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Foreword by
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FROM PENSIONS TO PROSPERITY

RETHINKING PENSIONS
UNLOCKING PROSPERITY



'THERE ARE RISKS AND COSTS TO
ACTION. BUT THEY ARE FAR LESS
THAN THE LONG-RANGE RISKS OF
COMFORTABLE INACTION'

John F Kennedy

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FOREWORD

Pensions represent the greatest avoidable disaster in British economic policy over the last three decades.

We have seen a series of regulatory interventions in the management of funds, the reserving of liabilities, modifications to accounting standards, developments in accounting practice, and innovations in the conduct of monetary policy - each of them well-intentioned and in part defensible, but without any recognition of the interactions between them or of their overall consequences.

The result is not only that a generation will be left with inadequate pensions but that they will experience during and beyond their working lifetime an economy less dynamic and sustainable than their parents and grandparents were able to enjoy.

If you feel, as too many people do, that pensions are boring and relevant only in the far distant future, turn at least to the charts on pages 18 and 20 of Joe Zammit-Lucia's pamphlet. There, you will see that UK investments make up only 32% of UK pension fund assets and that 66% of these are in government stocks and corporate bonds. No other country has an asset allocation remotely comparable.

Many different and interrelated policies will be needed to put things right - this is not a policy area where further tinkering will do the trick. We need to reform pension fund regulation, rethink risk interpretation, secure better infrastructure management, and distinguish ethical business and investment from virtue signalling.

This pamphlet is a compelling contribution to an urgently needed debate.

Professor Sir John Kay
London School of Economics
and Political Science

**TINKERING WON'T
DO THE TRICK**

**WE NEED URGENT
REFORM**

1. KEY MESSAGES

REFORMING THE RETIREMENT INVESTMENT SYSTEM IS CRUCIAL FOR ANY GOVERNMENT TO DELIVER GROWTH AND PROSPERITY

- No UK government can hope to deliver sustained economic growth and prosperity without effectively mobilising the large pool of retirement savings for productive investment in the UK economy.
- The system has been degraded to the extent that it can no longer even guarantee the financial benefits that members should rightfully expect.
- Additionally, pensioners don't care about money *per se*. They care about their quality of life and access to goods and services post-retirement. Yet financialisation of the pensions system has not only reduced financial security for pensioners, it has also largely ignoring funds' role in the macroeconomic factors that drive their members' quality of life.
- Retirement savings have a much broader and more important role to play in the UK political economy than being a mere financial service.
- Such a broader role for pension funds benefits funds themselves and their members, creating a virtuous cycle of higher economic growth, improved returns, and increasing inflows of retirement contributions.
- In a fiscally constrained environment facing demographic challenges, unlocking the overall economic potential of retirement savings must therefore be **a top political priority for any government wishing to deliver broad based prosperity while living up to the social contract for those reaching retirement.**

ENCOURAGING THE LARGE POOL OF SAVINGS INTO PRODUCTIVE UK INVESTMENT MUST BE A HIGH PRIORITY

2. WHAT IS THIS PAMPHLET ABOUT?

This pamphlet is intended to frame a broader role for pension funds in the UK political economy and how it can be achieved. While we all complain about the relatively low level of savings in the UK, we should, maybe, first examine how we can use the savings we do have in the most productive manner to deliver broad prosperity.

This paper is intended to stimulate a discussion around the *framing* of pensions rather than their operationalisation. Framing has a very powerful effect on thought. Finding an appropriate framing of what pensions systems are about and what they ought to be about is therefore the crucial foundation on which all other policy discussions must then be built.

At a meeting with pension asset allocators, one of the attendees managed a local government pension scheme. He was explaining his investment opportunities and challenges when he came up with this statement: *"It would all be fine if we could just get on with it, but sometimes politics gets in the way of our investment decisions."*

When it came to my turn to comment I suggested that politics is not something that 'gets in the way'. That politics – defined as the mechanism through which we make collective decisions on the type of society in which we wish to live – is both central and integral to investment decisions because where and how citizens' money is invested has a significant impact on the type of society in which we live. If funds invest in infrastructure, we're all likely to lead more comfortable lives. Whether funds invest in, say, the cleantech transition or not will significantly impact the lives of their members – current and future. If fund investments buoy up hostile or potentially hostile states, they are undermining their own members' security.

Whenever I make these points, I am usually told that

APPROPRIATE
FRAMING IS THE
FOUNDATION ON
WHICH ALL ELSE
MUST BE BUILT

POLITICAL
CONSIDERATIONS
ARE INTEGRAL TO
INVESTMENT
DECISIONS

ALL INVESTING IS IMPACT INVESTING

if I want to talk about these things, I should talk to the impact investment people. The term impact investing has gained traction, with much good work being done by many. But it does somewhat beg the question: what, exactly, is non-impact investing?

Every investment decision has an impact on people's lives – for better or for worse, depending on one's own outlook and opinion. All investing is impact investing, and we could, maybe, do better if we evaluated the wider impacts of all our investments alongside the focus on expected financial returns. If we're honest, there may well be less uncertainty about the former than the latter.

The local government pension fund manager mentioned above clearly saw the world, and the role of pension fund investments, differently to the way in which his political colleagues saw it. This pamphlet is about that. It contrasts two ways of understanding pension funds – what they are, or could be, about; what their role in our society and our political economy is, and what it could be.

The world is shifting from its current form of financial capitalism to what we describe as political capitalism.¹ What is that? you may well ask.

"I define political capitalism as a resilient capitalist system that is in tune with political and socio-cultural mores and works to deliver sustainable long-term benefits for society as a whole. Where private and public sectors are aligned in delivering to common socio-political objectives."²

WHAT WOULD PENSION FUNDS LOOK LIKE IF LOOKED AT THROUGH A POLITICAL ECONOMY LENS RATHER THAN A FINANCIALISED ONE?

This pamphlet will contrast what pension funds, including trust-based pensions and insured pensions, look like if looked at through the lens of political capitalism as opposed to through the lens of financial capitalism – the currently prevalent perspective. These different perspectives lead to different behaviours by asset allocators, a different set of skills built up within

funds, different metrics of performance, different approaches by governments and their appointed regulators and, ultimately, differences in the kind of society that we and future generations get to live.

The UK has the second largest base of funded assets in the OECD by market value and the eighth largest as a proportion of GDP.³ Yet those assets are not used as productively as they could be.

The job of politics is to shape how markets operate. The political system and its appointed regulators have two functions. One is the well-known policing function – making sure that market participants operate within the law and relevant regulations. But **more important is regulators' role in setting the framework within which markets operate. The incentives within the system, the way that the legal and regulatory structures drive behaviours, and the outcomes of those behaviours.**

"Regulation has the potential to create the conditions for new business activity and desired behaviours to emerge spontaneously. It can achieve systemic change through emergent effects and has the potential to drive innovation, to make industry more competitive and forward-looking."⁴

FROM CAPITAL TO CAPITALS

Another way of looking at this is to evaluate the use and generation of capital – or, more accurately, various forms of capital.

