These findings had important implications for the development of the survey as to the rationale for both selection routes. They also correspond neatly with the FCA (2016; p15) two-fold observations: 1) "actively managed investments do not outperform their benchmarks after costs"; and 2) "there is no clear relationship between price and performance…before or after costs". In other words having the administrative burden of engaging 2+ underperforming fund managers is more burdensome to the fund than having just one.

It was an imperative to interrogate the trustees making fund manager selection decision why, as it seems fund managers are adding little value to the benchmarks, they were being selected and on what basis. These decisions should be made by duty-bound and rational trustees to augment scheme value. Holland and Johanson (2003) see the fund manager value creation model as information aggregators. Information on market risk is communicated to pension schemes, removing the requirement for their own (purportedly less informed) analysis. Eichberger et al. (1999; p136) report on empirical examinations of the performance of equity investments in mutual funds that “seem to subtract rather than add value relative to the performance of the SandP 500 Index”. They also suggest that fund managers may actively ‘herd’ with other funds on similar assets. In a related field, Mahoney (2004) finds the literature on mutual funds focuses primarily on whether stock selection efforts generate additional returns that justify the associated fees and transaction costs, while treating the mutual funds’ actual governance as a black box. Houge and Wellman (2005) document how mutual funds have regularly employed trading strategies that increase fees while diluting shareholder returns and yet have escaped governance reforms. If the governance of a financial intermediary can be observed to destroy investor value with regularity, it would seem logical to conclude that this governance should be of immediate concern to pension trustees with fiduciary duties.

The survey had two main questions: 1) do trustees use any agency theory criteria in selecting a fund management agent that may suggest non-financial performance is an important predictor of future financial performance?; and 2) do trustees believe their agent has a fiduciary duty to manage assets in the pension scheme’s exclusive best interest? Between 2010 and 2015 the average profit of a fund manager rose by approximately 80%, while over the same period the assets they manage grew by only approximately 68% (FCA Annex 8: p9). In light of thesis statistics it was important to understand if trustees thought fund managers were operated for shareholder wealth maximisation, and whether this was a fiduciary duty when no such duty was owed to them. For instance, two of the largest fund managers globally (Legal and General and BlackRock) had significantly lower assets per member in the pension schemes they were managing than the general client population. Regardless of the size of the schemes they were managing. Box 7.1 looked at the case of Legal and General specifically to illustrate how, even as their aggregate fund performance was consistently rated poorly, their share price showed consistent growth. Interestingly, the (statistical) majority of respondents to the survey recorded Legal and General as holding their largest mandate. There was very little evidence that any corporate governance (agency) traits were considered in the selection process, with typical finance theory traits of asset class expertise, past performance and reputation all weighted higher in the selection process than any concepts of fees or value for money. This is an important contribution of the thesis to the literature as while it is regularly observed that fund managers do not add value, the fact that traits of the fund managers persistently underperforming has not been examined.

In further confirmation that agency characteristics were not incorporated into selection processes, the importance of managing the fund manager's own shareholder pressure was the lowest rated selection consideration of all those considered by the survey with 34% of the survey declaring it unimportant. This reinforces the view from the literature that finance theory characteristics continue to dominate the selection criteria in funds management. The contribution of the thesis to the FCA investigation has important implication for future research. The FCA (2016; p17) suggested that the factors driving fund manager choice were return achieved, price paid, risk taken and quality of additional services. However, they conclude that past performance is not a good indicator of future risk adjusted returns for two main reasons: 1) there is often no accurate comparability between past and future performance as portfolios are fluid (changing mandates, merging, closing or even liquidating); and 2) "The academic literature shows little evidence of persistence in outperformance. In other words, managers that outperform in one year do not reliably outperform in future years." They conclude that most pension schemes think of value for money as simply risk-adjusted returns. The implications for future research is in the thesis findings that this view is prevalent in pension schemes engaging PLC fund managers (86% of the respondents that expressed this view were outsourcing to PLCs, yet only 29% of respondents who viewed value for fees as the key performance indicator believed net value for cost was a key performance indicator). This finding is not explored in the literature, and implies that there is an agency effect at play supporting the earlier herding findings that smaller pensions outsource to marque brand fund managers with large marketing budgets and the ability to merge and adjust performance data across portfolios with more ease and less visibility than smaller fund managers. It is possibly in the belief that this reliance on the high profile brands discharges the pensions' fiduciary duty regardless of the lack of comparability across fund managers of different size and orientation.

William F. Sharpe is the Nobel Prize winning economist and father of thought in the development of the Capital Asset Pricing Model (CAPM). Over the past three years he has made possibly controversial contributions to this trend in pension fund management. In 2013, Sharpe (2013) agreed with Kinnel, (2010; p2-3): "In every single time period and data point tested, low-cost funds beat high-cost funds. . . . Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance." This is not modelled by the CAPM, and yet has come to be more important to the value proposition investors receive from an agent manager as time has gone on (Sharpe, 2014). This intimately implies that the decisions fund managers are making on charging clients for the management of their funds has increased in importance to one of the seminal thinkers in finance theory of our generation. In 2015, Sharpe (2015; p1) told a group of college students at Stanford University:

> Why should you be interested in the subject of financing retirement since *you haven't* even started your working career? For two reasons. First, you will almost certainly receive some retirement income from a social (government) policy designed to provide a minimum standard level of living. You should understand the issues associated with such programs as both a participant and a citizen. Second, you will probably need to save and invest a considerable part of your earnings to provide the overall standard of retirement living you would like. The more you know about this subject, the better.

The more research in this area that can shed light on the costs and benefits of the pensions supply chain to aid in this regard must be considered an academic research imperative. At its heart involves the increasingly complex issue of the fiduciary duty in finance. According to the business ethics canon, When the college students William Sharpe addressed are naïve to their need to care about the management of their own retirement funds, the finance industry has a duty to protect their best interests in providing this care as the manager of their private property interests (Boatright, 1999).

This brings the final contribution of the thesis neatly into light. The fiduciary duties behoved to the finance industry's responsibility to pension funds that has been greatly overlooked by pension governance research to date in the literature and practice of investment responsibility. There are two issues at play here: 1) Financial intermediation implies a race to the bottom must exist for the market to be considered as efficiently operating (Allen, 2001); and 2) Finance ethics implies that a fiduciary duty arises when one party is managing the private property of another (Boatright, 2011). The first issue is the conundrum expressed, not by means of fiduciary concern in the FCA Review, but rather as weak price and competition control, so where is the race to the bottom in terms of efficiency and transparent, readily available competition. The FCA has noted its instrumental concerns over the lack of competition in the market and has expressed an interest in addressing this through regulatory reform. The second issue is, as expressed in more normative terms by the Kay Review (2012) and Law commission Review (2013), the lack of fiduciary clarity throughout the pensions investment supply chain.

In the survey of pension trustees, respondents were asked binary questions on their views of the fiduciary nature of funds management in the pensions supply chain. This is an area of contribution for the thesis that is of great importance as it highlights the different opinions of trustees engaging alternative fund manager entities. Firstly, a fiduciary duty is a duty over and above the contract between parties to protect the assets of an investor subject to information asymmetry (Anabtawi and Stout, 2008; Boatright, 2000). This is descriptive of the average pension contributor and pension trustee (Clark, 2004). In the survey data there was consistency over the fund manager selection structures on whether fund managers should have a fiduciary duty to pension schemes (88%) yet very different opinions on whether they do (52% PLC versus 87% private entity engagement). One of the defining outcomes of the thesis is that this discrepancy is in need of urgent policy address. The conclusion reflects on whether there is need to consult with the FCA enquiry on the appropriate corporate vehicle for funds management in the supply chain to protect pension investments, such as auditing and legal firms that were historically required to be partnerships to avoid sheltering behind limited liability in their discharge of duties to clients (The Law Society, 2013; Oxera, 2007). It also suggests further investigation into why these discrepancies exist between the opinions of the pension selectors of the fund manager structure and duties most appropriate to them.

## 8.5 Contribution of the thesis to academia

There are two main contributions to academia: 1) A review of whether shareholders the owners of firms under the theory of the firm; and 2) A review of the theories from the Academy of Management best explain and interpret the fund management phenomenon. The first questions whether academia has advanced enough to answer the question of an appropriate corporate vehicle to manage pension wealth when the legal ownership question is still under debate. The second questions whether we yet have the appropriate theoretical tools to examine this question of the vehicle and its duties prescriptively and predictively.

Kuhn (1962) tells us that a theory in a scientific discipline can persist as a dominant paradigm until it no longer adequately explains or predicts empirical observations. At this time rival theories will be accommodated in attempts to restore normative and predictive legitimacy. Jensen (2001; p14) describes this phenomenon as it applies to business and economics: "In the last few hundred years a theory of market exchange based on property rights and freedom to act has come to dominate academic thinking". Described as "managerial capitalism" by Freeman (1984) it faces mounting pressure to address criticism Jensen (2001) pronounces as a lack of normative substance, nor grounding in the emerging theories of human behavioural influence over the firm, and a general questioning of the fundamental purpose of the corporation. Freeman's stakeholder theory came to prominence in the business ethics literature to rethink shareholder capitalism, the dominant model of the firm he claims is "no longer workable, resistant to change, not consistent with the law and for the most part, simply ignores matters of ethics" (Stieb, 2009; p401). With the fundamental understanding of the firm in question, academic scholarship continues through the fields of economics and business, now joined by political, social and behavioural fields, to take positions in a stakeholder versus shareholder debate. However, this does not suggest that stakeholder theory has yet represented Kuhn's subversive paradigm as a researchable tool for empirical investigations.

The premise of stakeholder theory that is relevant to the thesis is that the firm has relationships with many constituents that can affect or are affected by its decisions (Jones and Wicks, 1999). Key (1999) accords Freeman's 1984 work "Strategic Management: A Stakeholder Approach" the closest attempt at developing a new theory to challenge the old. The interests of "legitimate" stakeholders hold intrinsic value and no one group can assume to dominate the rights of others when it comes to management decision making, overturning the existing paradigm of shareholder bias. It was important to consider this development in the creation of the research, as pension clients represent exceptionally legitimate stakeholders to fund management organisations.

Freeman (1994; p410) acknowledges, when describing a multi-fiduciary interpretation, that stakeholder theory is pragmatic; less about "what is true" in favour of "how should we live," concluding "there is no such thing as stakeholder theory...[but] a genre of stories about how we could live". Therefore, not designed as a theory, it is a way of thinking about the firm that challenges the dominant paradigm. However, testing this pragmatically through empirical methods was problematic given its purely normative nature.

One of the limitations of agency theory considered by the thesis design was its inability to consider negotiating power when the agent has two (or more) principals. If the fund management firm wields enormous power (as Carroll (1996) has no doubt is the current consensus), does this premise naturally lead to the conclusion that business as usual is abusing power? Mitchell et al. (1997) use a Weberian definition, "the probability that one actor within a social relationship would be able to carry out his own will despite resistance", and describe the wrestle between power and legitimacy challenging most major theories of the firm (agency, behavioural, institutional, population ecology, resource dependence and transaction cost theories). Power can take different forms; physical (force), utilitarian (finance) and normative (symbolic), or the more firm centric interpretation of economic, voting and policy (Greenwood & Van Buren 2010). Managers could reasonably be expected to pay attention to the stakeholders who can reward or punish them. Indeed, power does not always reside with the shareholder, as stakeholder theorists advocate. Mitchell et al. (1997) reference minority shareholders and Greenwood and Van Buren (2010) the ability shareholders have to vote in the board of directors, but not to nominate them or vote on most other activity. This was the genesis of the proposition that traits of the pension scheme have the ability to mediate the power of the fund manager over dictating the terms of the funds management contract. According to the review undertaken by Mitchell et al. (1997) stakeholder theorists such as Freeman and Evan (1990), Hell and Jones (1992) and Cornell and Shapiro (1987) already view stakeholders as contractors or "participants in an exchange relationship". Freeman (1994; p412) says "start with the presumption of equality among contractors rather than the presumption in favour of financier rights" where a fair contract is one both parties would enter if unaware of their side. However, in a market place of contracting parties with unequal power contract law does not provide stakeholder theory with the rigour required to become a competing paradigm. Jensen (2001) says this about the stakeholder theory premise:

> New laws are constraining corporations in a way they once were not: therefore we have to (or should) change the beneficiaries of business from the stockholder to the stakeholders and give the stakeholders *serious decision making power…. Clearly, the conclusion need not follow* from the premise. The conclusion that we should or in fact are changing the beneficiaries and the decision makers from stockholders to stakeholders does not follow from laws preventing violations of the rights of stakeholders. Civil tort law regulates the relations between aggrieved parties. Such a remedy does not change beneficiaries nor award any greater decision making power to the plaintiff that she did not already possess as a right.

As the research established, the courts have asserted that the fund management contract is the binding agreement and the rights of pension schemes to a fiduciary duty from the fund manager has not been established by judge-made law. At the basic level Jensen (2001; p12) writes "the real issue is what corporate behaviour will get the most out of society's limited resources… not whether one group is or should be more privileged than another". Jones and Wicks (1999) believe stakeholder theorists find the reduction of human behaviour to a set of simple assumptions necessary for modelling to be inappropriate as it overly simplifies the very complex, however agency theory demands this. Freeman (1994), citing the Nemo Dat principle of protection in law, says shareholders can't expect managers to disobey reasonable community standards of ethics (neither principal nor agent can claim the agent has moral immunity). The academic contribution of the thesis is to highlight the flaws in agency theory in a multiple-principal environment where no aspects of social construction are considered in the reductionist economic modelling of compelling the agent to act on the principal's behalf through monitoring and incentivising. However, it asserted that it is the only academic theory currently available to study the phenomenon of corporate behaviour and motivation in the currently held view of pensions research that the financial intermediary is simply a vessel for pension funds to be placed into real world assets. In the funds management industry under investigation, this leads to the necessary further contribution to policy on consideration of the position that fiduciary duties hold in the management of social savings under such a reductionist theoretical view. Where academia's prescriptive and predictive theories fail to describe the phenomenon, the future response of the polity is paramount in guiding future research into fiduciary care.

## 8.6 Contribution to policy

The thesis came into being at a time of deep reflection into the financial services industry by numerous regulatory authorities (See Section 8.3). No longer an industry of bespoke bankers and brokers, it is now one of the most significant industries in the Anglo-American economies (Malkiel, 2013). The research showed that trustees have a confused and undefined understanding of what extra-contractual relationship they can demand of their pension supply chain. In the 1960s Nobel economist William Sharpe modelled a ground-breaking tool for modelling financial portfolio risk and return in the 1960s – the Capital Asset Pricing Model (CAPM) (Sharpe, 2014). It has formed the foundation of Modern

Portfolio Theory and established the still prevalent assumption that investment value for money can be assessed on risk-adjusted returns alone, without accounting for the cost of investment (or value for money). Financial returns should be modelled on risk diversification in portfolio design alone. In recent years Sharpe has turned his attention to the pension problem with a significant departure from his original doctrine of an agency free environment for the development of financial portfolios. His comments reflect the findings of ambiguity in fund manager selection highlighted in the thesis survey:

> Recent regulatory changes have brought a renewed focus on the impact of investment expenses on in*vestors'* financial well-being. The author offers methods for calculating relative terminal wealth levels for those investing in funds with different expense ratios. Under plausible conditions, a person saving for retirement who chooses low-cost investments could have a standard of living throughout retirement more than 20% higher than that of a comparable investor in high-cost investments. (Sharpe, 2013; p34)

Charles Ellis (2012; p4) wrote an article titled "Investment Management Fees Are (Much) Higher Than You Think," in which he argued that as a percentage of assets, such fees do look low, but calculated correctly, as a percentage of returns, fees no longer look low. Investors should consider fees charged by active managers not as a percentage of total returns but as incremental fees versus risk-adjusted incremental returns above the market index. Kinnel (2010; p2) concurs: "If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds. . . Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance."

