



Building personal accounts: designing an investment approach

PIRC response

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Pensions & Investment Research Consultants Ltd
6th Floor
9 Prescott Street
London E1 8AZ
Tel: 020 7247 2323 Fax: 020 7247 2457
Email: Info@pirc.co.uk Website: <http://www.pirc.co.uk>
Regulated by FSA

Introduction

Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareholder initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

We have only commented on those areas of the consultation where we have particular views and expertise.

General comments

As we stated in our response to the original White Paper, PIRC believes that the introduction of Personal Accounts is a very welcome response to the lack of pension saving by millions of Britons. We expect the system to deliver improved retirement incomes for many future pensioners over the long term.

We are also aware that a scheme of this size will, over time, become a very significant investor in UK and overseas companies, and thus will have significant ownership responsibilities. In the wake of the financial crisis many commentators have stressed the need for shareholders to exercise increased oversight of investee businesses in future. The Walker review of corporate governance devotes almost a quarter of its recommendations to encouraging shareholder engagement. Therefore it would be inconsistent for the Personal Accounts scheme to not take such issues seriously. More positively, the scheme has the opportunity to set an example to other large investors in the UK and around the world.

6.1 To what extent can the personal accounts scheme deliver high-quality corporate governance at a low cost?

The important point for PADA to note in its consideration of how to address corporate governance issues is that it will be taking a stance, and incurring a cost, whatever approach it takes. Though we believe it would be a mistaken strategy to employ, even delegating responsibility to fund managers for governance would mean that voting and engagement activity would be undertaken in respect of the scheme's assets, and the costs of this would be part of the annual management fee charged to the scheme. Effectively then PADA would be adopting the appointed manager(s)'

stance on governance, whatever that might be. There is no 'neutral' position that PADA can adopt.

In reality PIRC believes that given the scale and potential influence of the Personal Accounts scheme, it has a responsibility to take governance issues seriously, and that the most responsible approach would be to develop its own strategy. We do not believe that a coherent governance policy, applied across all the scheme's assets, need be a costly part of its operations, especially compared with other investment charges that are likely to be incurred.

In the short-term we believe that the scheme should at the least develop a governance and voting policy and apply this across all its assets (this is discussed further below). Voting is a core part of ownership, and actually carries much more weight with companies than some commentary suggests. Therefore it is vital that the scheme develops a coherent approach here initially.

In the longer term PIRC believes that the scheme should build up an internal governance resource, similar to that in place at some other pension funds. This would increase the scheme's ability to act as an owner, to engage directly with companies (rather than through an intermediary who may have other conflicting objectives) and to collaborate with other asset owners. Indeed given that other pension funds already have such a resource it would be unusual if PADA, as potentially the largest fund in the UK, did not.

Finally, PIRC believes that it is very important that the scheme's trustees articulate and agree a clear set of beliefs about the value of engagement, and responsibilities of ownership. This should inform the way the scheme approaches these issues. It should also ensure that the scheme does not simply sign up to an 'off the shelf' service provided by a third-party, but develops its own approach. We do not believe that an investor of the size of the Personal Accounts scheme should consider that it can simply 'tick the box' of being active by outsourcing all activities to a third party. It must take responsibility for ownership issues itself.

6.2 How will this evolve over time as the scheme's assets under management grow?

We envisage that as the scheme grows in size there will be greater opportunities for the fund to develop its engagement with companies in its equity portfolio. Whilst in the short term the scheme may wish to focus attention on ensuring it has a coherent and rigorously applied governance and voting policy, and restrict itself to a small number of key engagements with companies, in the longer this is where the scheme could have a significant impact.

In addition in the longer term PIRC believes that the scheme should explore collaborative engagement with other investors, working with those who are already active in this field. This reinforces the need for an internal resource to draw upon.

6.3 How do we achieve high-quality corporate governance where assets are managed passively?

We do not believe that the use of passive management presents any particular obstacles to the development of an active corporate governance programme. In theory passive managers ought to devote more attention (and resource) to engagement on governance issues since it is one area where they can potentially add value, or prevent its destruction.