In an age of financial capitalism, financial capital lay at the centre of how funds evaluated their contribution to society, to members, and to their own business – largely to the exclusion of all else.

Yet in how they make investments, funds utilise, create, or destroy various forms of capital. In addition to financial capital these include social capital, human capital, knowledge capital, political capital,

**THE UK'S LARGE BASE
OF RETIREMENT
SAVINGS IS NOT
INVESTED AS
PRODUCTIVELY AS IT
COULD BE**

**WHAT ARE PENSION
FUNDS' IMPACTS ON
THEIR VARIOUS
FORMS OF CAPITAL?**

PENSION FUNDS HAVE A MUCH MORE IMPORTANT ROLE THAN BEING A MERE FINANCIAL SERVICE

environmental capital, natural capital, How are funds doing in all of this? Are they running their business and making investments in a way that adds value to all their capitals? Or are they, in effect, consuming (some would say stealing) some forms of capital and converting them to financial capital?

As an example, funds are utilising political, social and fiscal capital to their and their members' benefit through the various tax advantages that surround pension savings. Are they delivering sufficient political and social capital in return? Maybe not, or not as much as they could. Or even as much as they previously did.

Today, pension funds have come to be seen as a financial service. They think of themselves and act as such. Some of the social value they were previously expected to deliver has been eroded.

What follows compares the implications of this narrow financial perspective on pension funds to a perspective that sees them as having a much more important role in our political economy than a mere financial service.

A perspective that, if adopted, would bring significant benefits to society, to governments acting in the broad societal interest, to members, and to funds themselves.

3. THE FINANCIAL PERSPECTIVE

FUNDS ARE STEADILY ABANDONING THEIR ORIGINAL VALUE PROPOSITION AND SOCIAL CONTRACT

A financial perspective on retirement savings funds sees them purely as a financial service. One that intermediates money over time.

Through such a lens, funds take in members' monies, invest them in a way that, hopefully and with a following wind, delivers a decent financial return, and, with luck, delivers a lump sum or a stream of income to members on their retirement. That's more-or-less it. To put it crudely, pension funds looked at in this way are giant piggy banks – eating tax-subsidised money at one end, digesting it to get a financial return, and pushing it out to members as they retire.

Let us examine for a moment the implications of this approach.

There used to be a time when the pension value proposition was to deliver to members a quality of life that was reasonably comparable to that to which they had become used towards the end of their working lives. That was the rationale for Defined Benefit (DB) schemes linked to income levels at retirement and with some degree of protection against post-retirement erosion of living standards through inflation or other factors.

As the industry moves to Defined Contribution (DC) schemes, this social contract is being abandoned. The former pension value proposition is no longer.

DC FUNDS HAVE SHIFTED RISK WHOLESALE TO THOSE WHO CAN LEAST BEAR IT

DC schemes no longer guarantee any level of income (or equivalent) post-retirement. With typical financial logic, 'de-risking' means, in practice, the transfer of risk from one place to the other. **There is no reasonable sharing of risk between members, funds that collect fees as they go along, and employers that have banked decades of benefit from their employees' labour. In DC schemes performance risk**

is transferred wholesale to members, arguably those who can least bear such risk.

DC schemes are no longer truly 'pension funds' in the social outcome sense defined above. Rather they are better described as retirement savings schemes. Some have described DC schemes as 'ersatz' versions of a pension system.⁵

In other words, there is no difference in principle between putting one's savings with a DC retirement savings fund as opposed to a standard savings account offered by any high street bank. Or placing one's assets with a bespoke asset manager.

Yet retirement savings funds are politically privileged in that the tax system (with some offsetting limitations on access to money) acts to encourage funnelling money to such funds rather than alternative savings vehicles. The question needs to be asked: if DC funds are, today, no more than savings accounts operating solely to financial logic, why should they be so privileged?

Further, if funds are becoming no more than savings accounts with all financial risk transferred to members, what level of fees should they be charging for this decreased level of service? Add to that the fact that so much of members' monies is now simply invested in gilts (see later) – some would argue that being no different to putting one's money on deposit – and one really has to question the value for money that is being provided.

Reacting to the recent letter by Larry Fink, Chairman and CEO of Blackrock⁶, Randi Weingarten, president of the American Federation of Teachers and Damon Silvers, former AFL-CIO policy director, put it bluntly:

"Fink thinks that the financialization of America's private sector defined benefit system since the 1970s and its replacement by

**ARE DC FUNDS
PROVIDING ENOUGH
SOCIETAL BENEFIT
TO JUSTIFY THEIR
FISCAL PRIVILEGES?**

underfunded savings accounts is a good thing. And so, he stands amid the destruction that flowed from that policy-driven disaster and wonders why Americans are facing retirement with no ability to support themselves.”⁷

It's not just about the money

PENSIONERS DON'T CARE ABOUT MONEY

Another crucial point is that, as Nicholas Barr points out⁸, pensioners don't care about money. What they care about is their quality of life and their ability to access and consume goods and services post-retirement. They care about access to health care, to social care, the quality of the transport network, ... In other words, they care about the supply of goods and services they wish to consume - the only reason that money is useful to them (and to the rest of us).

Yet, **financialisation has narrowed the focus on pension funds merely to accounting for money.**

There is little focus on the broader economic factors that are big drivers of pensioners' quality of life; economic factors that are also, as it happens, determinants of the financial returns that funds can make on their members' money (see Section 4).

This narrow focus may be comfortable for asset owners as it avoids having to trade off multiple objectives - just like a narrow focus on stock price performance is comfortable for business leaders. But it does not paint the full picture of what acting in the best interests of members actually means.