However, the research was conclusive in its findings on value for money being a secondary consideration for pension trustees, particularly those outsourcing to a listed fund manager. This leads to the significant contribution that fund manager governance matters to the selection framework. The FCA (2016; p17) made the observation in their interim report under the title "Factors that drive investor choice":

> The investor community is a diverse mix of individuals and institutions. However, we found broad agreement that value for money for asset management products is seen as a combination of the:
>
> - return achieved
> - price paid
> - risk taken
> - quality of any additional services provided by the asset manager
>
> This means that most investors generally think of value for money as risk-adjusted net returns. We found that a key focus for retail investors and, to some extent, institutional investors when choosing between asset managers is past performance. However, past performance is not a good indicator of future risk-adjusted net returns for two main reasons.

> First, it can be difficult to interpret and compare past performance information. Funds set up at different times will measure performance over different time periods, which can make comparison difficult. The performance of one fund might be measured more frequently than *another, which can affect the perceived volatility of the fund's* performance, especially over periods of volatility in the relevant market. Funds that perform poorly are often liquidated or merged into another fund, giving investors the false impression that there are few poorly performing funds on the market.
>
> Second, even if past performance were easier to interpret and compare, past performance has limited value as an indicator of future performance. The academic literature shows little evidence of persistence in outperformance. In other words, managers that outperform in one year do not reliably outperform in future years. Previous UK analysis has found that the majority of funds with historical outperformance do not continue to outperform the relevant market index or peer group for more than a few years.

When interpreting the research findings alongside the observations of William Sharpe and the FCA, both concur that fees are a significant issue in fund management selection criteria, yet the research finds that trustees do not account for this in their analysis of fund manager quality or value for money. The research also found that while overwhelmingly pension trustees believe that fund managers should have a fiduciary duty to pension trusts, only half believe they do (see Figure 7.3). Further, while the majority believe that these fiduciary duties should override the duty fund managers have to their own shareholders, only a small minority believe they do, more pronounced among contractors of privately owned fund managers than those engaging PLCs. Conversely, and contrary to the survey responses that finance theory criteria such as portfolio benchmarking drive fund manager selection, the majority believe that governance information on fund managers should be transparent to the fund management selection process. These gaps and contradictions are imperatives for further research informing policy development and the continued joint narrative between the contributions of academic pursuits such as this thesis to the future of policy development.

### 8.7 Limitations to the research and further enquiry

The theory of the firm has not yet concluded whether shareholders are the rightful owners of firms and rightful recipients of their residual claim. This is an important area of future corporate governance research, both from a legal and economic perspective. The research highlights much ambiguity in the common understanding of to whom and for what purpose a firm should be focused. This has deep and abiding consequences for funds management and the finance industry in general. The thesis was unable to conclude this matter, other than the speculation of a small sample of pension trustees on this issue, and it remains in the realm of corporate law and firm theorists to finalise the duties financial intermediaries have to the fiduciary care of all stakeholders in their societal sphere. Transparency (the lack there of) in the industry impairs this research currently, acknowledged by the broad range of scholars discussed. This is reflected in the paucity of data collection opportunities and still seeks empirical techniques to assist empirically robust investigations into the field of pension governance that avoids the reductionist nature of agency theory investigations. While it is important to note that the survey was completed by some of the largest pension schemes in the UK – thereby providing a view of a majority of UK members – it fails to capture the perspectives of smaller funds, ones that the FCA believe could benefit from collective bargaining and a more transparent contracting platform. This self-selection bias was recognised by the ONS in their own methodology. The research design does not capture the influence that pension consultants have over the fund management selection criteria, and this is an area of further research that is a definitive gap in the literature. These opportunities for further research were highlighted by the thesis as a result of its findings, rather than being currently expressed in the literature. It is a sincere hope that this research can assist regulatory authorities in shedding light on this social issue outside the parsimony of economic agency or financial theory, the current philosophies that continue to dominate pension governance decision making.

### 8.8 Conclusion

One of the most important voices in this industry who originally advocated a finance theory view of investment assessment, William Sharpe (2014) spoke at interview in 2014, articulating the importance of the thesis:

> Are public pensions a problem? You bet. Is this a disaster? You bet. The true liabilities of the public pensions in the United States—by which I mean governmental pensions—are, according to the actuaries, much larger than the assets. Using any sensible economic view of the value of those liabilities, the difference in value is astronomical. *It's a crisis of epic* proportions.

The view that funds managers are the Svengalis of knowledge on how to achieve long-term returns on pensions assets for reasonable value is not supported by current research, and yet this thesis has highlighted that it is still the current view among pension governance decision makers in their fund manager selection process (the bigger and more high-profile the fund manager the better). Stock market driven capital allocation did not occur until the twentieth century when corporate equity could be broken up into small shares and sold en masse to passive investors, leaving management with practically unshackled owner control, seminally captured by Berle and Means in 1932. Discussed in Chapter 2 was their observation that share ownership was so removed from control over the underlying asset that it bore only passing resemblance what was commonly understood as private property. However, it is possible that corporate control has shifted back to institutional owners in what has come to be called “investor capitalism” (Ryan and Dennis, 2003). Stock market manipulators, as owners, have currently come to assert increased levels of control over the corporate pursuit of their wealth maximisation. In this process, Brinkman and Brinkman (2002) see the making of money rather than the production of goods servicing society’s needs has increasingly come to prevail over the UK economy. This shift in focus can be described as the shift from stock picking to benefit from financial association with a well-run company for the long term benefit of pension holders to demanding that companies be run for short-term fortune, benefiting the performance fees and charges of the fund manager.

Stock markets are intended to distribute continuous information about the value and performance of the underlying corporation (Liedekerke, 2013). Even if that corporation is not raising capital in the market but through banks or retained earnings the stock market ensures continuous monitoring. Theory has it that firms with management not governing with the consensus in the market will eventually be forced to relinquish control either because they cannot raise additional, cost appropriate capital or they become a takeover target (Kumar and Langberg, 2009). This monitoring function theoretically allows what Jensen (1994) describes as the elimination of corporate excess capacity through leveraged acquisitions, stock buybacks, hostile takeovers, buyouts and divisional sales that helps the efficient allocation of resources in the real economy. This market functionality should advantage pension asset growth (Kay, 2012) and apply equally to fund manager entities that are subject to the same corporate governance requirements of efficiency and transparency.

However, The Kay Review (2012) criticised the development and even marketing of fund manager "expertise" in investment management as trading rather than investing, seeking to exploit short-term information advantages, or arbitrage opportunities within and between asset classes. Professor Kay took the view that short-term trading was encouraged by the market ecology rather than being grounded in investment fundamentals, concluding that "competition between asset managers to outperform each other by anticipating the changing whims of market sentiment…can add nothing, in aggregate, to the value of companies…and hence nothing to the overall returns to savers" (Kay, 2102; par 5.30). This corresponds with the suspicions of many scholars surrounding the reality that agnostic "mathematical" models of portfolio construction fund managers promote can consistently outperform the aggregate of buyers and sellers in the market over the long term (Petraki, 2012; Hoepner and Zeume, 2009; Angel and McCabe, 2008). Spitoven (2005) observes that portfolio selection does not model the real world, assuming full information, independent decision-making, perfect substitution, and fixed preferences. In reality investment behaviour exists in a social structure coordinated by the mechanism of price, but also mechanisms such as economic, political or social power, or accepted practices and routines. For instance, Belasco et al. (2012) find that SandP 500 stock uptake in one managed portfolio increased the flow of funds into that stock and hence raised its value, unconnected to corporate activity, and warn "mispricings among individual stocks arising from index fund investing may reduce the allocative efficiency of the stock market and distort investors' performance evaluations of managed funds." Conversely, Joly (2010; p21) mused on the received wisdom of managed funds that simply tracked an index assuming that market efficiency implies that over time no manager can individually beat the market. He interprets this as a portfolio theory flaw; if every portfolio were floating on the index, who is making the price? At the macroeconomic level "passive investment taken to its ultimate conclusion means the end of markets made up of buyers and sellers, the end of information and of making judgments about the future. It is the ultimate falsification of the efficient market theory." In theory this questions whether it is possible for fund managers to add value for money.

Conversely, in Anglo-American economies stock and bond market activity is dwarfed by funding from retained earnings to the point that Liedekerke (2013) believes stock markets have not even marginally fulfilled an investment role. Rather than raising funds through Initial Public Offerings or bond issues for investment in real economic development, stock markets have become casinos for investor speculation on the future fortunes of existing firms. The fund manager is one of these speculators and past performance of a manager is not a reliable indicator of future performance. With the private property appreciation in value of shares enjoyed by the investor having only tangential benefit to the underlying corporation, Anabtawi and Stout (2008) would concur that owning a share and owning a corporation may have become separate endeavours. There are two questions arising from this view in the literature. Firstly, are the shareholders of fund managers the owners of those fund managers, or simply the owners of their shares? Secondly, are fund managers identifying value-added real world opportunities, or simply speculators in the market casino, in which case what value does the intermediary bring to the pension fund? While a shareholder primacy view of corporations continues to dominate Anglo-American thinking, and these questions remain ambiguous, corporations may not be appropriate vehicles for improving the efficiency and value of pension long term pension assets.

Mutual funds developed as the financial product of a new financial intermediary, bundling the services of other intermediaries, which seems to Allen and Santomero (2001) as "if not contrary to standard theory, at least inconsistent with it." They argue that understanding these industry changes requires different theories of intermediation that stress risk trading, risk management and participation costs as the key reasons for their existence in order to capture the change in the length of intermediation chains. Adding a new intermediary adds an additional layer of transaction costs to the end buyer (Harris and Souder, 2004). Fund managers package the intermediary costs of purchasing underlying assets then wrap their own transaction costs of portfolio creation, advertising and administration into the end-user price (Mahoney, 2004). The fund manager has a management team that legitimately subtract the entirety of their own production costs (including performance linked remuneration) from the fund performance. Crespo's (2009; p224) examination of Spanish mutual funds concluded, "the only beneficiary seems to be the financial institution itself. On this view, the survival of intermediaries seems to depend on the lack of financial sophistication of their clientele, combined with market inefficiencies. It is worth asking about the ethics of a situation of market segmentation that allows managing institutions to benefit from the segment of the least sophisticated investors". This equally applies to fund managers with financially naïve pension clients. The relationship between risk and ROI has become abrogated by the amount of financial return withheld by the intermediary who is bearing no financial risk. The financial returns rightly belonging to the end investor are distorted by the lengthening of the intermediation chain. The finance industry can no longer be theoretically viewed as a veil, but as an industry of institutional agents that aggregate or repackage information and risk, and sell these products to one another along the intermediation chain, increasingly unconnected to production in the real economy (Allen and Santomero, 2001).

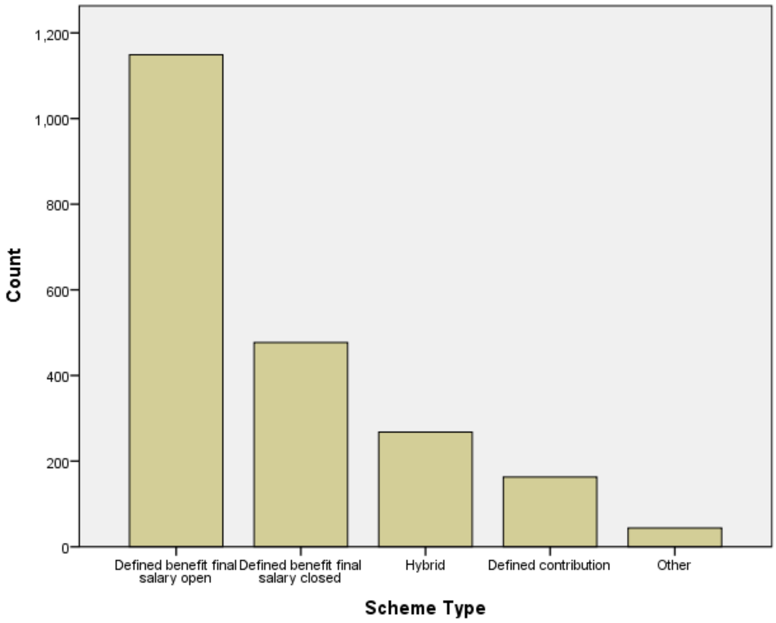
The thesis has contributed to the concept that the current contractual arrangement between pension schemes and fund managers is under-examined. It has established that the courts will seek the contract as the induction of duties established and has not envisioned a fiduciary role for the managers of social savings. This may be acceptable where pension schemes are large and well resourced (powerful stakeholders in negotiations). However for the contributing members to small and increasingly outsourced pension schemes, this does not appear to present a desirable industry outcome. The agent is incentivised to extract risk-free fees that bear little relationship to underlying performance. This relationship is no longer predicted by agency theory or represented by finance theory. The intermediary pressure on fees should not only be a race to the bottom, this should be of primary concern to trustees with fiduciary responsibilities. Social savings should be protected and better regulated, their custodians managing them with competence and care. It will be a timely and fascinating to examine the results of the final Financial Conduct Authority review to see where market change can be enacted, appropriately regulated, and supported by the research of the Academy. The thesis presents a quantitative analysis of the structure of the pensions industry that supports the call for reform of the appropriateness of intermediary institutions and contracting regulations in this fundamental social industry.

# Appendix I
# The target population: The Office of National Statistics description of the occupational pension schemes in the United Kingdom

## I.I The description of the Wilmington Directory data

The average pension scheme's assets under management were £529 million (± £2,033 million) and the average member base was 10,616 (± 30,722) allowing for an average of funds per member of £87,000 ± £135,000 (maximum £2,319,000; minimum £2,000). The majority of schemes were Defined Benefit final salary open to new members (57%) and Defined Benefit final salary closed to new members (23%), with the remaining schemes (Defined Contribution, Hybrid, Stakeholder and PPP) accounting for the remaining 22% (see Figure A1.1).

Figure A1.1 Frequencies of pension scheme type in the original database



The Office of National Statistics has identified Defined Benefit schemes as a separate population to Defined Contribution in their methodology and the logic for adopting this methodological stance is borne out by the significant size differences between them in both by assets under management (F=91.598, df4, p=0.0001) and membership size (F=84.461, df4, p=0.0001) (see Table A1.1).

Table A1.1 Schemes by assets under management and total membership

| **Pension Scheme** | **Assets under management mean and SD (£)** | **Total membership mean and SD (retired and current participants)** |
|---|---|---|
| **Defined benefit open**<br>**(n=1,146)** | 477,674,018 ± 1,770,094,353 | 13,013 ± 31,974 |
| **Defined benefit closed**<br>**(n=477)** | 567,434,725 ± 2,141,828,927 | 7,757 ± 24,467 |
| **Hybrid**<br>**(n=267)** | 911,030,768 ± 3,147,755,498 | 13,251 ± 44,144 |
| **Defined contribution**<br>**(n=160)** | 105,716,831 ± 228,132,743 | 5,186 ± 9,823 |

The large disparity in size of both assets and members, particularly in hybrid schemes most likely reflects the complexity and resource intensity of running multiple schemes for different parts of a large workforce, and reflected in the size of their mean membership, only an option for large employers. In order to evaluate whether any attributes of the fund manager affect the sustainability of a scheme when the size of schemes are heterogeneous, the unit of measurement should be the amount of the assets each member is entitled to, allowing a member of a small scheme to be fungible with a member of a large scheme. This also allows cross-scheme comparisons to determine whether their size itself has any mediating effect on the size of the assets of a single member.

The majority of pension schemes outsource their assets to fund managers (86%), with many outsourcing to multiple fund managers. Defined Benefit Open schemes outsourced in 545 schemes, Defined Benefit Closed in 365 schemes, Hybrid in 231 schemes and Defined Contribution in 129 schemes, with the average number of fund managers engaged across all schemes being 3.80 (±4.99). Pension schemes had various fund management engagement strategies, with 41 (3%) schemes managing funds internally, 502 (37%) engaging a single funds manager and 120 (7%) engaging over 10 fund managers (average 3.4 ± 5.0). Given that 86% of pension schemes outsource their assets under management to one or more fund manager(s), the corporate governance characteristics of these management institutions, described in the literature as the mechanism to protect shareholders rather than specifically clients, should have important implications to the sustainability of pension assets for any given member. These characteristics form the independent variables in the analysis of this secondary data.

### I.II The description of the Occupations Pension Schemes Annual Report 2010 data

According to the Occupational Pension Schemes Annual Report for 2010 (OPSAR 2011), the most recent time the ONS survey sought scheme information, there were 44,380 schemes registered in the UK, 21,730 of these still operating. The majority of registered schemes (80%) have only 2-11 members and the largest schemes (5,000+ members) account for only 1% of the population (Table A1.2).

Table A1.2 Number of private sector occupational pension schemes in the United Kingdom: by size and operational status, 2010

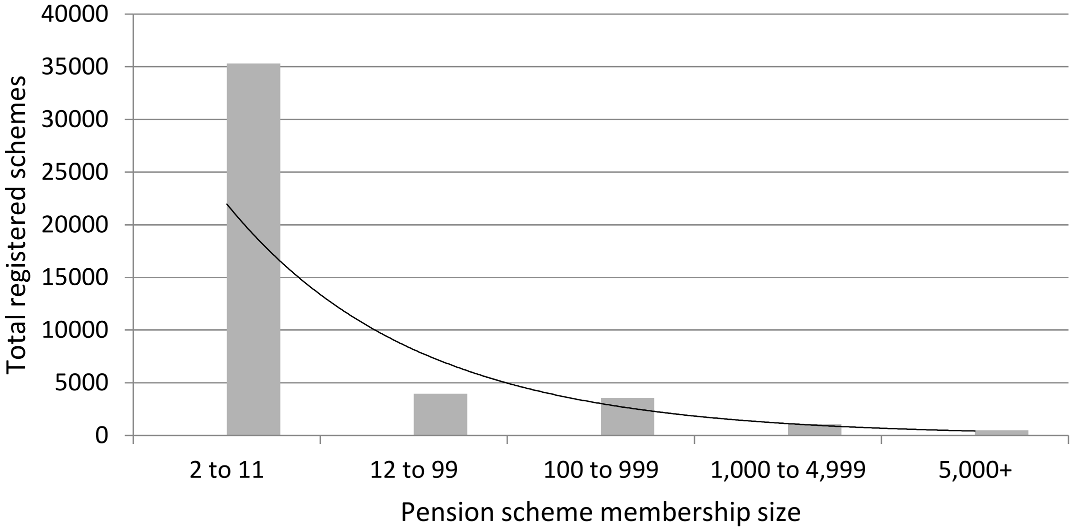
| **Members** | **Open** | **Closed** | **Frozen** | **Winding up** | **Total** |
|---|---|---|---|---|---|
| **5,000+** | 250 | 180 | 40 | 10 | 480 |
| **1,000 to 4,999** | 430 | 400 | 160 | 70 | 1,060 |
| **100 to 999** | 760 | 1,220 | 1,180 | 410 | 3,570 |
| **12 to 99** | 1,020 | 960 | 1,460 | 510 | 3,950 |
| **2 to 11** | 19,270 | 10,240 | 5,560 | 250 | 35,320 |
| **Total** | 21,730 | 12,990 | 8,400 | 1,250 | 44,380 |

Source: Occupational Pension Schemes Survey 2010

This skewed distribution (mean 8,876 ± 14,860: see Figure A1.2) has provided the ONS with a methodological challenge of large scheme self-selection bias, unsolved by a methodology review post the unsatisfactory results of the 2008 survey:

> *“The review has improved the methodology for weighting estimates of* scheme numbers, but the problem of sampling variability which produced a set of unusual results in 2008 has not been solved by the new methodology. The only way to solve this problem would be to allocate additional resources to the survey so that sample size could be increased, particularly for very small schemes. ONS does not consider this to be a priority in terms of resource allocation at a time of tight budgets. It is important to note, therefore, that the estimates of numbers of very small schemes continue to be subject to considera*ble uncertainty”* (OPSAR 2011; p6).

Figure A1.2 Number of occupational pension schemes by membership size



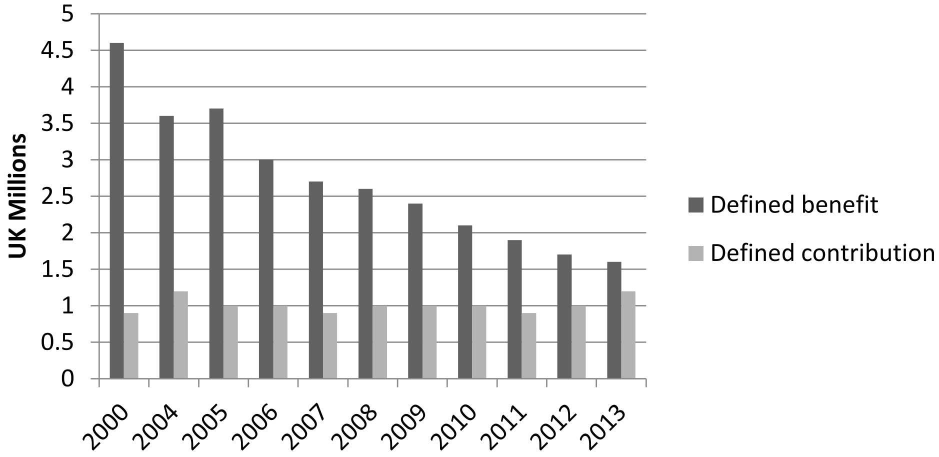
This self-selection challenge and the violation of normal distribution of the population are reflected in the sample frame. The Occupational Pension Schemes Survey (OPSS 2014) is an annual survey of occupational pension schemes, run by the ONS. The survey was first undertaken in 1953, and took place every four to five years until 2004, when it became an annual survey. The 2013 results published in September 2014 describe the demography of the UK occupational pension members. Total membership of pension schemes with two or more members was reported at 27.9 million in 2013. The ONS distinguishes between Defined Contribution (DC) schemes and Defined Benefit (DB) schemes only (not covering commercial schemes such as money purchase or GPPP), illustrating the considerable advantage of DB scheme membership. For DB schemes, the average contribution rate was 5.2% of earnings for members (employees) and 15.4% for employers. For private sector DC schemes, the average contribution rate was 2.9% for members (employees) and 6.1% for employers. According to the Annual Survey of Hours and Earnings UK 2013, published by the ONS in December 2013 (ASHE 2013) the average national weekly salary for public sector and private sector earners was £574 and £490 respectively. Table A1.3 extrapolates these aggregate statistics into an overview of the average annual contributions base between benefit structures. In both the public and private sector the average salary earner in a DB scheme has an asset accumulation advantage over their DC contemporaries.

Table A1.3 Average contributions to defined benefit and defined contribution schemes based on the ONS ASHE data

| Sector | Defined Benefit (£) | | Defined Contribution (£) | | Total | |
|---|---|---|---|---|---|---|
| | Employee | Employer | Employee | Employer | DB | DC |
| **Public** | 1,552 | 4,597 | 866 | 1,821 | 6,149 | 2,687 |
| **Private** | 1,325 | 3,924 | 739 | 1,554 | 5,249 | 2,293 |

The total contribution benefit between schemes, based on the average salary form statistically different populations (t=12.66, df1, p=0.05), supporting the growing belief that steering new active members towards DC schemes allows sponsoring employees to de-risk away from Liability Driven Investment (LDI) commitments (Figure A1.3). Taking the calculation for private sector earners and the number of active members in 2013 approximately £9.118 billion in

Figure A1.3 Number of active members of occupational pension schemes by benefit structure 2000-2013



Source: Office for National Statistics (data available to download from ONS2013)

contributions are flowing into DB schemes and £2.988 billion into DC schemes. This counter weighted trend away from the financially advantageous DB for new entrants suggests that the cost of contributions management will be crucial to the welfare of member contributions not protected by DB contracts. Alongside this phenomena, when examining the destination of these ~ £12 billion in pension funds injects annually, table 6 outlines the division of contributions between active and passive members (pensions in payment or preserved entitlement) has changed dramatically over time to 8.1 million active (employee) members supporting 9.6 million pensions in payment and 10.2 million preserved pension entitlements in 2013. From a high level perspective, as contributions decline in the trend towards DC enrolment, fewer active members are now supporting more non-contributing members with historical preserved entitlements than ever before. From a ratio of 70% active/passive membership three decades ago, active members now support a combined passive membership of almost 250% their size in 2013 (Table A1.4). The preservation of current contributions ringfenced for active members through leakage prevention in the investment supply chain will only grow in importance in the light of these two phenomena.

Table A1.4 Number of members of occupational pension schemes by membership type, 1983 to 2013 in the UK (millions)

| | 1983 | 1995 | 2000 | 2006 | 2008 | 2010 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| **Active members** | 11.1 | 10.3 | 10.1 | 9.2 | 9.0 | 8.3 | 7.8 | 8.1 |
| **Pensions in payment** | 5.0 | 8.5 | 8.2 | 8.2 | 8.8 | 9.0 | 9.5 | 9.6 |
| **Preserved pension entitlements** | 2.8 | 7.0 | 6.7 | 9.4 | 9.9 | 9.8 | 10.2 | 10.2 |
| **Combined passive entitlements** | 7.8 | 15.5 | 14.9 | 17.6 | 18.7 | 18.9 | 19.7 | 19.8 |
| **Percentage of active members** | 70% | 150% | 148% | 191% | 208% | 227% | 253% | 244% |
| **Total** | 18.9 | 25.8 | 25.0 | 26.7 | 27.7 | 27.2 | 27.6 | 27.9 |

Adapted from: Office for National Statistics 2013 (ONS 2013)

Pension Protection Fund (PPF) estimates of DB scheme liabilities have increased over the last few years, suggesting schemes may need to consider raising regular contribution rates. Increasing liabilities could be linked to several factors such as ageing population and influenced by the returns on investment in gilts (ONS 2013). As employers continue to adjust to pension reforms, such as compulsory automatic enrolment, the desirability of Defined Contribution schemes, where the sponsor bears no fixed liability to the member should continue to grow in popularity.

### I.III Comparing the sample frame to the ONS population

Given the comprehensive information regarding the UK pension scheme population provided by the ONS, assessing the sample frame against this respected and comprehensive dataset compiled using a published methodology provides comfort to a post-positivist study that the basis for knowledge generation is supported by the findings in the ONS population.

### I.IV Comparing the sample frame to the ONS population

The total registered occupational pension schemes (2,154) represent the pension assets of 15,987,000 members. This accounts for 57.3% of the membership population recorded by the ONS in 2013 (Table A1.5). Total members were reported by 1,506 (70%) of schemes, distributed around the mean as 10,616 ± 30,722 (Range: 10 – 425,823). Categorising total members into scheme size using the ONS methodology enables the sample frame to be compared to the population for representativeness in Figure A1.4. Noting the ONS concerns regarding self-deselection in the category of 2-11 members, supported by the single case in the Wilmington (2013) sample frame (Table A1.5), the category was discarded.

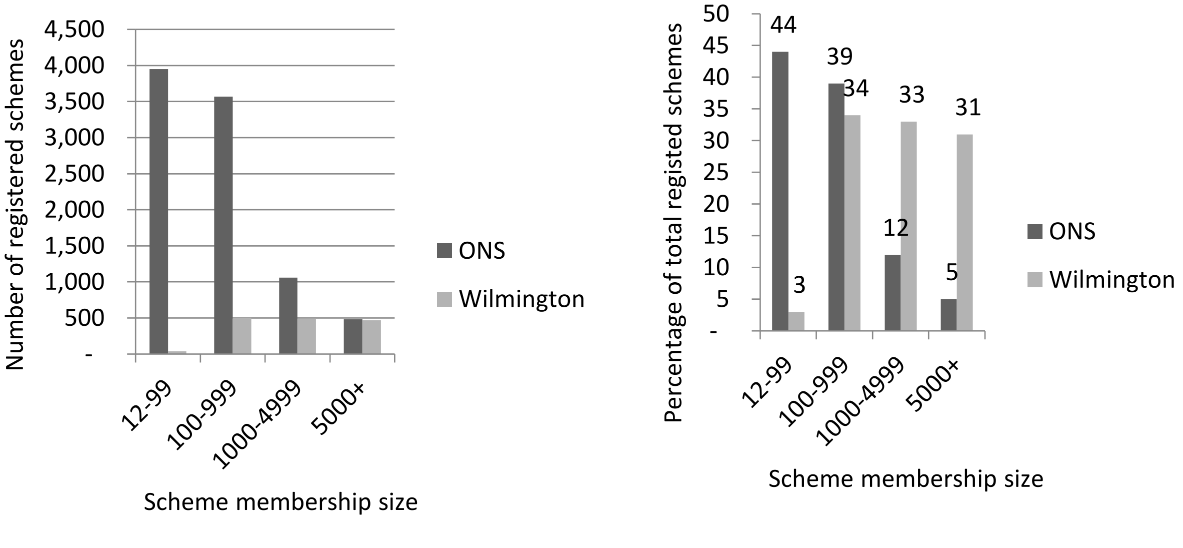
Table A1.5 Total number of registered occupational pension schemes by membership size

| Membership size categories | ONS reported | Wilmington reported | Wilmington/ONS |
|---|---|---|---|
| 2-11 | 35,320 | 1 | 0% |
| 12-99 | 3,950 | 39 | 1% |
| 100-999 | 3,570 | 505 | 14% |
| 1000-4999 | 1,060 | 492 | 46% |
| 5000+ | 480 | 469 | 98% |
| Unreported | - | 647 | - |

Source: Office of National Statistics (ONS2013) and Wilmington Pension Directory (Wilmington 2013)

The average assets under management for the 647 cases where membership size was unreported are £132,574,624 ± 697,998,192 or approximately £20, 490 ± £1,078,823 per unreported case supports the ONS concern that these are generally small funds self-excluded from the survey.

Figure A1.4 Number and percentage of registered pension schemes per ONS size categories in the ONS and Wilmington datasets



Source: Office of National Statistics (ONS2013) and Wilmington Pension Directory (Wilmington 2013)

It will be important in the analysis of the observational and survey data to acknowledge that, as the ONS observed, any contributions can only be seen as representing the larger end of the occupational pension schemes spectrum.

### I.V Description of pension scheme by benefit structures

When the occupational pension schemes dataset was constructed, the benefit structures recorded were divided into five categories (see Table A1.6). Conversely, the ONS records DB and DC schemes alone. This is consistent with the small schemes omission, where smaller employers may find running bespoke schemes cost prohibitive compared with enrolling members in commercially available schemes that bear the administrative burden. The distinction between DB open and DB closed has been retained on the basis that the later receive no active member contributions. The remaining categories "Hybrid" and "Other" contain dual schemes, Stakeholder schemes and GPPP schemes, all involving no LDI commitment from the sponsor, making it logically consistent that they merge with the DC schemes to reflect the ONS methodology (see Table A1.6).