INVESTMENT BEHAVIOUR

CAPTURED BY FINANCIAL LOGIC

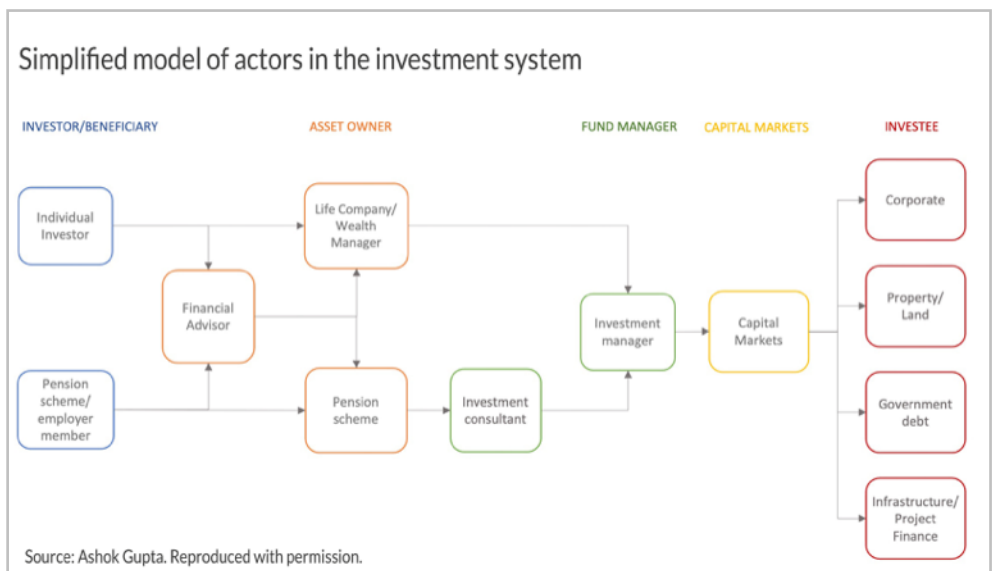
Funds' investment behaviour is driven by a combination of their own views of their role in society and the regulatory framework within which they operate. Both have been captured by pure financial logic. In fact, as the diagram on the next page shows,

funds' investment decisions are fully mediated by investment managers and investment consultants (a highly concentrated market with few available offerings) all embedded in the financial system and financialised approaches. Investments then flow through largely borderless capital markets.

In other words, funds have become fully captured by what Professor Colin Mayer calls '*a financial system of absent owners*' that is paralysing for UK economic development.⁹ In fact, it's worse than that. Having shifted most of their investments to bonds rather than equities, many UK funds are not even at scale 'absent owners.'

FOCUS

In their investment behaviours, the narrative goes that funds are players in global financial markets. That their fiduciary duty is limited to optimising financial returns and trumping any particular loyalty to place or other considerations. '*The primary focus of pension funds is to ensure a retirement income for their members*' according to the Pensions and Lifetime



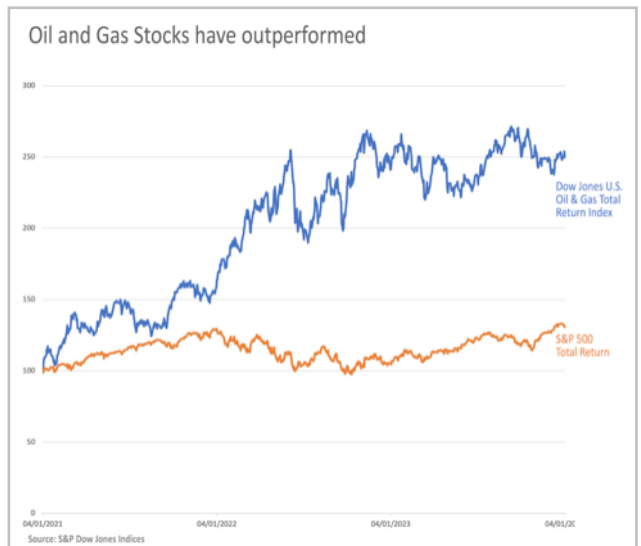
*Savings Association.*¹⁰

Such a statement is far too limited in scope as we shall see later. As mentioned previously, when applied to DC funds, it shrugs off both any responsibility for the level of retirement income and any responsibility for a fair sharing of risk between employers, funds and members.

Besides, the statement is empirically incorrect.

INVESTMENT DECISIONS TAKE ACCOUNT OF NON- FINANCIAL CONSIDERATIONS

For instance, a number of funds have stopped or limited their investment in the oil and gas industry in an attempt to help decarbonisation. Yet that sector continues to provide superior returns (figure). If funds' focus were, indeed, exclusively on financial returns, they should have been piling in as soon as it became clear that geopolitical and other developments would lead to windfall profits for oil and gas companies.



Further calls for taking a broader view have come from within the retirement savings industry itself. Christopher Ailman, outgoing chief investment officer at the California State Teachers' Retirement System

FIDUCIARY DUTY REQUIRES TRUSTEES TO BALANCE MULTIPLE FACTORS

(CalSTRS) argues of private equity investments that *'it's great [private equity funds] make money for our retirees – who are teachers...they need also to share the wealth with the workers of those companies and with the communities they invest in.'*¹¹

In the UK, the *Butler-Sloss and ors v Charity Commission and anor* [2022] Ch 371 (Butler-Sloss) has become the leading case in the area and the judgment in that case applies equally to pension fund trustees. The case made clear that Trustees *"need to exercise good judgment by balancing all relevant factors."*

*"If that balancing exercise is properly done and a reasonable and proportionate investment policy is thereby adopted, the trustees have complied with their legal duties in such respect and cannot be criticised, even if the court or other trustees might have come to a different conclusion."*¹²

In other words, there is already a clear recognition that presumed financial returns to investors do not, in fact, trump all other considerations. The question, therefore, is not one of principle but whether current approaches are the most appropriate and the most productive.

It is also worth reflecting on whether divestment strategies are mainly symbolic; virtue signalling action that may keep activists off one's back while providing the opportunity to market 'green' or 'responsible' funds. Such superficial virtue signalling can come with extraordinary consequences.

The Australian government is trying to encourage pension funds to invest in ways that enhance the country's defence capabilities – an understandable and judicious policy objective in an increasingly perilous world and given Australia's geographic position. Yet many funds have an internal prohibition

IMPACT OR VIRTUE SIGNALLING?

THE UK'S LARGE BASE OF RETIREMENT SAVINGS IS NOT INVESTED AS PRODUCTIVELY AS IT COULD BE

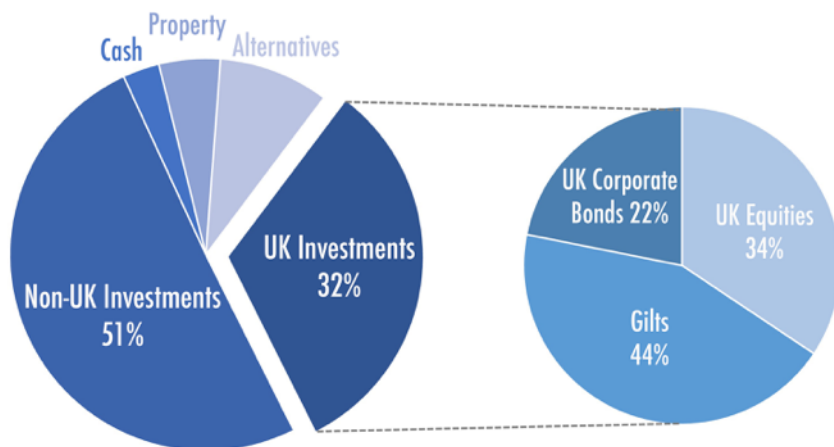
on investing in defence-related projects and companies for supposedly 'ethical' reasons. Which raises the question as to how not investing in what is likely to be a significant growth industry AND failing to support their country's and its citizens' (pension fund members) national security all represent being 'ethical' and acting in the interests of members.