Table A1.6 Total members per pension benefit structure

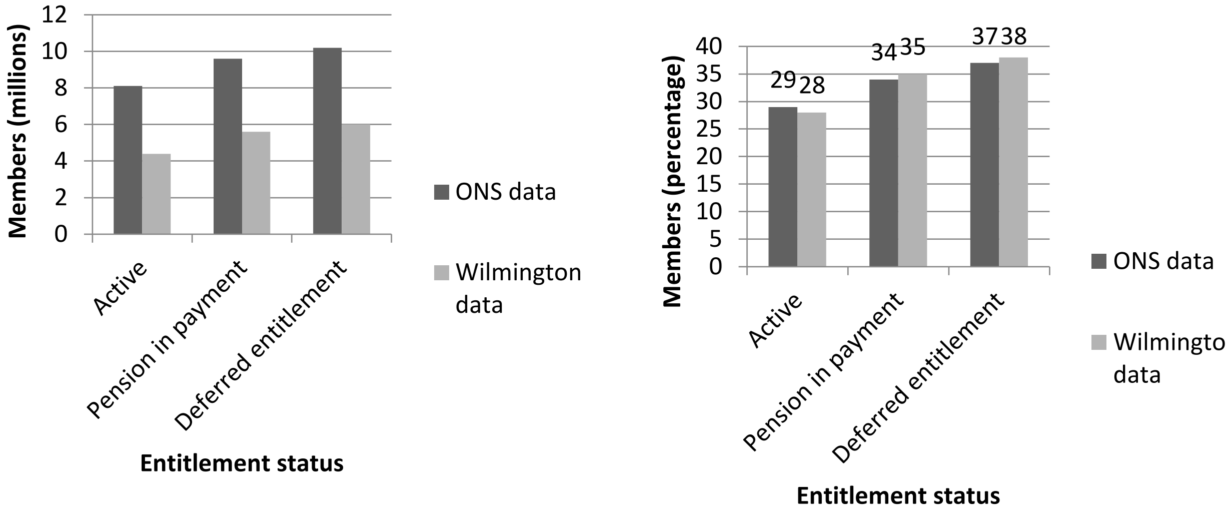
| Benefit structure | Total members |
|---|---|
| **Defined benefit open** | 8,315,595 |
| **Defined benefit closed** | 3,125,892 |
| **Hybrid** | 3,299,530 |
| **Defined contribution** | 788,269 |
| **Other** | 372,397 |
| **Unreported** | 85,317 |
| **Total** | 15,987,000 |

Source: Wilmington Pensions Directory (Wilmington 2013)

## I.VI Description of the membership base composition

The similarity between the Wilmington and ONS data as a percentage is salient (Figure A1.5). The large group of non-contributing members has significant implications for the performance required of the underlying fund. The fund must either minimise its non-contributing membership base or maximise the return on investment of its pooled assets under management in order to meet its estimated liability.

Figure A1.5 ONS and Wilmington members by entitlement to pension payments



Adapted from Office of National Statistics (ONS 2013) and Wilmington Pension Directory (Wilmington 2013)

## I.VII Summary: the Wilmington data as a representation of the ONS data

The Wilmington data provides a sample size based on the number of members equal to 57.3% of the ONS data (once the membership category containing two to eleven members has been removed from both data sets). The similarity between the datasets based on active and passive membership, and division of membership between DB and DC schemes provides support for the inferential use of the Wilmington data provided care is taken to acknowledge, as the ONS acknowledges, larger scheme self-selection is more evident in the Wilmington observations.

# Appendix II
# Survey of Pension Trustees 2014 shown as raw downloaded format from Qualtrics

Q1 Informed Consent Form Introduction This survey aims to examine the fund manager selection process by UK Pension Trusts Procedure This survey should take approximately 15 minutes to complete.The survey comprises 16 questions divided into four discrete sections. It will explore the characteristics of one of the fund managers running the Trust mandate. It concludes with some details of the scheme(s) the Trust is operating, including their assets under management.This questionnaire will be conducted with an online Qualtrics-created survey. Benefit from participating As an acknowledgement for fully completing the survey the researchers will provide a report on where this individual case feedback benchmarks against the overall distribution of respondents, as an indication of relative satisfaction in the decision making process. Confidentiality At no stage is the Trust or Trustee asked to identify themselves in this survey. All data obtained will be kept confidential and will only be reported in an aggregate format. No one other than then primary investigator will have access to the questionnaires. The data collected will be stored in the HIPPA-compliant, Qualtrics-secure database until it has been deleted by the primary investigator. Participation Participation in this research study is completely voluntary. Questions about the Research If you have questions regarding this study, you should contact Kira Shevchenko of the University of Canterbury Christ Church Business School, on +44(0)1227 506423, or at k.shevchenko416@canterbury.ac.uk.

Q2 Please let us know if you would like to be informed of the results of the survey?

○ Yes (1)

○ No (2)

Q4 Section 1:  Fund management mandate detailsQ1. Does the Trust as a whole have a preference for active (Alpha) or passive (Index) fund management?

| | Active (1) | Passive (2) | No preference (3) |
|---|---|---|---|
| Equities (1) | ○ | ○ | ○ |
| Fixed income (2) | ○ | ○ | ○ |
| Other asset classes (3) | ○ | ○ | ○ |

Q5 Q2. Does the Trust have a preference for single or multiple fund manager appointments?

| | 1 (1) | 2-5 (2) | 6-10 (3) | >10 (4) | In-house (5) |
|---|---|---|---|---|---|
| Equities (1) | ○ | ○ | ○ | ○ | ○ |
| Fixed income (2) | ○ | ○ | ○ | ○ | ○ |
| Other asset classes (3) | ○ | ○ | ○ | ○ | ○ |

Answer If Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - 2-5 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Equities - 6-10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - >10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income

- 2-5 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments? Fixed income - 6-10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments? Fixed income - >10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments? Other asset classes - 2-5 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments? Other asset classes - 6-10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments? Other asset classes - >10 Is Selected

Q6 Q2a. What is the rationale for multiple fund manager appointment? (Please select the most pertinent of the following):

○ Hedging risk of under-performance in one fund manager with outperformance in another (1)

○ Benchmarking relative performance across fund managers (2)

○ Professional consulting advice (6)

○ Providing competition incentives between appointed fund managers (3)

○ Providing multiple sources of fund management comparison for the buy/sell decision (4)

○ Other* (5)

Answer If Q2a. What is the rationale for multiple fund manager appointment? (Please select the most pertin... Other* Is Selected

Q27 Please specify:

Answer If Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - 2-5 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Equities - 6-10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - >10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income - 2-5 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income - 6-10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income - >10 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Other asset classes - 2-5 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Other asset classes - 6-10 Is Selected And Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Other asset classes - >10 Is Selected

Q7 Q2a.  What could be the major disadvantage in multiple fund manager appointments? (Please select the most important of the following):

○ Administrative burden on the Trust (1)

○ Transactions costs inefficiency (2)

○ Other* (3)

○ None encountered (4)

Answer If Q2a. &nbsp;What could be the major disadvantage in multiple fund manager appointments? (Please select the most important of the following): Other* Is Selected

Q28 Please specify:

Answer If Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - 1 Is Selected And Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income - 1 Is Selected And Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Other asset classes - 1 Is Selected

Q8 Q2b. What is the rationale for engaging a single fund manager? (Please select the most important of the following):

○ Minimising fund transactions costs (1)

○ Fostering long term relationship (2)

○ Minimising administrative complexity (3)

○ Simplifies the fund manager buy/sell decision (4)

○ Other* (5)

○ Professional consulting advice (6)

Answer If Q2b. What is the rationale for engaging a single fund manager? (Please select the most important... Other* Is Selected

Q29 Please specify:

Answer If Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - 1 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income - 1 Is Selected Or Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Other asset classes - 1 Is Selected

Q9 Q2b. What could be the major disadvantage of single fund manager appointment? (Please select the most important of the following):

○ Key client reliance risk (1)

○ Difficulty with relative performance benchmarking (2)

○ Other* (3)

○ None encountered (4)

Answer If Q2b. What could be the major disadvantage of single fund manager appointment? (Please select the most important of the following): Other* Is Selected

Q30 Please specify:

Answer If Q2. Does the Trust have a preference for single or multiple fund manager appointments? Equities - In-house Is Selected And Q2. Does the Trust have a preference for single or multiple fund manager appointments? Fixed income - In-house Is Selected And Q2. Does the Trust have a preference for single or multiple fund manager appointments? Other asset classes - In-house Is Selected

Q10 Q2c. What is the rationale for managing funds in-house? (Please select the most important of the following):

○ Minimising fund transactions costs (1)

○ Existing internal financial expertise (2)

○ Professional consulting advice (6)

○ Ensuring full control and oversight (3)

○ Trust Terms of Reference (4)

❍ Other* (5)

Answer If Q2c. What is the rationale for managing funds in-house? (Please select the most important of the... Other* Is Selected

Q31 Please specify:

Answer If Q2. Does the Trust have a preference for single or multiple fund manager appointments?   Equities - In-house Is Selected And Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Fixed income - In-house Is Selected And Q2. Does the Trust have a preference for single or multiple fund  manager appointments?   Other asset classes - In-house Is Selected

Q11 Q2c. What could be the major disadvantage of in-house fund management? (Please select the most important of the following):

❍ Cost of expertise (1)

❍ Cost of compliance (2)

❍ Other* (3)

Answer If Q2c. What could be the major disadvantage of in-house fund management? (Please select the most important of the following):<o:p></o:p> Other* Is Selected

Q32 Please specify:

Q12 Q3:  Who is the fund manager managing the most of the Trust's assets (largest mandate)?

Q14 Q4:  How many years has this fund manager been appointed for?

○ < 1 year (1)

○ 2 to 5 years (2)

○ > 5 years (3)

Q15 Q5:  What was the Trust's rationale for selecting this fund manager? (Please select as many as relevant):

□ asset class expertise (1)

□ reputation (2)

□ past performance data (3)

□ lowest overall fees (4)

□ provision of useful information (5)

□ managing unease (6)

□ consultant recommendation (12)

□ transparency of fee structure (7)

□ Risk sharing (including downside risk) (8)

□ ESG and engagement strategies (9)

□ value for fees (10)

□ other industry recommendation (13)

□ other criteria were applied* (11)

Answer If Q5:  What was the Trust's rationale for selecting this fund manager? (Please select as many as re... ESG and engagement strategies Is Selected

Q33 Please specify:

Q16 Q6. Which metric is of key importance when the Trust rates the financial performance of this fund manager? (Please indicate the key metric and any further metrics that may be examined):

| | Key metric (1) | Somewhat important (2) | Not applicable (3) |
|---|---|---|---|
| Nominal financial returns generated in the last financial year of engagement (1) | ❍ | ❍ | ❍ |
| Nominal returns compared to the requisite benchmark (2) | ❍ | ❍ | ❍ |
| Nominal returns compared to verbal undertaking (promises) (3) | ❍ | ❍ | ❍ |
| Value added performance (above market) (4) | ❍ | ❍ | ❍ |

| | | | |
|---|---|---|---|
| Value for Annual Management Cost (AMC) (5) | ○ | ○ | ○ |
| Value for Total Expense Ratio (TER) (6) | ○ | ○ | ○ |

Q18 Section 2:  Fund Manager governanceQ7. Who owns the fund manager discussed in the last section?

○ Publicly traded corporation (1)

○ Privately owned corporation (2)

○ Conglomerate owned (3)

○ Employee owned corporation (4)

○ Partnership (5)

○ Other* (6)

○ Don’t know (7)

Q19 Q8. Where are the headquarters of this fund manager‘s holding company?

○ United Kingdom (1)

○ United States (2)

○ European Union, outside of the UK (3)

○ Other European country outside of the EU (4)

○ Asia/Pacific (5)

○ Africa (6)

○ Other* (7)

○ Don’t know (8)

Q20 Q9. Were the two corporate governance characteristics of the fund manager in questions 7 and 8 explicitly considered in the decision to engage them? (Please select one only):

○ Yes* (1)

○ No (2)

○ Implicitly only (3)

○ N/A (4)

Q34 Q10. Does the trust as a whole believe any of the following corporate governance issues are important to the financial performance less fees of the fund manager? (Please rate between 1 and 7, where 1 is not important and 7 is highly important)

| | Not important (1) | 2 (2) | 3 (3) | 4 (4) | 5 (5) | 6 (6) | Highly important (7) |
|---|---|---|---|---|---|---|---|
| CEO/Chairman separation (1) | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| Gender equality (2) | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| Employee engagement (3) | ○ | ○ | ○ | ○ | ○ | ○ | ○ |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Corporate social responsibility (4) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Say on pay (5) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Board composition (6) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |

Q35 Q11. Was information on any of the corporate governance issues provided to the Trust by the fund manager?

❍ Yes (1)

❍ Don't know (2)

❍ No (3)

Q21 Q12. Do you think the Trust believes that the corporate governance profile of the fund manager helps them manage any of the following challenges? (Please rate between 1 and 7, where 1 is not important and 7 is very important)

| | Not important (1) | 2 (2) | 3 (3) | 4 (4) | 5 (5) | 6 (6) | Very important (7) |
|---|---|---|---|---|---|---|---|
| Managing pressure from their own | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| shareholders (1) | | | | | | | |
| Prioritising the client relationship (2) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Prioritising value for money (3) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Prioritising transparency (4) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Prioritising spending on expertise (5) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Prioritising outperformance (6) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |
| Sharing risk (7) | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ | ❍ |

Q36 Section 3:  Fiduciary dutiesQ13. Please indicate of you agree or disagree with the following statements:

| | Agree | Disagree |
|---|---|---|

| | | |
|---|---|---|
| Fund managers should have fiduciary duties to Pension Trusts (1) | ○ | ○ |
| Fund managers do have fiduciary duties to Pension Trusts (2) | ○ | ○ |
| This duty should override fiduciary duties to their own shareholders/owners (3) | ○ | ○ |
| This duty does override fiduciary duties to their own shareholders/owners (4) | ○ | ○ |
| Governance analysis is available on fund managers (5) | ○ | ○ |
| Governance analysis should be available on fund managers (6) | ○ | ○ |

Q23 Section 4: Pension fund detailsQ14: What is the composition of the Trust

| | Member elected | Sponsor elected | Other* |
|---|---|---|---|
| Number of members | | | |

Answer If Section 4: Pension fund details Q14: What is the composition of the Trust Number of members - Other* Is Not Empty

Q37 Please specify:

Q24 Q15: What type of Schemes operated by the Trust Please complete for one or more schemes operated as applicable:

|  | Establishment year | Assets under management (£000) | Total Members | Total pensioners |
|---|---|---|---|---|
| Defined benefit Open |  |  |  |  |
| Defined benefit Closed |  |  |  |  |
| Defined contribution |  |  |  |  |
| Other* |  |  |  |  |

Answer If Q15: What type of Schemes operated by the Trust Please complete for one or more schemes operat... Other* - Establishment year Is Not Empty Or Q15: What type of Schemes operated by the Trust Please complete for one or more schemes operat... Other* - Assets under management (£000) Is Not Empty Or Q15: What type of Schemes operated by the Trust Please complete for one or more schemes operat... Other* - Total Members Is Not Empty Or Q15: What type of Schemes operated by the Trust Please complete for one or more schemes operat... Other* - Total pensioners Is Not Empty

Q38 Please specify:

Q25 Q16: Sponsor industry sector

○ Private sector (1)

○ Public sector (2)

○ Industry sector (3)

○ Charity sector (4)

○ Other* (5)

Q26 Further comments(Optional) If you wish to provide further information we would be greatly interested in learning more about your views on the topics mentioned in the questionnaire.

## II.I Feedback from respondents

- There is no "go back" button;
- Your questions did not address managers with multiple mandates with the same manager (I could only select one time horizon when in fact I have several mandates some appointed within last year and others 2-5);
- I think that you are asking the wrong questions. There are no specific questions on the methodology on how we select managers, the interplay of the different skills and attributes of the managers and the relative complementarity and diversifications required for large pension funds. This therefore suggests to me that you have already decided on the messages/conclusions you want to reach and you have angled the questions accordingly. The gaps in your questions are otherwise too large and you have not at all asked about how we go about selecting managers. Disappointing.
- Like many Trustee Boards, we rely heavily on the research and advice from our investment consultants. The governance of fund managers is a topic we expect the consultants' research team to investigate. Your research will be more grounded in actual practice if you are able to ask similar questions of the research teams at Towers Watson, Aon Hewitt

and Mercer. As these three are all pushing fiduciary management hard, you might also want to ask for input from Lane Clark and Peacock;

- Interesting but the main drive is on obtaining returns and avoiding capital losses
- Questions 10 and 14 were badly worded. On 10 specifically, we felt that it should have referenced whether the corporate governance factors impacted the overall long-term performance of the company (or companies in general) rather than performance less fees.

### II.II Response to feedback from respondents

The constructive criticism from the respondents was gratefully received. The first and second points are technical aspects of the software construction to be investigated. The third point criticises the semantics of the survey content. The purpose of the survey was to enquire into the specific corporate governance issues that were factored into the fund management selection process as the fiduciary management of value for money for the contributing beneficiaries. The feedback that the survey should go over and above this remit loses the focus of the objective, which research methods manuals explain as the constant tension in survey research (the dyadic challenge of researcher led bias versus a survey so broad and ambitious that it actually addresses no issue: Bernard, 2006). Much thought was put into the optimal way of linking one trust with one fund manager (as with Chapter 6) so that the respondent could generate meaningful and comparable variables. At the cost of trying to explore “relative complementarity and diversifications required for large pension funds," the survey author and advisers agreed that selecting one fund manager (the manager with the largest of the trust's mandates) to answer the questions related to the specific variables. While acknowledging that this is legitimate criticism, it is the inevitable opportunity cost associated with closed question survey techniques. The questions were designed (and validated through piloting the survey with industry experts) to look specifically at the corporate governance characteristics of the fund manager considered by the trust in the fulfilment of their fiduciary duty to defray cost to the beneficiary. It would be hubristic to attempt to capture the infinite set of motivations for selecting a particular manager.

The objection that the survey should have dealt with the corporate governance of the underlying equities rather than the fund manager is the contradiction at the heart of the thesis. The pension industry already employs this practice extensively. An established industry of non-financial performance analysts (ESG analysts) exists to support this practice and is extensively researched. This research was discussed in Chapter 3 as the identification of a link between non-financial sustainability performance in the asset and its financial performance. The gap in knowledge that that the thesis in general and survey in particular attempts to contribute to is the non-financial performance of the fund managers themselves, specifically their governance behaviour. These financial intermediaries are the corporations who will engage ESG analysts to assess the non-financial performance of the equities they are selecting for their pension clients, but thus far have eluded scrutiny of their own behaviour. The survey attempts to determine if this is a pension industry norm, or whether there are characteristics of the trust or the fund manager that exacerbates this blind spot.

The feedback is valuable for further development of the survey for future research, and appreciatively received.  Particularly the advice to enquire into the role consultants such as Towers Watson, Mercer and Aon Hewitt play in the integration of governance characteristics into the recommendations they make to pension clients on fund manager selection.  These firms have been contacted for comment that will be incorporated in the discussion in Chapter 8 and would be the target of future qualitative research.

# Appendix III
# List of Fund Managers

Table A3.1 Table of Fund Management Entities

| FMID | Fund Management Corporation | FMOS | FMRR | FMAUM (USD) |
|---|---|---|---|---|
| **0** | Assets Managed Inhouse | 0 | 0 | 0 |
| **1** | 300 North Capital | 3 | 1 | 429,040,000 |
| **2** | Abbott Capital Management | 2 | 1 | 7,000,000,000 |
| **3** | Aberdeen Asset Management | 1 | 2 | 304,808,400,000 |
| **4** | Absolute Return Partners LLP | 4 | 2 | 500,000,000 |
| **5** | Acadian Asset Management (UK) Ltd | 1 | 2 | 55,000,000,000 |
| **6** | Adam & Company Investment Management Ltd | 1 | 2 | 2,433,600,000 |
| **7** | Adams Street Partners UK LLP | 2 | 1 | 22,000,000,000 |
| **8** | Adrian Lee & Partners | 4 | 2 | 6,000,000,000 |
| **9** | Advent Capital Management UK Ltd | 2 | 1 | 7,300,000,000 |
| **10** | Aegis Investment Partners | 3 | 1 | 125,000,000 |
| **11** | Aerion Fund Management | 5 | 2 | 23,575,500,000 |
| **12** | Affiliated Managers Group | 1 | 1 | 508,000,000,000 |
| **13** | A.G. Bisset & Co Ltd | 2 | 1 | 1,340,000,000 |
| **14** | Alchemy Parners LLP | 4 | 2 | 2,281,500,000 |
| **15** | Alignment Capital Group LLC | 5 | 1 | 99 |
| **16** | Alinda Capital Partners | 3 | 1 | 7,800,000,000 |
| **17** | AllianceBernstein Institutional Investment | 1 | 1 | 447,000,000,000 |
| **18** | Allianz Global Investors | 1 | 5 | 389,728,000,000 |
| **19** | Altius Associates | 3 | 2 | 25,400,000,000 |
| **20** | Altrinsic Global Advisors UK Ltd | 3 | 1 | 5,860,000,000 |

|  |  |  |  |  |
|---|---|---|---|---|
| **21** | American Century Investments | 2 | 2 | 52,000,000,000 |
| **22** | American Securities | 2 | 1 | 8,000,000,000 |
| **23** | AMP Capital Investors | 1 | 3 | 131,000,000,000 |
| **24** | Amundi | 1 | 5 | 961,500,000,000 |
| **25** | AnaCap Financial Partners | 4 | 2 | 2,179,400,000 |
| **26** | Analytic Investors LLC | 3 | 1 | 1,800,000,000 |
| **27** | Anchorage Capital Partners | 3 | 3 | 99 |
| **28** | AQR | 2 | 1 | 105,000,000,000 |
| **29** | Aon Hewitt | 1 | 2 | 39,000,000,000 |
| **30** | Apax Partners Ltd | 4 | 2 | 58,000,000,000 |
| **31** | Archer Capital | 2 | 3 | 3,126,000,000 |
| **32** | Arcus Infrastructure Partners LLP | 4 | 2 | 15,384,000,000 |
| **33** | Arden Asset Management | 3 | 1 | 7,500,000,000 |
| **34** | Ares Management Tld | 2 | 1 | 68,000,000,000 |
| **35** | Armstrong Investment Managers LLP | 4 | 2 | 200,000,000 |
| **36** | Arrowgrass Capital Partners | 4 | 2 | 4,500,000,000 |
| **37** | Arrowstreet Capital LP | 4 | 1 | 47,000,000,000 |
| **38** | Artemis Investment Management LLP | 4 | 2 | 25,552,800,000 |
| **39** | Ascend Capital | 4 | 1 | 2,690,000,000 |
| **40** | Ashmore Investment Management | 1 | 2 | 78,500,000,000 |
| **41** | Atlantis Investment Management Ltd | 5 | 2 | 3,200,000,000 |
| **42** | Auriel Capital Management LLP | 4 | 2 | 99 |
| **43** | Aurora Investment Management LLC | 2 | 1 | 9,300,000,000 |

| | | | | |
|---|---|---|---|---|
| **44** | Avenue Advisors | 5 | 1 | 53,700,000 |
| **45** | Avenue Capital Group | 5 | 1 | 12,300,000,000 |
| **46** | Aviva Investors | 1 | 2 | 374,166,000,000 |
| **47** | AXA Investment Management UK Ltd | 1 | 5 | 687,152,000,000 |
| **48** | AXA Rosenberg Investment Management Ltd | 1 | 5 | 23,717,000,000 |
| **49** | Baillie Gifford | 4 | 2 | 153,621,000,000 |
| **50** | Bain Capital | 2 | 1 | 70,000,000,000 |
| **51** | Balderton Capital | 4 | 2 | 2,000,000,000 |
| **52** | Banco Votorantim SA | 1 | 3 | 141,917,400,000 |
| **53** | BankInvest Asset Management | 2 | 4 | 15,127,600,000 |
| **54** | Barclays Wealth | 1 | 2 | 308,458,800,000 |
| **55** | Baring Asset Management Ltd | 1 | 1 | 57,433,600,000 |
| **56** | Battery Financial Management Inc | 1 | 1 | 10,900,000,000 |
| **57** | Beach Point Capital | 4 | 1 | 4,408,000,000 |
| **58** | The Beck Group | 5 | 2 | 99 |
| **59** | Bedlam Asset Management | 3 | 2 | 532,350,000 |
| **60** | Belgrave Capital Management | 2 | 5 | 8,432,000,000 |
| **61** | Benchmark Plus | 3 | 1 | 2,350,000,000 |
| **62** | Berenberg Bank | 2 | 5 | 12,820,000,000 |
| **63** | Beringea | 3 | 1 | 330,000,000 |
| **64** | Berry Asset Management plc | 1 | 4 | 6,000,000,000 |
| **65** | Blackstone Alternative Asset Management | 1 | 1 | 272,000,000,000 |
| **66** | Blackhorse Asset Management Pte Ltd | 3 | 3 | 137,000,000 |

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|---|---|---|---|---|
| **67** | BlackRock | 1 | 2 | 3,792,000,000,000 |
| **68** | Blakeney Management | 4 | 2 | 99 |
| **69** | BlueBay Asset Management | 1 | 2 | 56,000,000,000 |
| **70** | BlueCrest Capital Management | 4 | 2 | 215,000,000,000 |
| **71** | BlueMountain Capital Partners LLP | 1 | 1 | 12,000,000,000 |
| **72** | BNP Paribas Investment Partners Ltd | 1 | 5 | 612,796,000,000 |
| **73** | BNY Mellon | 1 | 1 | 27,400,000,000,000 |
| **74** | BNY Mellon Investment Management EMEA | 1 | 1 | 1,400,000,000,000 |
| **75** | The Boston Company Asset Management | 1 | 1 | 45,000,000,000 |
| **76** | Bramdean Asset Management LLP | 5 | 2 | 99 |
| **77** | Brandeaux Administrators Ltd | 2 | 2 | 1,825,200,000 |
| **78** | Brandes Investment Partners L.P | 4 | 1 | 26,400,000,000 |
| **79** | Brevan Howard | 3 | 4 | 40,000,000,000 |
| **80** | Brewin Dolphin Asset Management | 1 | 2 | 42,588,000,000 |
| **81** | Brian Shearing & Partners Ltd | 4 | 2 | 99 |
| **82** | Bridgepoint | 3 | 2 | 15,384,000,000 |
| **83** | Bridges Ventures | 4 | 2 | 190,125,000 |
| **84** | Bridgewater Associates | 4 | 1 | 150,000,000,000 |
| **85** | Broadstone Pensions & Investments | 3 | 2 | 3,042,000,000 |
| **86** | Brockton Capital LLP | 4 | 2 | 91,260,000,000 |
| **87** | Brookfield Investment Management UK Ltd | 5 | 1 | 175,000,000,000 |
| **88** | Burgundy Asset Management Ltd | 3 | 1 | 9,000,000,000 |
| **89** | Cairn Capital Ltd | 2 | 2 | 3,300,000,000 |

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|---|---|---|---|---|
| **90** | Calamos International LLP | 1 | 1 | 27,800,000,000 |
| **91** | Caliburn Capital Partners | 4 | 2 | 600,000,000 |
| **92** | The Cambridge Strategy | 5 | 2 | 130,000,000 |
| **93** | Canada Life Asset Management | 1 | 3 | 565,812,000,000 |
| **94** | Cantillon Capital Management LLP | 5 | 2 | 1,000,000,000 |
| **95** | Cantor Fitzgerald | 4 | 1 | 99 |
| **96** | Canyon Partners | 3 | 1 | 23,000,000,000 |
| **97** | Capital & Regional plc | 1 | 2 | 1,270,035,000 |
| **98** | Capital Dynamics | 2 | 4 | 17,000,000,000 |
| **99** | Capital International Limited | 1 | 1 | 1,147,000,000,000 |
| **100** | Capula Investment Management LLP | 4 | 2 | 22,000,000,000 |
| **101** | Carlyle Group | 1 | 1 | 185,000,000,000 |
| **102** | Carnegie Asset Management | 3 | 4 | 15,300,000,000 |
| **103** | CarVal Investors | 2 | 1 | 68,000,000,000 |
| **104** | Castlefield Investments Partners | 4 | 2 | 99 |
| **105** | Catapult | 4 | 2 | 100,000,000 |
| **106** | Cavendish Asset Mangement | 2 | 2 | 1,438,866,000,000 |
| **107** | Cazenove Capital Management | 1 | 2 | 26,161,200,000 |
| **108** | CBPE Capital | 4 | 2 | 608,400,000 |
| **109** | CBRE Global Investors | 2 | 1 | 87,600,000,000 |
| **110** | CCLA Investment Management Ltd | 2 | 2 | 6,996,600,000 |
| **111** | CCMP Capital Advisors (UK) LLP | 2 | 1 | 12,000,000,000 |
| **112** | Cedar Rock Capital Ltd | 3 | 2 | 3,848,130,000 |

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|---|---|---|---|---|
| **113** | Central Finance Board of the Methodist Church | 5 | 2 | 1,444,950,000 |
| **114** | Cerberus | 4 | 1 | 20,000,000,000 |
| **115** | Chamberlin & Hill plc | 1 | 2 | 99 |
| **116** | Charlemagne Capital (UK) Ltd | 3 | 2 | 2,400,000,000 |
| **117** | Charles Stanley Securities | 1 | 2 | 24,883,560,000 |
| **118** | Charlesbank Capital Partners | 2 | 1 | 2,000,000,000 |
| **119** | Chayton Capital | 4 | 2 | 99 |
| **120** | Cheviot Asset Management | 2 | 2 | 22,815,000,000 |
| **121** | Chilton Investment Company | 2 | 1 | 7,000,000,000 |
| **122** | CI Capital Partners | 3 | 1 | 1,100,000,000 |
| **123** | Cinven Partners LLP | 4 | 2 | 19,773,000,000 |
| **124** | City of London Investment Group plc | 1 | 2 | 3,500,000,000 |
| **125** | Close Brothers Asset Management | 1 | 2 | 13,841,100,000 |
| **126** | Cohen & Steers UK Ltd | 1 | 1 | 46,300,000,000 |
| **127** | Colchester Global Investors Limited | 3 | 2 | 22,000,000,000 |
| **128** | Coller Capital Ltd | 5 | 2 | 5,500,000,000 |
| **129** | Collins Alternative Solutions | 3 | 1 | 1,800,000,000 |
| **130** | Colonial First State Global Asset Management | 1 | 3 | 52,100,000,000 |
| **131** | Columbia Capital | 3 | 1 | 2,500,000,000 |
| **132** | Comgest Asset Management International Ltd | 1 | 5 | 17,947,800,000 |
| **133** | Conning Asset Management Ltd | 1 | 1 | 86,000,000,000 |
| **134** | ConvergEx | 2 | 1 | 32,000,000,000 |
| **135** | Coronation International Ltd | 1 | 3 | 46,872,000,000 |