It is time that investment approaches evolved from virtue signalling, simplistic divestment strategies, and a focus on marginal reductions of harms to a more active outlook on how investment decisions can generate positive and desirable real-world outcomes.

PLACE AND INSTRUMENTS

UK pension funds invest more outside the UK than within the country. And they invest largely in financial instruments – stocks and bonds (figure). In other words, investments are at least one removed (and

Asset Allocation - All UK pension funds



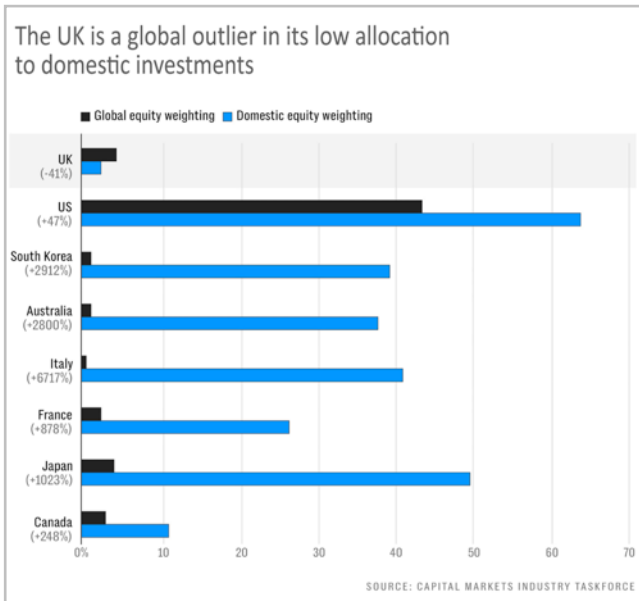
Source: Pensions and Lifetime Savings Association

more) from the UK's real economy. They are investments (some would call them speculation) in tradeable financial instruments rather than primary investments in industrial and economic development.

Much has been talked about increasing UK focused investment, with limited success. Some have even suggested the introduction of fiscal incentives to encourage investment in the UK. This is probably unreasonable.

Funds already benefit from substantial fiscal support – to the tune of some £60 billion annually according to some estimates. Adding yet more fiscal incentives to encourage funds to do what they should be doing anyway if they were to understand their fiduciary duty to members more broadly, is probably a step too far. In fact, some have argued that it might not be unreasonable for government to link the tax breaks, or part of them, to a stipulation of primary investment into the UK economy.*

UK FUNDS ARE OUTLIERS IN THEIR LOW ALLOCATION TO LOCAL INVESTMENT



* By primary investment we refer to direct investment in the UK economy – R&D, infrastructure projects, etc. as opposed to secondary investments through stocks and bonds.

THERE IS NO INCENTIVE FOR TAX BREAKS WHEN INVESTMENT PATTERNS DO NOT BENEFIT THE UK ECONOMY

It is argued that the fact that such investments are currently largely limited to bonds and stocks may well put a cap on the amount of UK investment possible without driving unsustainable asset bubbles. Yet that argument does not provide sufficient explanation as to why UK funds are outliers to such an incredible extent (figure).

In the developed world the average overweight position of each country in its own domestic equity market is 2089%, whilst the UK pensions industry is 41% **underweight** its own country. Why? Smaller economies with higher levels of savings, such as Australia, still manage to be over 2000% overweight in their domestic markets.

There is little incentive for government to provide further fiscal incentives when funds do not seem currently to have the capability to make meaningful direct primary investments in the UK's real economy. In fact, it may be reasonable to question whether the billions currently spent on tax breaks are justified given the limited benefits to UK prosperity.

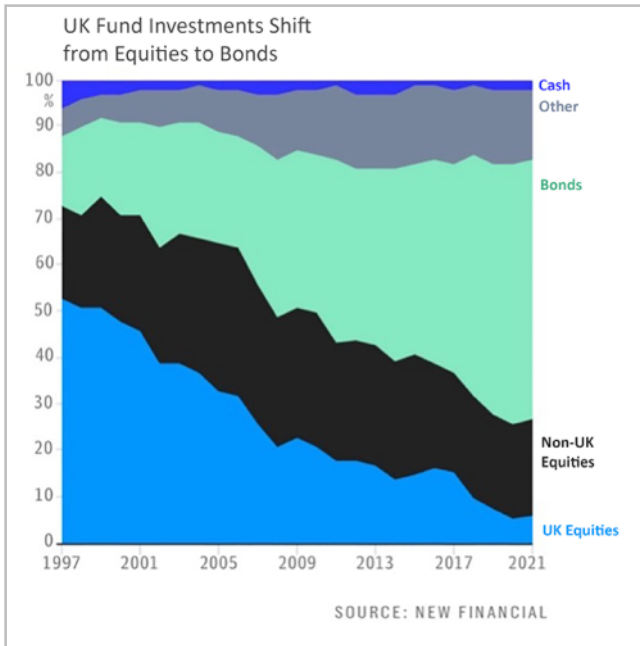
Further distancing fund investments from stimulating the economy is the fact that UK investments have shifted substantially from stocks to bonds (figure, next page).

Domestic pension and insurance funds now hold less than 5% of UK quoted companies, down from nearly 50% in 1997.

Some in the industry have argued that buying up large volumes of gilts helps the political economy by providing government with financing for essential services and investments in public goods. This has some truth to it, but it is, again, a highly incomplete argument.

The fact that the UK government needs to continue to access increasing amounts of public debt for its own

HIGH LEVELS OF GILT
ISSUANCE IS A SIGN
OF ECONOMIC
FAILURE



financing needs is nothing to be celebrated. It is, in fact, evidence of economic failure with successive governments unable to balance their books. **We would all be much better off if fund investments were better utilised to stimulate growth in the real economy and reduce the need for ever more government debt.**

GILTS ARE NOT
RISK FREE

Besides, gilts may not be as risk-free as some seem to believe absent a thriving economy:

*"Any investment strategy that relies wholly on the Government's ability to keep servicing its debts from future tax revenues might seem just as risky as the rollercoaster of the stock market, if not rather more so when the productive part of the economy is dying from neglect. But that's not the way the actuaries look at it."*¹³

Or, some would argue, it's not the way actuaries are

SLEEPWALKING INTO THE STABILITY OF THE GRAVEYARD?

required to look at it given the regulatory straitjacket within which they must operate.