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|---|---|---|---|---|
| **136** | CP2 | 3 | 3 | 2,917,600,000 |
| **137** | Credit Suisse Asset Management Ltd | 1 | 2 | 825,598,800,000 |
| **138** | Crestline Investors Inc | 1 | 1 | 7,200,000,000 |
| **139** | Crown Agents Investment Management Ltd | 2 | 2 | 1,374,223,500 |
| **140** | Cube Infrastructure Fund | 4 | 5 | 1,410,200,000 |
| **141** | CZ Capital | 4 | 2 | 167,000,000 |
| **142** | Daiwa SB Investments (UK) | 1 | 5 | 50,000,000,000 |
| **143** | Dalton Strategic Partnership | 4 | 2 | 2,000,000,000 |
| **144** | Darwin Property Investment Management Ltd | 3 | 2 | 351,351,000 |
| **145** | Dasos Capital Oy | 3 | 4 | 301,270,000 |
| **146** | Davis Selected Advisers L.P. | 4 | 1 | 56,000,000,000 |
| **147** | DB Advisors | 1 | 5 | 1,240,000,000,000 |
| **148** | Delmore Asset Management | 3 | 2 | 15,210,000,000 |
| **149** | Duetsche Bank AG | 1 | 5 | 1,210,208,000,000 |
| **150** | Diapason Commodities Management UK LLP | 1 | 4 | 8,500,000,000 |
| **151** | Dimensional Fund Advisors Ltd | 3 | 1 | 315,400,000,000 |
| **152** | Diversified Global Asset Management | 3 | 3 | 6,700,000,000 |
| **153** | Dorchester Investment Management | 4 | 3 | 750,000,000 |
| **154** | Driehaus Capital Management | 3 | 1 | 11,900,000,000 |
| **155** | DTZ | 1 | 1 | 2,000,000,000 |
| **156** | Duke Street Capital | 4 | 2 | 3,954,600,000 |
| **157** | Dunedin Capital Partners | 4 | 2 | 608,400,000 |
| **158** | Dynagest | 3 | 4 | 99 |

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|---|---|---|---|---|
| **159** | East Midlands Early Growth Fund | 2 | 2 | 7,605,000 |
| **160** | Eaton Vance Management (international) Ltd | 3 | 2 | 260,600,000,000 |
| **161** | ECI Partners | 4 | 2 | 1,673,100,000 |
| **162** | ECM Asset Management Ltd | 1 | 2 | 9,500,000,000 |
| **163** | Edinburgh Partners | 3 | 2 | 7,900,000,000 |
| **164** | Efficient Capital Management | 3 | 1 | 1,000,000,000 |
| **165** | EFG Asset Management (UK) Ltd | 1 | 4 | 82,949,800,000 |
| **166** | E.I.M. S.A. | 3 | 4 | 7,000,000,000 |
| **167** | EIM (UK) Ltd | 3 | 4 | 7,000,000,000 |
| **168** | Elysian Capital | 4 | 2 | 38,025,000 |
| **169** | Emerald Hill Capital Partners | 3 | 3 | 500,000,000 |
| **170** | Environmental Technologies Fund | 4 | 2 | 167,310,000 |
| **171** | EQT Funds Management Ltd | 2 | 4 | 25,640,000,000 |
| **172** | Equitix | 2 | 2 | 158,184,000 |
| **173** | Equitable Life | 1 | 2 | 13,600,000,000 |
| **174** | eSecLending | 5 | 1 | 99 |
| **175** | Esemplia | 1 | 2 | 698,000,000 |
| **176** | Europa Capital LLP | 4 | 2 | 8,974,000,000 |
| **177** | Evercore  Pan Asset Capital Management | 1 | 2 | 901,953,000 |
| **178** | F&C Asset Management plc | 1 | 2 | 137,042,100,000 |
| **179** | Fauchier Partners | 1 | 1 | 22,000,000,000 |
| **180** | Fidelity Worldwide Investment | 3 | 1 | 1,489,400,000,000 |
| **181** | Financial Risk Management (FRM) | 1 | 2 | 8,200,000,000 |

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|---|---|---|---|---|
| **182** | First Quadrant | 4 | 1 | 17,000,000,000 |
| **183** | First State Investments | 2 | 3 | 52,100,000,000 |
| **184** | Fisch Asset Mangement | 3 | 4 | 1,791,800,000 |
| **185** | Fortress Investment Group | 1 | 1 | 62,500,000,000 |
| **186** | FourWinds Capital Management | 2 | 1 | 4,000,000,000 |
| **187** | Friends Life | 1 | 2 | 199,920,000,000 |
| **188** | Frankin Templeton Investments | 1 | 2 | 792,441,000,000 |
| **189** | Friess Associates | 3 | 1 | 1,250,000,000 |
| **190** | Frontpoint | 5 | 1 | 99 |
| **191** | Fulcrum Asset Management | 4 | 2 | 500,000,000 |
| **192** | FundQuest | 1 | 5 | 40,000,000,000 |
| **193** | FX Concepts Inc | 5 | 1 | 99 |
| **194** | GAM | 2 | 4 | 1,228,964,000 |
| **195** | Gardner Lewis | 3 | 1 | 369,060,000 |
| **196** | GE Asset Management | 1 | 1 | 116,000,000,000 |
| **197** | Generali Portfolio Management | 1 | 4 | 90,960,200,000 |
| **198** | Generation Investment Management LLP | 4 | 2 | 6,000,000,000 |
| **199** | Genesis Investment Management LLP | 4 | 2 | 13,036,000,000 |
| **200** | GLG Partners LP | 1 | 2 | 27,700,000,000 |
| **201** | Global Fund Analysis Ltd | 1 | 2 | 99 |
| **202** | Global Infrastructure Partners | 4 | 1 | 15,000,000,000 |
| **203** | Global Wealth Allocation Ltd | 2 | 2 | 6,000,000,000 |
| **204** | GMO UK Limited | 3 | 1 | 112,000,000,000 |

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|---|---|---|---|---|
| **205** | Goldman Sachs Asset Management International | 1 | 1 | 878,000,000,000 |
| **206** | Goodhart Partners LLP | 3 | 2 | 496,000,000 |
| **207** | Gottex Asset Management | 2 | 4 | 640,000,000 |
| **208** | Governance for Owners LLP | 4 | 2 | 1,240,000,000 |
| **209** | Graham Capital Management | 4 | 1 | 7,200,000,000 |
| **210** | Gramercy | 4 | 1 | 3,900,000,000 |
| **211** | Great Hill Partners | 3 | 1 | 3,000,000,000 |
| **212** | Greenpark Capital Ltd | 5 | 1 | 10,000,000,000 |
| **213** | Greenspring Associates | 4 | 1 | 2,400,000,000 |
| **214** | Gresham Investment Management | 3 | 1 | 16,000,000,000 |
| **215** | Greystone Financial Services Ltd | 2 | 2 | 337,205,700 |
| **216** | Grosvenor Fund Management Ltd | 2 | 2 | 18,000,000,000 |
| **217** | H2O Asset Management LLP | 4 | 2 | 3,954,600,000 |
| **218** | Halcyon Asset Management (UK) LLP | 3 | 1 | 13,000,000,000 |
| **219** | SG Hambros Bank Ltd | 1 | 2 | 107,688,000,000 |
| **220** | Hamilton Lane | 2 | 1 | 28,000,000,000 |
| **221** | Hancock Timber Resourse Group | 1 | 1 | 11,500,000,000 |
| **222** | HarbourVest Partners (UK) Ltd | 3 | 1 | 11,800,000,000 |
| **223** | Harding Loevner LP | 1 | 1 | 32,000,000,000 |
| **224** | Havenport Asset Management | 4 | 3 | 1,300,000,000 |
| **225** | Headland Capital Partners | 3 | 3 | 2,400,000,000 |
| **226** | Heitman | 3 | 1 | 27,800,000,000 |
| **227** | Henderson Global Investors | 1 | 2 | 70,800,000,000 |

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|---|---|---|---|---|
| **228** | Herald Investment Management | 3 | 2 | 98,865,000 |
| **229** | Hermes Fund Managers Limited | 5 | 2 | 39,698,100,000 |
| **230** | Heronbridge Investment Management LLP | 4 | 2 | 1,233,531,000 |
| **231** | HgCapital | 4 | 2 | 7,757,100,000 |
| **232** | Highland Capital Partners | 4 | 1 | 23,000,000,000 |
| **233** | Highstar Capital | 4 | 1 | 7,600,000,000 |
| **234** | Honister Capital | 5 | 2 | 99 |
| **235** | Hony Capital | 2 | 3 | 6,800,000,000 |
| **236** | Horsley Bridge Partners | 2 | 1 | 9,680,000,000 |
| **237** | HSBC Global Asset Management (UK) Limited | 1 | 3 | 419,100,000,000 |
| **238** | ICAP | 1 | 2 | 99 |
| **239** | IGNIS Asset Management Ltd | 2 | 2 | 102,819,600,000 |
| **240** | IMAS Investment Monitoring and Accounting Services | 99 | 99 | 99 |
| **241** | Impax Asset Management Ltd | 1 | 2 | 3,498,300,000 |
| **242** | Independent Franchise Partners | 4 | 2 | 3,900,000,000 |
| **243** | Indigo Capital | 4 | 2 | 705,100,000 |
| **244** | Indus Capital Advisors (UK) LLP | 3 | 1 | 6,200,000,000 |
| **245** | Industry Funds Management | 5 | 3 | 50,016,000,000 |
| **246** | Informed Portfolio Management (IPM) | 2 | 4 | 6,000,000,000 |
| **247** | Infracapital | 1 | 2 | 2,585,700,000 |
| **248** | ING Real Estate Investment Management | 5 | 99 | 99 |
| **249** | Innisfree Ltd | 5 | 2 | 28,746,900,000 |
| **250** | Innova Investments | 3 | 5 | 99 |

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|---|---|---|---|---|
| **251** | Insight Investment Management (Global) Limited | 1 | 2 | 413,559,900,000 |
| **252** | Institutional Capital Inc | 1 | 1 | 402,000,000,000 |
| **253** | Institutional Venture Partners | 4 | 1 | 2,900,000,000 |
| **254** | Integrity Life Settlement Solutions Ltd | 99 | 99 | 99 |
| **255** | Intermediate Capital Group Plc | 1 | 2 | 15,512,200,000 |
| **256** | International Administration Guernsey Ltd | 3 | 2 | 23,000,000,000 |
| **257** | International Asset Management Ltd | 3 | 2 | 2,700,000,000 |
| **258** | Invesco Global Cash Management | 1 | 1 | 763,900,000,000 |
| **259** | Invesco Perpetual | 1 | 2 | 106,470,000,000 |
| **260** | Investec Asset Management | 1 | 3 | 107,000,000,000 |
| **261** | Investment Solutions Ltd | 2 | 2 | 16,620,000,000 |
| **262** | IronBridge Capital Partners | 4 | 2 | 99 |
| **263** | ITG Europe | 1 | 1 | 222,000,000,000 |
| **264** | Ivory Investment Management | 4 | 1 | 2,110,000,000 |
| **265** | Jacobs Levy | 3 | 1 | 5,680,000,000 |
| **266** | Janus Capital International Ltd | 1 | 1 | 167,700,000,000 |
| **267** | JD Asset Management Plc | 5 | 2 | 99 |
| **268** | Jefferies International Ltd | 1 | 1 | 2,000,000,000 |
| **269** | Jegi | 5 | 1 | 99 |
| **270** | J.O. Hambro Investment Management Ltd | 1 | 2 | 19,164,600,000 |
| **271** | JP Morgan Asset Management | 1 | 1 | 1,500,000,000,000 |
| **272** | Jupiter Asset Management | 1 | 2 | 45,477,900,000 |
| **273** | K2 Asset Management Ltd | 1 | 3 | 1,000,000,000 |

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| **274** | Kames Capital | 1 | 2 | 80,613,000,000 |
| **275** | Kazimir Partners UK Ltd | 3 | 3 | 1,500,000,000 |
| **276** | Kennet Venture Partners Ltd | 4 | 2 | 600,000,000 |
| **277** | Key Asset Management (UK) Ltd | 5 | 99 | 99 |
| **278** | Key Capital Partners | 4 | 2 | 99 |
| **279** | Keyhaven Capital Partners Ltd | 4 | 2 | 1,200,000,000 |
| **280** | Khosla Ventures | 5 | 1 | 1,300,000,000 |
| **281** | Killik & Co | 3 | 2 | 3,700,000,000 |
| **282** | King Street Capital Management | 4 | 1 | 20,000,000,000 |
| **283** | Knight Vinke Asset Management | 3 | 4 | 1,570,000,000 |
| **284** | Knightsbridge | 3 | 1 | 446,900,000 |
| **285** | Kohlberg & Co. | 3 | 1 | 5,300,000,000 |
| **286** | KPS Capital Partners | 4 | 1 | 6,000,000,000 |
| **287** | Lane Clark & Peacock LLP | 4 | 2 | 99 |
| **288** | LaSalle Investment Management | 1 | 1 | 47,600,000,000 |
| **289** | Lazard Asset Management Ltd | 2 | 1 | 159,300,000,000 |
| **290** | Leadenhall Capital Partners LLP | 4 | 2 | 1,500,000,000 |
| **291** | Legal & General Investment Management Ltd | 1 | 2 | 608,400,000,000 |
| **292** | Levin Capital Strategies | 4 | 1 | 5,000,000,000 |
| **293** | Lexington Partners UK Ltd | 3 | 2 | 20,000,000,000 |
| **294** | LGT Capital Partners | 4 | 4 | 25,000,000,000 |
| **295** | Liberty Square Asset Management Ltd | 5 | 2 | 2,205,450,000 |
| **296** | Lindsell Train Ltd | 3 | 2 | 63,200,000 |

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|---|---|---|---|---|
| **297** | Liontrust Asset Management | 1 | 2 | 3,194,100,000 |
| **298** | Lloyd George Management | 1 | 3 | 26,100,000 |
| **299** | Logan Circle Partners | 4 | 1 | 23,600,000,000 |
| **300** | Lombard Odier Darier Hentcsh Asset Management | 4 | 4 | 163,370,000,000 |
| **301** | Lansdowne Partners | 3 | 2 | 7,460,000,000 |
| **302** | Longview Partners | 4 | 2 | 10,760,000,000 |
| **303** | Loomis Sayles | 2 | 1 | 193,500,000,000 |
| **304** | Lothbury Investment Management | 2 | 2 | 1,840,410,000 |
| **305** | LSV Asset Management | 4 | 1 | 77,000,000,000 |
| **306** | Lucidus Capital Partners LLP | 4 | 2 | 1,500,000,000 |
| **307** | Lyster Watson | 3 | 1 | 1,720,000,000,000 |
| **308** | Lyxor Asset Management | 1 | 5 | 110,800,000,000 |
| **309** | Mackay Shields | 1 | 1 | 77,700,000,000 |
| **310** | Macquarie Infrastructure and Real Assets | 1 | 3 | 265,000,000,000 |
| **311** | Magnitude Capital LLC | 3 | 1 | 3,100,000,000 |
| **312** | Majedie Asset Management | 2 | 2 | 12,168,000,000 |
| **313** | Man Investments Ltd | 1 | 2 | 52,500,000,000 |
| **314** | M&G Investments | 2 | 2 | 356,370,300,000 |
| **315** | Maple-Brown Abbott | 2 | 3 | 8,961,200,000 |
| **316** | Marathon Asset Management | 4 | 2 | 53,000,000,000 |
| **317** | Martin Currie Investment Management Ltd | 3 | 2 | 7,909,200,000 |
| **318** | Marvin Palmer Associates Inc | 1 | 1 | 152,780,000,000 |
| **319** | Maverick Capital Ltd | 3 | 1 | 9,700,000,000 |

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|---|---|---|---|---|
| **320** | MaxCap Partners LLP | 4 | 2 | 99 |
| **321** | McKinley Capital Management | 3 | 1 | 7,400,000,000 |
| **322** | Mercator Asset Management | 4 | 1 | 5,400,000,000 |
| **323** | Meridiam Infrastructure | 2 | 5 | 3,589,600,000 |
| **324** | Meridian Capital Partners | 1 | 1 | 825,000,000 |
| **325** | MFS Investment Management | 1 | 1 | 397,500,000,000 |
| **326** | Midas Capital Partners Ltd | 1 | 2 | 9,000,000,000 |
| **327** | Mercer | 1 | 1 | 5,300,000,000 |
| **328** | Millenium Global Investments Ltd | 2 | 2 | 13,000,000,000 |
| **329** | MIR Investment Management Pty Ltd | 1 | 3 | 1,025,600,000 |
| **330** | Mirabaud Investment Management Ltd | 4 | 4 | 26,350,000,000 |
| **331** | Mirae Asset Global Investment | 2 | 2 | 60,100,000,000 |
| **332** | Mitsubishi UFJ Asset Management (UK) Ltd | 1 | 3 | 529,000,000,000 |
| **333** | MMIP Investment Management Limit (Guernsey) | 3 | 2 | 99 |
| **334** | Mondrian Investment Partners Ltd | 4 | 2 | 66,000,000,000 |
| **335** | Montag & Caldwell Inc | 3 | 1 | 12,800,000,000 |
| **336** | Montagu Private Equity | 4 | 2 | 5,128,000,000 |
| **337** | Montanaro Asset Management | 2 | 2 | 3,205,000,000 |
| **338** | Morgan Stanley Investment Management | 1 | 1 | 347,000,000,000 |
| **339** | MTM Capital Partners Ltd | 5 | 2 | 99 |
| **340** | Muzinich & Co Ltd | 1 | 1 | 15,000,000,000 |
| **341** | Natwest | 1 | 2 | 78,667,641,000 |
| **342** | Navis Capital Partners Ltd | 1 | 3 | 3,000,000,000 |

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|---|---|---|---|---|
| **343** | Nephila Capital | 2 | 3 | 8,000,000,000 |
| **344** | Neptune Investment Management Ltd | 3 | 2 | 8,821,800,000 |
| **345** | Neuberger Berman | 3 | 2 | 227,000,000,000 |
| **346** | New Forests Pty Ltd | 3 | 3 | 1,875,600,000 |
| **347** | New Mountain Partners | 2 | 1 | 10,000,000,000 |
| **348** | New Star | 2 | 2 | 9,180,000,000 |
| **349** | Newedge Group UK | 5 | 5 | 99 |
| **350** | Schroders NewFinance Capital LLP | 4 | 2 | 6,844,500,000 |
| **351** | NewSmith Asset Management | 4 | 2 | 3,194,100,000 |
| **352** | Newton Investment Management Ltd | 1 | 2 | 77,418,900,000 |
| **353** | NGAM UK Ltd | 1 | 5 | 838,200,000,000 |
| **354** | Nikko Asset Management Europe Ltd | 2 | 3 | 163,000,000,000 |
| **355** | Nomura Asset Management UK Limited | 2 | 2 | 287,000,000,000 |
| **356** | Nordea Investment Management | 1 | 4 | 292,039,600,000 |
| **357** | Northern Trust Asset Management | 1 | 1 | 846,200,000,000 |
| **358** | Northwater Capital | 2 | 1 | 9,000,000,000 |
| **359** | Norwich & Peterborough Building Society | 5 | 2 | 7,452,900,000 |
| **360** | Nova Capital Management Ltd | 3 | 2 | 1,666,600,000 |
| **361** | Numeric Investors | 2 | 1 | 10,500,000,000 |
| **362** | Oaktree Capital Management Limited | 4 | 1 | 78,800,000,000 |
| **363** | Objective Completion Ltd | 3 | 2 | 2,281,500,000 |
| **364** | Och-Ziff Capital Management Group | 2 | 1 | 39,200,000,000 |
| **365** | Odey Asset Management | 4 | 2 | 11,300,000,000 |

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|---|---|---|---|---|
| **366** | Orbis | 3 | 3 | 40,000,000,000 |
| **367** | Oldfield Partners | 4 | 2 | 6,100,000,000 |
| **368** | Olympia Capital Management Ltd | 3 | 5 | 5,000,000,000 |
| **369** | Optimal Fund Management | 3 | 3 | 2,500,800,000 |
| **370** | Orchard Street Investment Management LLT | 4 | 2 | 4,563,000,000 |
| **371** | Origin Asset Management | 4 | 2 | 2,500,000,000 |
| **372** | Orion Capital Managers | 4 | 2 | 5,128,000,000 |
| **373** | Overlay Asset Management | 1 | 5 | 99 |
| **374** | Oxford Investment Partners | 5 | 1 | 99 |
| **375** | P-Solve Investments Limited | 2 | 1 | 13,000,000,000 |
| **376** | Pacific Alternative Asset Management Company LLP | 2 | 1 | 8,500,000,000 |
| **377** | Pantheon Ventures | 4 | 2 | 25,400,000,000 |
| **378** | Pareto Investment Management | 5 | 99 | 99 |
| **379** | Parish Capital Advisors Europe LLP | 5 | 99 | 99 |
| **380** | Partners Group | 3 | 4 | 38,460,000,000 |
| **381** | Pathway Capital Management (UK Ltd | 4 | 1 | 25,000,000,000 |
| **382** | Paul Capital Advisors | 4 | 1 | 6,700,000,000 |
| **383** | Payden & Rygel Global Ltd | 3 | 1 | 80,000,000,000 |
| **384** | Perennial Investment Partners | 2 | 3 | 18,000,000,000 |
| **385** | Permira Advisers LLP | 4 | 2 | 25,640,000,000 |
| **386** | Pictet Asset Management | 3 | 4 | 317,254,000,000 |
| **387** | PIL Invests | 5 | 99 | 99 |
| **388** | PIMCO Europe Ltd | 1 | 2 | 1,970,000,000,000 |

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|---|---|---|---|---|
| **389** | Pinebridge Investments Europe Ltd | 5 | 3 | 69,100,000,000 |
| **390** | Pioneer Investments Ltd | 2 | 2 | 216,658,000,000 |
| **391** | PIRC Ltd | 5 | 2 | 99 |
| **392** | Plainfield Asset Management LLC | 5 | 1 | 99 |
| **393** | Polaris Capital Management | 2 | 1 | 7,692,000,000 |
| **394** | Pomona Capital | 3 | 1 | 6,900,000,000 |
| **395** | Premier Asset Management | 99 | 3 | 12,087,200,000 |
| **396** | PRIMECAP Management Company | 3 | 1 | 64,000,000,000 |
| **397** | Principal Global Investors (Europe) Ltd | 1 | 1 | 292,400,000,000 |
| **398** | Prudential | 1 | 2 | 753,000,000,000 |
| **399** | Prisma Capital Management International | 2 | 1 | 8,100,000,000 |
| **400** | Private Wealth Management | 1 | 5 | 1,000,000,000,000 |
| **401** | Psignma Investment Management | 2 | 2 | 18,252,000,000 |
| **402** | Putnam Investments Ltd | 5 | 1 | 148,000,000,000 |
| **403** | Pyramis Global Advisors UK Ltd | 1 | 1 | 198,800,000,000 |
| **404** | Pyrford International Plc | 1 | 3 | 10,000,000,000 |
| **405** | Pzena Investment Management | 1 | 1 | 24,400,000,000 |
| **406** | Quester Capital | 1 | 1 | 450,000,000 |
| **407** | Quilter | 2 | 2 | 22,815,000,000 |
| **408** | Rathbone Unit Trust Management | 1 | 2 | 23,773,230,000 |
| **409** | RC Brown Investment Management | 1 | 2 | 304,200,000 |
| **410** | RCM UK Ltd | 5 | 2 | 99 |
| **411** | Realty Capital Partners | 3 | 1 | 350,000,000 |

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|---|---|---|---|---|
| **412** | Record Currency Management Ltd | 1 | 2 | 35,439,300,000 |
| **413** | Reech CBRE Alternative Real Estate LLP | 4 | 2 | 200,000,000 |
| **414** | Relational Investors LLC | 3 | 1 | 5,550,000,000 |
| **415** | River & Mercantile Asset Management Ltd | 4 | 1 | 2,585,700,000 |
| **416** | RMB Asset Management | 1 | 3 | 3,500,000,000 |
| **417** | Robeco (Schweiz) AG | 1 | 5 | 242,298,000,000 |
| **418** | The Rock Creek Group | 2 | 1 | 7,000,000,000 |
| **419** | Rockspring Property Investment Managers | 4 | 2 | 8,204,800,000 |
| **420** | Rogge Global Partners plc | 3 | 2 | 57,000,000,000 |
| **421** | T. Rowe Price | 1 | 1 | 647,200,000,000 |
| **422** | Royal London Asset Management Ltd | 1 | 2 | 76,050,000,000 |
| **423** | Royal London Cash Management | 1 | 2 | 9,126,000,000 |
| **424** | RREEF | 1 | 5 | 1,210,208,000,000 |
| **425** | Ruffer LLP | 4 | 2 | 20,685,600,000 |
| **426** | Russell Investments | 2 | 2 | 246,800,000,000 |
| **427** | RWC Partners | 3 | 2 | 6,100,000,000 |
| **428** | St James Place Wealth Management | 1 | 2 | 62,665,200,000 |
| **429** | Sankaty Advisors Ltd | 1 | 1 | 70,000,000,000 |
| **430** | Sarasin & Partners | 4 | 2 | 19,925,100,000 |
| **431** | Scale Venture Partners | 4 | 1 | 900,000,000 |
| **432** | Schroder Investment Management Ltd | 1 | 2 | 390,440,700,000 |
| **433** | Schroders New Finance Capital LLP | 4 | 2 | 4,500,000,000 |
| **434** | Scottish Widows Investment Partnership Ltd | 1 | 2 | 221,746,590,000 |

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|---|---|---|---|---|
| **435** | SEI | 1 | 1 | 529,000,000,000 |
| **436** | Semperian PPP Investment Partners LP | 4 | 2 | 1,977,300,000 |
| **437** | Sequoia Capital | 2 | 1 | 4,000,000,000 |
| **438** | Signet Capital Management Ltd | 2 | 2 | 700,000,000 |
| **439** | Siguler Guff | 4 | 1 | 10,000,000,000 |
| **440** | Silver Creek Capital Management LLC | 2 | 1 | 5,500,000,000 |
| **441** | Silverfleet Capital | 4 | 2 | 1,410,200,000 |
| **442** | Skagen Funds | 2 | 4 | 7,244,142,000 |
| **443** | Skandia Investment Group | 1 | 2 | 115,596,000,000 |
| **444** | SL Capital Partners LLP | 1 | 2 | 8,333,000,000 |
| **445** | Slater Investments Ltd | 3 | 2 | 45,630,000 |
| **446** | Souteastern Asset Management | 1 | 1 | 34,200,000,000 |
| **447** | Speirs & Jeffrey Ltd | 3 | 2 | 7,605,000,000 |
| **448** | Squadron Capital Advisors Ltd | 2 | 3 | 6,000,000,000 |
| **449** | Stafford Timberland Group | 3 | 2 | 1,300,000,000 |
| **450** | Standard Life Investment Ltd | 1 | 2 | 280,016,100,000 |
| **451** | Standard Pacific Capital LLC | 3 | 1 | 483,890,000 |
| **452** | State Street Global Advisors UK Ltd | 1 | 1 | 2,100,000,000,000 |
| **453** | SteelRiver | 4 | 1 | 1,900,000,000 |
| **454** | Stenham Asset Management | 2 | 2 | 2,000,000,000 |
| **455** | Stone Harbor Investment Partners UK | 4 | 1 | 63,100,000,000 |
| **456** | Stonepoint Capital LLC | 2 | 1 | 9,000,000,000 |
| **457** | Stralem & Company Inc | 2 | 1 | 3,500,000,000 |

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|---|---|---|---|---|
| **458** | Strategic Fixed Income LLC | 3 | 1 | 1,540,000,000 |
| **459** | STW Fixed Interest Management Ltd | 1 | 1 | 2,910,000,000 |
| **460** | Sumitomo Mitsui Asset Management (London) Ltd | 1 | 3 | 117,180,000,000 |
| **461** | Sun Capital Partners | 3 | 1 | 10,000,000,000 |
| **462** | Sun Life Financial of Canada | 1 | 3 | 12,200,000,000 |
| **463** | SVG Investment Managers | 1 | 2 | 3,954,600,000 |
| **464** | SVM Asset Management | 3 | 2 | 1,140,750,000 |
| **465** | SW Mitchell Capital | 4 | 2 | 1,700,000,000 |
| **466** | Taiyo Pacific Partners LP | 4 | 1 | 2,000,000,000 |
| **467** | Taube Hodson Stonex Partners LLP | 4 | 2 | 5,400,000,000 |
| **468** | Taylor Young Investment Management Ltd | 2 | 2 | 575,698,500 |
| **469** | TCW | 2 | 1 | 130,800,000,000 |
| **470** | Thames River Capital (UK) Ltd | 5 |  | 99 |
| **471** | Threadneedle Asset Management Ltd | 1 | 2 | 129,132,900,000 |
| **472** | Times Square Capital Management | 1 | 1 | 18,400,000,000 |
| **473** | Tokio Marine Asset Management (London) Ltd | 1 | 3 | 59,400,000,000 |
| **474** | Trilogy Global Advisors LP | 4 | 1 | 4,640,000,000 |
| **475** | TT International | 4 | 2 | 9,100,000,000 |
| **476** | UBP Asset Management LLC | 2 | 4 | 85,700,000,000 |
| **477** | UBS Global Asset Management | 1 | 4 | 621,000,000,000 |
| **478** | UBS Infrastructure and Private Equity | 1 | 4 | 1,520,000,000 |
| **479** | Unicorn Asset Management | 3 | 2 | 228,150,000 |
| **480** | Unigenstion (UK) Ltd | 2 | 4 | 14,000,000,000 |

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|---|---|---|---|---|
| **481** | Union Cancaire Privee (UPB) | 2 | 4 | 84,320,000,000 |
| **482** | UOB Global Capital LLC | 1 | 1 | 8,821,800,000 |
| **483** | Vanguard Asset Management Limited | 1 | 1 | 2,400,000,000,000 |
| **484** | VenCap International plc | 1 | 2 | 1,900,000,000 |
| **485** | Veritas Asset Management | 4 | 2 | 11,407,500,000 |
| **486** | Vestra Wealth LLP | 4 | 2 | 2,889,900,000 |
| **487** | Victory Capital Management Inc | 2 | 1 | 18,000,000,000 |
| **488** | Vintage Asset Management | 3 | 1 | 233,513,000 |
| **489** | Vontobel Europe S.A | 1 | 4 | 44,000,000,000 |
| **490** | Walker Crips Investment Management | 1 | 2 | 3,042,000,000 |
| **491** | Walter Scott & Partners Ltd | 1 | 1 | 59,800,000,000 |
| **492** | Wasserman Asset Management Ltd | 3 | 1 | 96,000,000 |
| **493** | WAY Fund Managers | 2 | 2 | 6,692,400,000 |
| **494** | WCM Investment Management | 3 | 1 | 1,910,000,000 |
| **495** | Wellington Management International Ltd | 2 | 1 | 774,000,000,000 |
| **496** | Wesleyan Assurance Society | 5 | 2 | 7,909,200,000 |
| **497** | Western Asset Management Co. Ltd | 1 | 1 | 442,700,000,000 |
| **498** | Westfield Capital Management | 4 | 1 | 16,000,000,000 |
| **499** | Wilky Fund Management Ltd | 2 | 2 | 45,630,000 |
| **500** | Winton Capital Management | 3 | 2 | 29,000,000,000 |
| **501** | YFM Equity Partners | 3 | 2 | 1,368,900,000 |
| **502** | York Capital Management | 3 | 1 | 3,900,000,000 |
| **503** | Other manager (unlisted) | 99 | 99 | 99 |

Sources: Fund Managers: Wilmington Directory of Pension Funds and their Advisors 2013: (Wilmington 2013)

FMOS: Individual fund manager websites (accessed September 2013-January 2014)

- 1= public entity
- 2= private entity
- 3= employee owned
- 4= partnership
- 5= other

FMRR: Individual fund manager websites (accessed September 2013-January 2014)

- 1= USA
- 2= UK
- 3= Asia Pacific
- Europe Other
- European Union

FMAUM: Individual fund manager websites (accessed September 2013-January 2014)

[Missing data coded as “99” or “999”]

# Appendix IV Additional supporting analysis for Chapter 6

This appendix provides support for the analysis in Chapter 6 and visibility into the data that was not covered in the descriptive statistics and regression analysis. The results are consistent with the outcomes of the Chapter.