Yet, the above statement is fully vindicated by the £425bn in lost pension fund value resulting from the bond market turmoil following the Truss-Kwarteng 'mini budget.'

Added to which, if mature DB funds start dumping gilts to generate cash to pay out their liabilities (see later), the cost of servicing the public debt may well climb putting public finances under increasing strain.

Much, though maybe not all, such behaviours of mature DB funds can be put down to the regulatory framework in which they are forced to operate rather than to the funds themselves. The government is not helping itself.

Overall, it is hard to argue that these current investment practices are particularly helpful for the UK economy. **Through their investment behaviours and the regulatory framework surrounding them, are funds sleepwalking into what has been called the stability of the graveyard?**

The reality is that it doesn't have to be this way. Many Local Government Pension Schemes remain open DB schemes. Yet some have implemented investment strategies that include, for instance, investment in social housing, student accommodation and other such infrastructure. Maybe this is driven by a combination of factors. Such funds are not subject to the same regulatory constraints on their investment decisions as are private sector funds. They also have a governance structure that has local councillors sitting on pension committees and pushing for socio-politically important investment (as per the investment manager mentioned at the start of this pamphlet). They have established regional pool structures.

What all this shows is that different investment approaches are, indeed, viable even for private open and closed DB funds.

Embedding short-termism in a long horizon industry

It all reflects the limited options that arise from financialised thinking both within funds and among regulators. While fund performance continues to be evaluated using traditional financial metrics on a rolling short-term basis, funds will continue to be risk averse and with a not insubstantial focus on supposed 'safety' and short-term financial returns.

Mark to market requirements lead to a focus on balance sheet protection and the confusing of volatility with risk – when short-term volatility is largely irrelevant for funds that are supposed to have a multi-decade time horizon. **In short, the risk is that the long-term becomes degraded into a series of short-term periods each driven by short-term decisions.**

Alternative investment practices

Investment in 'Alternatives' forms such a small part of fund investments that it is almost irrelevant. Yet, even when investments are made in, for instance, start-up and scale up companies, funds tend to do so through existing venture capital (VC) and private equity (PE) players in the market. Yet the culture and objectives of some such players can be fundamentally different from that which should prevail in a retirement savings fund.

Some VC and PE players are focused on limited term investments, high levels of leverage, dubious valuations, routes to exit and, some have argued, a skewed playing field that shifts most of the rewards

INVESTMENTS
THROUGH
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CULTURE AND
OBJECTIVES

PROVISION OF LONG-TERM, PATIENT CAPITAL IS THE PRIMARY VALUE OF RETIREMENT FUNDS

towards PE executives¹⁴ – and all with a lower level of public transparency. Others have argued that in some sectors like US health care, *“PE ownership was most consistently associated with increased costs for patients or payers...[and] with mixed to harmful impacts on quality.”*¹⁵

The primary value of retirement fund investments, on the other hand, is their ability to provide patient, long-term stewardship capital with multi-decade time horizons. If this advantage is not to be totally blown away, funds need to be selective when investing through market-based VC and PE funds, focusing on those funds that have cultures and objectives that are in line with those of retirement savings funds themselves.

There is, of course, nothing wrong with companies being or becoming privately owned – reflecting the fact that capital markets seem to be moving in that general direction. Later in this pamphlet we provide one example of how private ownership can be a catalyst for long horizon stewardship. **The challenge is to avoid financialised approaches that create a gap between financial investment and the creation of real economic and social value in the UK.**

THAMES WATER IS A SALUTARY LESSON

The travails of Thames Water provide a salutary lesson of how much social, environmental, political and financial value can be destroyed when retirement funds invest alongside investors with what some would call a predatory financial approach, with the latter then allowed to determine the shape of corporate activity.

Some have argued that many ‘alternative investments’ are no more than cleverly disguised ways for financial companies to charge higher fees by re-packaging existing assets, with the level of fees eating into investor returns to a significant degree (in some cases half of all returns go to intermediaries with investors

left carrying all the risk).

Which is why the debate as to whether PE investments provide superior investor returns continues to rage.¹⁶ Further stimulated by the end of the low interest rate era.

UNCERTAINTY

For all the focus on 'optimising' financial returns, we also need to accept that financial returns on investments are always highly uncertain. It is now well accepted that, over the long term, return on investment in public stock markets are primarily determined by overall market sentiment and market movements not by the skills of investment managers.

Performance varies between investment managers and within the same investment managers over time. Very few can credibly and sustainably break out of the cage of market movements over which they have neither control nor predictability. Few consistently beat the market over the long term. Even the legendary Warren Buffet has underperformed the S&P 500 since 2015.

*"Benefits depend on the return on assets (which are stochastic and with the right stochastic process in dispute) and on the pricing of annuities (which is also stochastic and also subject to dispute about mortality trends as well as future rates of return)."*¹⁷

In other words, while funds may argue that their fiduciary duty is to optimise financial returns, they cannot know whether they are doing that given the substantial uncertainties surrounding future performance. They place themselves at the mercy of that over which they have no control with investment decisions having an impact only at the margins. Hence the rise of passive investment approaches.

INVESTMENT
DECISIONS HAVE AN
IMPACT ON RETURNS
ONLY AT THE
MARGIN

WE HAVE CHOSEN TO USE INADEQUATE TOOLS TO MEASURE PERFORMANCE

As stated in the recently published consultation responses to the Government-Regulator Value-For-Money review, *"Several respondents found issue with the reliability of forward-looking metrics, arguing that schemes cannot accurately predict the future performance of assets and market behaviour."*¹⁸

Neither does looking at past performance help. Certain funds may perform better than others but that tells us nothing about whether investment returns have been 'optimised'. There is always someone (or several) out there in the investment world that has performed better, thereby showing that financial performance was, in fact, not maximised – at least over any given period.

Such uncertainty is unavoidable, and investors all do their best to optimise their positions. Yet it could be argued that **a narrow focus on financial returns creates a situation where funds are simply unable to evaluate whether they are fulfilling their fiduciary duty as they themselves have chosen to define it.**

We are then reduced merely to performance comparisons across funds that tell us little or nothing either about absolute performance or about the productivity and usefulness of those investments. But that's what we do simply because it's the only tool we have chosen to have in the box rather than because it drives the sorts of investment behaviours that build prosperity.

Different types of funds also have different perspectives. For instance:

Mature or maturing DB schemes (which currently form the bulk of pension capital in the UK) means that they are largely fully funded, have a shorter time horizon, and tend to look for assets that can be readily liquidated. They therefore eschew assets considered risky

and focus on corporate or government bonds that generate cashflow.¹⁹

**INSURERS WILL BE
EVEN MORE
CONSERVATIVE**

A number of such schemes will be considering being bought out by an insurance company. Besides the necessary 25% uplift required to do so, the need to comply with Solvency II regulations means that insurance companies could be even more conservative in their investment approaches. In other words, a proportion (maybe a large one) of the £2 trillion in current DB funds could become even less available for investment in the UK's real economy.

Not to mention the questionable ability of the insurance sector to absorb the whole DB sector and the as yet unknown risks associated with insurers selling on to offshore reinsurers that are not subject to the UK's regulatory regime. Yet more daisy chains of risk shifting.

Growing DC schemes, on the other hand would benefit from investing in higher return assets. As we have already seen, and despite some claims to the contrary, such 'returns' to members are already defined more broadly than in exclusively financial terms. The question is whether funds can do even better in that regard.

Overall, it is reasonable to conclude that an unsupportable false dichotomy has been created through the narrative that funds must largely invest through international financial markets to optimise their financial returns and provide predictability while primary investing directly in the UK economy is riskier and provides less predictability of returns. All of that is untrue.

**WE MUST MOVE
AWAY FROM FALSE
DICHOTOMIES**

Can funds do better? That is the subject of the next section.

4. THE POLITICAL ECONOMY PERSPECTIVE

WHAT MATTERS MOST?

Let's look at things differently.

There is nothing that will bring greater benefits both to funds and their members than a healthy UK economy that grows sustainably.

A sustainably growing economy will put more money in members' pockets, increase employment, bring in, in turn, more money into retirement saving schemes and provide greater opportunities for higher return investments. In addition, members will lead more comfortable lives pre- and post-retirement as a growing, sustainable economy can support improvements in infrastructure and public services.

All of which requires much greater direct primary investment in the productive part of the economy. Establishing such a virtuous cycle will provide benefits to funds and their members that far outweigh anything that can possibly be achieved by chasing the



GOVERNMENTS HAVE NO INCENTIVE TO INCREASE AUTO- ENROLMENT

unpredictable odd few basis points of extra financial returns on the bond and secondary public equity markets.

Increasing the currently relatively low amount of UK pension contributions would also improve the country's balance of payments and could be a more productive tool than interest rate hikes to counter inflationary pressures*.

Yet, as we shall see later, the incentive for government to increase such auto-enrolment contributions is blunted when **investment behaviours by pension funds tend to lead successive governments to see increased tax-deductible pension contributions as a tangible fiscal cost rather than as another mechanism to boost the country's economic performance.**

This all dovetails into ongoing efforts by many organisations to make the use of capital more productive for the UK economy. As the Bank of England's Productive Finance Group put it:

"Low interest rates and relatively slow economic growth, by historic standards, have increased the challenge for savers in terms of returns on their investments. One way to achieve higher returns, net of cost, is to invest in longer-term, less liquid assets, managed appropriately.

Investment in such assets, including productive finance assets, could also benefit the wider economy. It can support the supply of long-term capital, financial stability and the transition to net zero. Examples of productive assets include research and development, technology, and infrastructure."

*Both Australia and Denmark used increased automatic pension contributions as part of wage negotiations to modulate the inflationary pressures of increased wage demands

Let us put all this into context as to how we define the role of funds in our society and therefore what we should all be expecting from them.

LET'S TALK ABOUT FIDUCIARY DUTY

WHAT ARE FUNDS FOR?

Pension and retirement savings funds are not merely a financial service like any other. They are the custodians of UK citizens' lifetime savings aided by privileges given to them by fiscal policy. They are forever businesses. They are important players in the political economy and their role in society is manifold.

The first, and most important, test of '*fiduciary duty*' is that funds should not be set up nor should they behave or be regulated in ways that create any conflict of interest between what is in their members' interests and what is in their own interests. This is the driving force for the conclusion that "*the distinguishing obligation of a fiduciary is the obligation of loyalty.*"²⁰

We can discuss whether that test is met under the current business models and regulatory regimes. Some would argue that even this most fundamental of fiduciary duties is not sufficiently satisfied. For instance, despite the increased focus on value for money, cost remains the key metric used to secure market share, resulting in an over-reliance on bonds and passive equities and a reluctance to include more expensive – and maybe more effective – strategies. Does that work to the long-term benefit of the UK economy and therefore of fund members?

According to James Brundrett, senior investment consultant at Mercer, "*There needs to be a greater focus on creating higher quality, member-focused outcomes in DC schemes because at the moment there is a race to the bottom driven by fees.*"²¹

We also need to define what constitutes acting in the interests of their members to whom the money belongs.

As mentioned above, this duty has been reduced to financial numbers. However, that is not members' only interest. As outlined in a recent paper²² by the Financial Markets Law Committee*, the Law Commission of England & Wales identified 'non-financial factors', such as improving members' quality of life, as legitimate considerations for trustees' investment decisions provided that they are believed to be reasonably in line with members' views and that they do not pose significant financial risk to the fund.

The paper goes on to point out that *"many factors that may appear at first to be "non-financial factors" are "financial" when properly understood."*

If one accepts the principles behind the above 'virtuous cycle' model, it becomes difficult if not impossible to argue that effective, direct, primary investment in the UK's real economy is at odds with trustees' fiduciary and stewardship duties. In fact, **it could be argued that failure to invest in the UK's real economy represents a fiduciary failure.** A failure driven by overly narrow perspectives, trustees not exercising sufficient direction, oversight and control, merely rubber stamping the recommendations of advisers embedded in a financialised system, an inadequate level of skills and capabilities within many funds, combined with a regulatory regime that works against such an investment outlook.

As for members' own views, there is an ever-increasing risk that the waters will be muddied further by the current fashion of focusing on 'responsible investing' and the marketing of a number of funds

* The quoted paper focuses only on the areas of environmental sustainability and climate change but its analysis is applicable more broadly.

WHAT IS 'RESPONSIBLE INVESTMENT'?

under that moniker. Research by Royal London revealed that *'people simply don't know what responsible investment involves or where to start'*²³

As mentioned previously, much so-called responsible investing ends up being no more than virtue signalling rather than having any meaningful impact in the real world. It doesn't have to be so. There are opportunities to take a different approach (see next section on Political Capital).

Add to this people's increasing discomfort that products or services marketed as 'responsible' or 'green' or any other similar label are no more than quasi-empty sales ploys.

Added to all of this is the false impression that has been created that 'responsible investment' is inevitably associated with lower financial returns and/or higher management fees. None of this has to be true.

This pamphlet argues that the first step towards 'responsible investment' is for funds to see themselves as part of the above virtuous cycle and to explore whether their members would support such an approach.

SUCCESSIVE GOVERNMENTS HAVE ERODED THE BENEFITS AVAILABLE TO PENSION FUNDS

Building Political Capital

Were both government and voters to see retirement savings used much more productively to help drive success of the UK economy, funds would gain more political capital. Calls for public policy support for the industry would gain more resonance.