## IV.I Fund manager ownership structure and pension scheme AUM

There significant difference between the AUM means of pension schemes engaging publicly listed corporation compared with partnerships (t=7.9209, df3919, p=0.0001; see Table A4.1). As with the fund manager ownership structure relationship with assets per member previously, the category is dominated by PLCs. When analysed as the binary internal owners and external owners (PLC v other: mean 2,933 ± 4,658) the result is also statistically significant (t=10.0537, df4878, p=0.0001). Larger pension schemes share a relationship with internally owned fund managers.

Table A4.1 Pension Scheme AUM by Fund manager ownership structure

| Ownership structure | Mean (£million) | Standard deviation (£million) |
|---|---|---|
| Publicly listed corporation (n=3,297) | 1,637 | 3,987 |
| Privately owned corporation (n=551) | 2,962 | 5,693 |
| Employee owned corporation (n=408) | 2,646 | 4,947 |
| Partnership (n=624) | 3,099 | 5,328 |

Conversely, smaller pension schemes share a relationship with PLCs. Given they are statistically correlated with lower scheme assets, fiduciary prudence would suggest that these are not the ownership structures benefiting less resourced pensions.  This premise holds regardless of the direction of the cause and effect in the relationship.

### IV.II  Fund manager reporting regime and pension scheme AUM

The sample is dominated by UK based fund management firms (64.2%).  Table A4.2 illustrates that UK reporting fund managers are statistically significantly managing smaller pension schemes (t=9.0763, df4969, p=0.0001).

Table A4.2 Pension Scheme AUM by Fund manager reporting regime

| **Ownership structure** | **Mean (£million)** | **Standard deviation (£million)** |
|---|---|---|
| United States (n=1,324) | 2,656 | 5,181 |
| United Kingdom (n=3,193) | 1,760 | 4,151 |
| Asia Pacific (n=135) | 3,446 | 5,914 |
| Europe Other (n=227) | 2,178 | 4,613 |
| European Union (n=92) | 2,398 | 4,613 |

Smaller schemes seem to be predominantly selecting UK based fund managers. As with the ownership structure analysis previously, the direction of the relationship cannot be determined.  However, the results suggest that these schemes may benefit from emulating the investment destinations of their larger cousins.

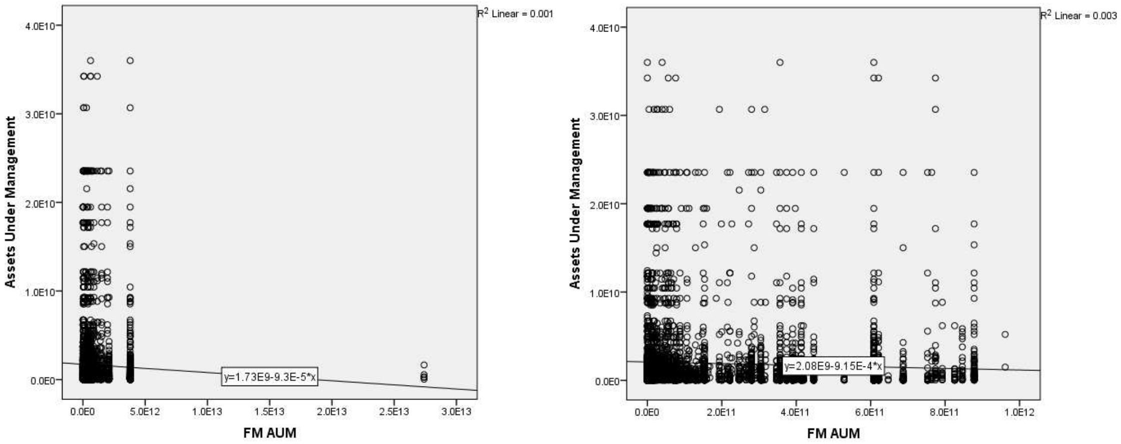
### IV.III Fund manager AUM and pension scheme AUM

The association between fund manager assets and pension scheme assets was negatively and significantly correlated (r= -0.071, p=0.001). This result included the fund manager AUM outliers. Figure A4.1 depicts how the cases spread when the outliers are removed.

Figure A4.1 Assets under management correlation between pension schemes and fund managers assets under management

A. Correlation with all cases

B. Outliers >= £1 trillion removed



The interesting result is that the relationship still remains negative and significant (r= -0.052, p=0.0001). Smaller pension schemes are gravitating towards larger fund managers, as predicted by the ownership structure results.

### IV.IV Fund manager ownership structure and pension scheme multiple fund manager engagements

This relationship was also statistically significant (F=105.030, df3, p=0.0001). The majority of pension schemes in every category of fund management engagement numbers preference PLCs. This is statistically likely, given the predominance of this ownership structure.

Table A4.3 Number of fund managers engaged by ownership structure as a percentage

| FM Engaged | PLC (%) | Private (%) | Employee owned (%) | Partnership (%) | Total (n) |
|---|---|---|---|---|---|
| 1 | 82.9 | 9.0 | 3.1 | 5.0 | 486 |
| 2-5 | 80.3 | 7.2 | 5.3 | 7.3 | 1,576 |
| 6-10 | 64.4 | 12.9 | 9.5 | 13.3 | 1,275 |
| 11-30 | 55.3 | 14.1 | 11.4 | 19.2 | 1,285 |
| >30 | 38.0 | 19.0 | 16.3 | 26.7 | 258 |

However, as the schemes gravitate towards larger numbers of fund engagement, the likelihood of engaging a PLC decreases markedly. This is in keeping with previous results reported in Section 6.5.2. Larger schemes are more likely to spread their funds management across a range of ownership structures, regardless of the fact that this shows no evidence of benefiting the individual member.

### IV.V Fund manager reporting regime and pension scheme multiple fund manager engagements

The predominant territory where funds are placed is the UK, regardless of the number of fund managers engaged. However, this dominance dissipates as the number of schemes engaged increases. As Table A4.4 implies, the trend strongly inclines toward the USA as schemes diversify.

Table A4.4 Number of fund managers engaged by reporting regime as a percentage

| FM Engaged | USA (%) | UK (%) | Asia Pacific (%) | Europe other (%) | EU (%) | Total (n) |
|---|---|---|---|---|---|---|
| 1 | 16.1 | 78.2 | 1.4 | 3.7 | 0.4 | 491 |
| 2-5 | 18.7 | 74.1 | 1.6 | 4.0 | 1.6 | 1,595 |
| 6-10 | 28.6 | 61.0 | 2.6 | 5.5 | 2.2 | 1,301 |
| 11-30 | 34.8 | 53.9 | 4.0 | 4.6 | 2.3 | 1,327 |
| >30 | 42.6 | 44.5 | 5.7 | 4.9 | 1.9 | 265 |

As with the previous result, larger schemes who engage more fund managers are more likely to spread their assets with geographic diversity. This does not improve the statistical significance of the asset per member, so the expedience of portfolio diversification requires further investigation.

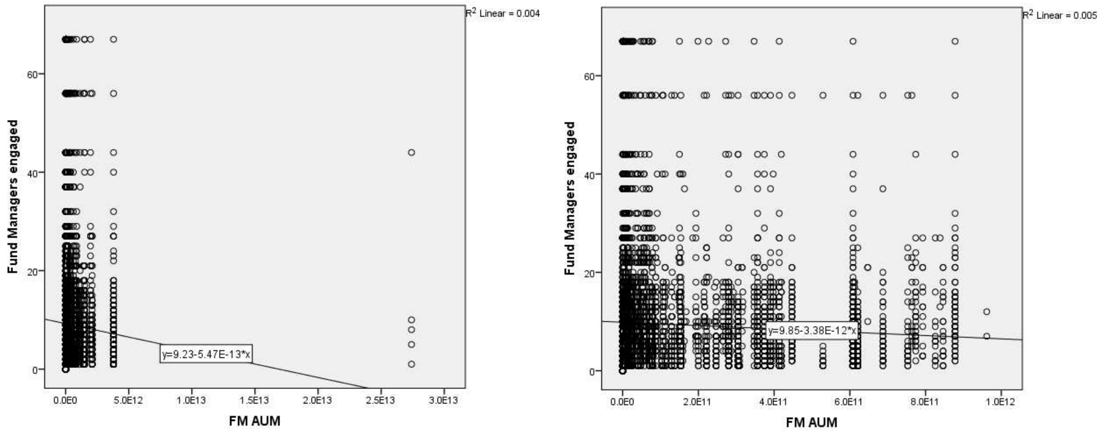
### IV.VI Fund manager AUM and pension scheme fund manager engagement

Removing the outliers gives a better indication of the relationship between the size of the fund managers pension schemes are engaging as they select more management parties. It is still statistically (and negatively) significant (r= -0.3, p=0.0001) that the more fund managers engaged, the smaller those fund managers will tend to be. The reverse is the same, choosing fewer fund managers inclines the pension scheme towards larger fund managers.

Figure A4.2 Assets under management correlation between pension schemes assets under management and fund managers engaged

A. Correlation with all cases

B. Outliers >= £1 trillion removed



The correlation between multiple engagement and fund manager size implies that the smaller the pension scheme, the fewer fund managers and those fund managers will be large.

### IV.VII Summary

There is a consistent relationship between the characteristics of the pension scheme and the fund managers they have engaged. The larger the pension scheme, the more fund managers they will engage and the smaller (more boutique) these become.  This has no bearing on the wealth of the individual pension scheme member (evidenced from Section 6.7) but does suggest that there are trends, or consistent behaviours based around the size of the pension scheme.  The issue of the direction of this relationship, the cause and effect, is undetermined.

This may suggest, for recommendations to policy makers and practitioners, that decision making including collective bargaining and consolidated fund manager choices may be beneficial to the efficient placement of assets.  The fact that PLC owned fund managers dominate asset management may not be a trend that is benefiting the pension schemes, with the caveat that these pension schemes may be investing their smaller funds into large fund managers possibly to provide fiduciary security and limit potential exposure to the risks of boutique investing.

### IV.VIII Analysis of the relationship between the governance variables and assets per member by pension scheme type

In keeping with the Office of National Statistics methodology described in Chapter 4, the pension scheme types (Defined Benefit Open, Defined Benefit Closed, Hybrid and Defined Contribution) have been treated as significantly distinct taxa by both assets under management and total membership (Assets under management (F=91.598, df4, p=0.0001) and membership size (F=84.461, df4, p=0.0001: see Table A4.5).

Table A4.5 Schemes by assets under management and total membership

| **Pension Scheme** | **Assets under management mean and SD (£)** | **Total membership mean and SD (retired and current participants) (£)** |
|---|---|---|
| Defined benefit open (n=1146) | 477,674,018 ± 1,770,094,353 | 13,013 ± 31,974 |
| Defined benefit closed (n=477) | 567,434,725 ± 2,141,828,927 | 7,757 ± 24,467 |
| Hybrid<br>(n=267) | 911,030,768 ± 3,147,755,498 | 13,251 ± 44,144 |
| Defined contribution (n=204) | 105,716,831 ± 228,132,743 | 5,186 ± 9,823 |

To determine whether the governance constructs are a statistically significant, in-house and defunct results were removed to consider ownership structures of fund manager agents alone, without these categories prejudicing the results. Similarly, in-house results were removed from FMRR to examine external fund managers only. The results for Defined Benefit Open schemes are depicted in Table A4.6, Defined Benefit Closed schemes in Table A4.7, Hybrid schemes in Table A4.8. The last population to test the premise in is the defined contribution sample in Table A4.9. The dataset used for analysis was the converged database.

Table A4.6 The relationships between the governance, mediating pension and dependant variables relating to the member assets in Defined Benefit Open Schemes (n=2,898)

| Number/ dataset[1] | Governance construct | Dependant construct | Result |
|---|---|---|---|
| 1 CD | FMOS | AUMPM | F=32.421, df5, p=0.0001*** |
| 2 CD | FMRR | AUMPM | F=32.401, df5, p=0.0001*** |
| 3 CD | FMAUM | AUMPM | r=0.065,<br>p=0.0001*** |

Table A4.7 The relationships between the independent, mediating and dependant variables determining the existence of mediation in Defined Benefit Closed Schemes (n=1,492)

| Number/ dataset[1] | Governance construct | Dependant construct | Results |
|---|---|---|---|
| 1 CD | FMOS | AUMPM | F=3.076, df5, p=0.010** |
| 2 CD | FMRR | AUMPM | F=3.076, df5, p=0.009** |
| 3 CD | FMAUM | AUMPM | r=- 0.014,<br>p=0.573 |

Table A4.8 The relationships between the independent, mediating and dependant variables determining the existence of mediation in Hybrid Schemes (n=938)

| Number/ dataset[1] | Governance construct | Dependant construct | Results |
|---|---|---|---|
| 1 CD | FMOS | AUMPM | F=0.403 df5, p=0.847 |
| 2 CD | FMRR | AUMPM | F=0.384, df5, p=0.860 |
| 3 CD | FMAUM | AUMPM | r=-0.018,<br>p=0.571 |

Table A4.9 The relationships between the independent, mediating and dependant variables determining the existence of mediation in Defined Contribution Schemes (n=395)

| Number/ dataset1 | Governance construct | Dependant construct | Results |
|---|---|---|---|
| 1 CD | FMOS | AUMPM | F=0.561, df5, p=0.730 |
| 2 CD | FMRR | AUMPM | F=1.404, df5, p=0.222 |
| 3 CD | FMAUM | AUMPM | r=0.055,<br>p=0.269 |

As sponsoring employers move to close Defined Benefit Open schemes and move members into schemes that no longer guarantee the end benefit, the analysis by scheme taxa is important to the results. Defined Benefit Open schemes are the only ones to share a direct relationship with the three governance variables. These schemes are more likely to diversify in fund manager selection away from the UK and into boutique ownership structures. Most importantly, there is a positive correlation between the assets under management of the fund manager engaged and the assets per member.

As the direction of this relationship cannot be determined it requires further examination in the following analysis chapter. The inference may be that the statistically larger pension schemes are better managers of their principal. Alternatively, it could be that large fund managers court large pension schemes are key clients and expend more effort ensuring their principal receives exclusive best interest.

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