Whether it's imposing a tax on pension fund surpluses, introduced in 1988 under Margaret Thatcher, abolishing Advanced Corporation Tax relief under Gordon Brown, the re-introduction of the lifetime savings cap as toyed with by the current Labour Party before being abandoned (at least for the moment), or

MOVING FUNDS FROM BEING A FISCAL COST TO AN ECONOMIC BENEFIT

the current relatively low level of auto-enrolment contributions, all these public policy initiatives have cost the industry hundreds of billions of pounds. They all speak to the fact that the current approach leads policy makers to focus more on the fiscal cost of pension contributions than on the benefits to the UK economy.

By broadening their focus and positioning retirement savings as a route to broad prosperity, funds have the opportunity to change the focus of fiscally constrained governments from reducing pension related tax expenditures to seeing increased retirement savings as a route to economic growth and consequent increased tax revenues.

Enabled by appropriate regulatory changes (see later) funds could change this over time if they invested in the UK economy and could show their positive contributions. There is an opportunity to build on the extensive work done by the impact investment community and start to evaluate the socio-economic impact of funds' investment choices in parallel with the financial returns. All this is summarised in one paragraph by Harmen van Wijnen, Chair of the Board of Trustees at Dutch pension fund ABP that recently announced an increased focus on 'double returns' – financial and social impacts:

*"ABP's investments wield influence on the world, presenting opportunities to make meaningful societal impact by investing in sustainable and dependable energy solutions and affordable rental housing, including within the Netherlands. This multi-faceted approach ensures that ABP's investments yield dividend for our participants. There is resounding support for this approach among our participants."*²⁴

It is possible that a government focused on directing more investment into the UK economy might mandate

FUNDS SHOULD EVALUATE THE SOCIO-ECONOMIC IMPACT OF THEIR INVESTMENTS

such evaluations as part of a regulatory regime. Yet, government and regulatory intervention would inevitably come with substantial bureaucratic baggage and the risk that it all gets reduced to another meaningless tick-box exercise. We would all, including funds themselves, be much better served if funds took it upon themselves* to evaluate and communicate the socio-economic impact of their investment choices in ways that are appropriate to their own investment approaches.

Policy initiatives in support of retirement savings would become much more politically palatable were funds to take such approaches, recognise the need to build political capital in these ways and change the narrative to retirement savings being seen as a vital component of UK economic success rather than a fiscal cost.

* By this we mean that funds should evaluate such impact for themselves tailored to their own particular needs rather than delegating such evaluation to third party providers as has happened with ESG metrics with the consequent limitations and mechanistic, tick-box approaches that has generated.

5. CHANGING THE INVESTMENT OUTLOOK

*"Economies face a "paradox of risk" – in seeking to avoid risks, we are amplifying them. Rules and regulations put in place to curb risk are having the same, paradoxical, impact."*²⁵

IT'S TIME FOR A
BROADER OUTLOOK

If pension funds were to see it as part of their fiduciary duty, as ABP and others have done, to invest in a successful UK economy, what would they be investing in?

The UK is an Advanced Capitalist Democracy (ACD) – a political system that has generated massive improvements in prosperity over the long term in many countries. What are the primary investments necessary for the continued success of such a system?

They include:

- An effective lifetime education system appropriate for the 21st century
- The ready availability of large amounts of risk capital for R&D and for the development and growth of advanced technology clusters and 21st century industrial companies
- Investment in the ever-hotter global competition around the cleantech industrial revolution
- Well-functioning infrastructure
- Protection from, and resilience to, major economic and political shocks that will arise from climate change, biodiversity degradation and geopolitical tensions

Further, progress and prosperity can only be achieved in an environment of political stability and effective institutions. They are crucial underpinnings of

EVERYONE HAS A ROLE TO PLAY TO DRIVE POSITIVE CHANGE

economic and commercial success. Of course, business cannot impose political stability. However, through their practices, some businesses can, and sometimes do, contribute to bubbling social issues that drive political instability (the role of executive pay in raising the profile of the socially divisive question of growing inequality is one such issue). Avoiding investing in, and using shareholder voice to curb, business practices that risk social and political tension and upheaval is also, therefore, an important fiduciary consideration.

HOW TO GET THERE

If we want to travel in this direction, how do we lay a path?

Developing specific and detailed recommendations is beyond the scope of this pamphlet. These will emerge as the ongoing New Capital Consensus project on improving the UK investment system matures.

Naturally, there is no magic 'solution' that can be implemented overnight. Funds, government, and its appointed regulators all have a role to play if we are to move in a more positive direction.

However, what now seems certain is that achieving the necessary transformation cannot be achieved either by government alone, or by the private sector alone. What is needed is a functioning industry-government ecosystem to deliver broad based benefits for the UK economy and its citizens' retirement.

Government

Government and its appointed regulators are central to any transformation.

There seems little doubt that governments of any colour would welcome a shift of fund investments into the UK's real economy and working towards the virtuous cycle described above. In fact, given the very

real fiscal constraints, no government determined to drive growth and prosperity can do so without mobilising the large pool of retirement savings for productive investment in the UK economy.

There will, however, likely be much contestation around the practical interventions needed to get there. Some will favour the 'leave it all to the market' approach. Others will show a preference for more interventionist approaches.

An important role of government is to make investible those key elements of an ACD mentioned above.

How do we make education more investible by the private sector? What is the role of government in encouraging and incentivising patient risk capital for the development and growth of advanced technology clusters and 21st century industrial companies?²⁶

Will we ever see any action to reduce the cost and complexity of UK infrastructure projects that are now *"highly uncertain and volatile, which impacts private sector willingness to participate"* according to Jagjit Chadha, director of the National Institute of Economic and Social Research?²⁷

The recently introduced Sovereign Infrastructure Guarantee by the UK Infrastructure Bank is an important first step on which further initiatives can be built.

But maybe most important, and seemingly most elusive, is that government provides, in as much as is possible in a volatile world, a degree of stability and predictability in terms of policy direction that encourages long-horizon investment.

Note that we are not arguing for financial repression, or a return to closed capital accounts. But government does need to focus its efforts on making UK assets more attractive investment propositions.

THE CURRENT REGULATORY FRAMEWORK DISCOURAGES PRODUCTIVE INVESTMENT

Regulators

It has been argued that the UK regulatory framework needs fundamental revision. That the current approach discourages the long-horizon investments needed and is overly focused on asset owners' balance sheets rather than on the achievement of savers' objectives and driving overall prosperity. That risk asymmetry has been allowed to go too far.

Are there better mechanisms than those currently in place both to evaluate 'risk' better, to share risk more broadly than is currently the case, and to include broader economic perspectives into the regulatory regime?

Financial regulators' remit has recently been expanded to include productive economic growth. Can this set the stage to start evaluating pension fund performance from a broad political economy perspective?

Is the regulatory framework currently aligned with the overall policy objectives that government is hoping to achieve? Many argue that it is not.

MEMBERS WOULD WELCOME A DIFFERENT APPROACH BY FUNDS

Funds

What about changes within funds themselves?

Much has been continuously talked about. From the need to achieve consolidation in an overly fragmented industry, to funds to see their fiduciary duty to their members as extending more broadly than a mere financial service, to improvements in governance quality, less reliance on external financial advisers, a better balance between short-term liquidity requirements and long-horizon investment, exploration of different investment models (see box next page), and much more.

Member research by the London Pensions Fund

Forever Paybacks from Forever Businesses

In the US, equity paybacks from prioritized cash flows have proven a reliable approach for financing Real Estate/Affordable Housing, Renewable Energy, and other public policy initiatives. How do they work?

Funds pool resources to make equity investments in multiple long-horizon businesses, in effect keeping them or taking them private. Investors agree a defined rate of return with the investee company. Funds receive their payback on an ongoing basis from the free cash flows generated by the business on an agreed basis over time.

For instance, funds can invest in a water utility that generates free cash flow. The parties agree rates of return and funds receive an agreed percentage of the free cash flow annually; a percentage that can decrease over time as desired returns are achieved. Such cash flow can go towards funds' short term payout liabilities.

Should the business require further investment, funds can provide such investment with the cash flow sharing being adjusted to cover returns on the new investment. As such investments are sourced from citizens' savings, neither is there any need to load companies with debt nor any need to service such debt the high cost of which was one reason for the failure of Private Finance Initiatives.

Seeing as both funds and the water utility are forever businesses, there never needs to be an 'exit'. Neither does anyone have to worry about manufactured valuations, stock price volatility and mark to market exercises. Everyone is getting what they need through long-term, responsible stewardship of the business.

Although this approach is not universally applicable, it can be successful across a range of infrastructure projects and other policy driven initiatives.

Acknowledgement: With thanks to Tim MacDonald, co-Founder of the Project Law Group, for bringing this approach to my attention and patiently explaining it.

FUNDS NEED TO BUILD INTERNAL CAPABILITIES - AS SOME HAVE DONE

Authority found that 68% of members considered responsible investment as being very important with a further 26% considering it quite important. Some 85% of members considered it important to influence the behaviour of the wider financial community to focus on better environmental and social outcomes.²⁸

Yet, a survey around 'social impact investing' conducted among funds in 2017 by MJ Hudson Allenbridge, an investment research and advisory services firm found that nearly 50% of respondents said that they had little knowledge around such investments with a further 15% saying they had no knowledge at all. Only 12% claimed to have a significant amount of knowledge.²⁹

That said, the same Allenbridge survey found that some 34% of respondents stated that they did, in fact, have investments in social housing or infrastructure related to education, health, or renewable energy. It is all possible.

WE MUST AVOID HEADING TOWARDS THE WORST OF ALL WORLDS

The launch of the Pensions Infrastructure Platform in 2012 is one example of helping investment in infrastructure by pooling funds' resources into a single investment fund. The platform has since invested in the Thames Tideway Tunnel Project, Southmead Hospital, the Scottish Road Partnership, among others.

THE POLITICAL ROLE OF RETIREMENT SAVINGS

All this brings us back to where we started in this pamphlet: **where and how citizens' money is invested has a significant impact on the type of society in which we live – and therefore whether current and future retirement fund members get to live healthy and fulfilling lives – both pre- and post-retirement.**

This makes the activities of pension and retirement savings funds inevitably political.

This pamphlet has attempted to give prominence to that political role by peeling away from the many detailed technical discussions that can risk obscuring the broader questions around the socio-economic-political value of retirement savings.

More technical discussions on practical implementation will form the important next stages. Yet we cannot possibly agree on practical reform until there is some degree of common understanding of what we, as a society, are trying to achieve with our pool of retirement savings.

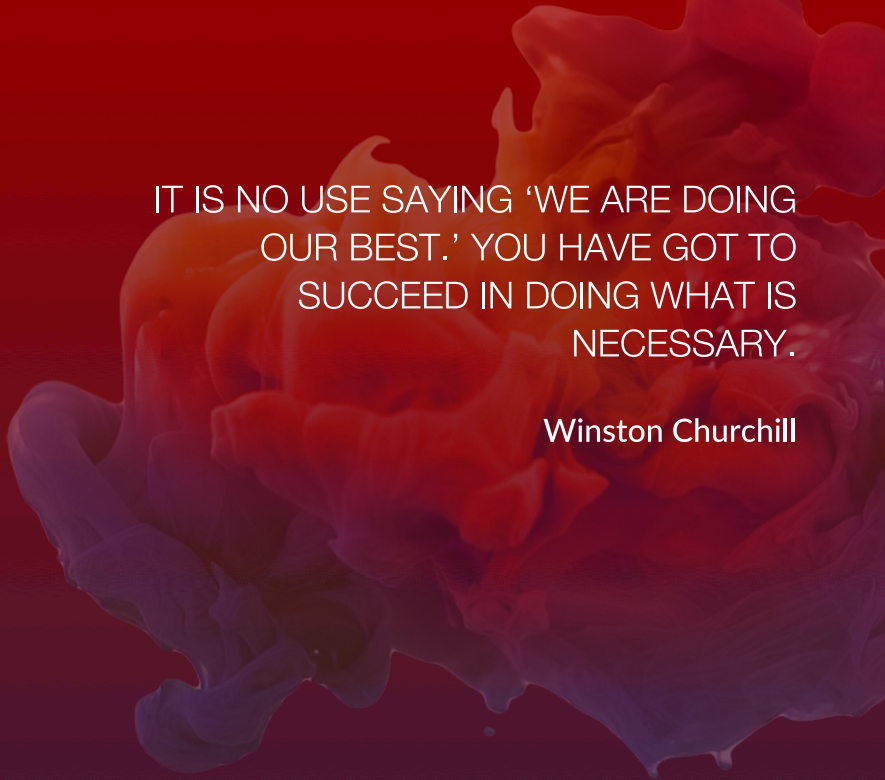
Absent a significant rethink, we risk heading towards the worst of all worlds. A DB pensions system replaced by financialised retirement saving schemes that leave members with a grossly inadequate retirement income, combined with investment approaches that fail to benefit the UK economy and the quality of life of savers.

Though it's a long, difficult, and winding road, the fact that these issues are now the subject of broad discussion and on-the-ground action by the more forward-looking of funds provides room for optimism.

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IT IS NO USE SAYING 'WE ARE DOING
OUR BEST.' YOU HAVE GOT TO
SUCCEED IN DOING WHAT IS
NECESSARY.

Winston Churchill





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