In practice of course we recognise that this is not necessarily the case. PADA should also be aware that research carried out by RImetrics for the Local Authority Pension Fund Forum has established that there are limited resources devoted to voting and engagement by the main passive managers. Indeed some do not always vote, even in well-developed markets. Therefore it is important to recognise that there may be practical problems to overcome if, as we assume, the scheme will principally opt for passive management in order to keep costs low.

But equally there are many active managers whose commitment to good governance is not obvious. Indeed the investment industry's representative bodies have gone to great lengths to defend the right of active managers not to involve themselves in governance issues, as many will typically sell rather than engage.

6.4 What approach should the trustee corporation take to the voting of shares, both overseas and in the UK?

There are several significant points we would make in respect of the exercise of voting rights.

First, PADA should not simply delegate responsibility for the exercise of voting rights to appointed fund managers. There are a number of reasons for this. If multiple fund managers are appointed then this will almost inevitably result in very different stances being taken. If more than one manager is employed to run UK equities it could even result in votes being cast in different ways at the same company. In addition the track record of a number of fund managers in respect of voting does not suggest that they will use their voting rights effectively (some managers do not even always vote, or vote in all markets). Finally it should be noted that some managers do not believe that shareholder engagement is a relevant strategy, and indeed the Walker Review accepts that this will be the case (provided that managers disclose what their policy is). For all these reasons PIRC believes that delegation would be the wrong approach for PADA to take.

Secondly, there are also important issues to be considered in the appointment of a so-called 'overlay' service. In our own analysis of the voting decisions of providers of such services to funds evidence exists about whether they used these rights effectively to challenge banks and other financial institutions in the run-up to the current crisis. Whilst it is clear that there is not a 'correct' way to vote at company

meetings, we believe that PADA should examine the voting records of overlay providers and compare them to those of other fund managers. We do not believe that they have a good story to tell here. Effectively the Personal Accounts scheme's share-ownership (which on its own will be significant and potentially very influential) would simply be aggregated with those of other clients of the service provided, and simply bundled into the engagement stance taken..

In addition market feedback suggests that an overlay mandate can be a very costly service for the client, whilst for the provider there is very little extra cost (perhaps only in terms of client reporting). So the trustees could incur significant costs without receiving a service that is not specific to the scheme. Given the size of fees potentially chargeable for an overlay service it may well be more cost-effective to employ someone in-house.

PIRC believes that the most sensible option would be for PADA to develop its own corporate governance guidelines and voting policy and apply this across all out its investments. The advantages are clear. First, PADA would be in control of the process, and there would be no danger of different voting stances being taken with different tranches of assets. Second it would be easy to review voting outcomes and amend the implementation of the policy if necessary. Thirdly, we believe this would be a relatively cost-effective way to exercise ownership – and in a way that was driven by PADA rather than a service provider – in contrast to the overlay services available.

As suggested above, in order to achieve such an approach we believe that it would be appropriate for PADA to develop an in-house post responsible for corporate governance, as is the practice of a number of other pension funds (USS, Railpen, PPF, LPFA etc).

Finally, looking further ahead, PIRC believes that the Personal Accounts scheme should consider whether there is any scope to give individual scheme members any role in voting. There are currently attempts in the US to enfranchise mutual fund investors in this way, but arguably, if it is possible to give individual savers the option to have a role in voting, the Personal Accounts scheme would be even better placed to develop this, and could set an example for other schemes.

7.1 How can the personal accounts scheme engage in responsible investment in a cost-effective way?

Fundamentally the scheme has the potential to exercise influence with investee companies through three principal channels – voting, engagement and investment decisions (buy/sell). As we outline below, we believe that there is a case for at least one fund, utilising screening, to offer responsible investment as an investment style, because we believe that members should have this option. But we believe that the scheme should restrict such an approach to a specialist fund or funds.

In addition we assume that given the desire for the scheme's assets to be run as

cheaply as possible the preference will be for passive rather than active investment management. In which case 'voting with your feet' will not typically be an option. Therefore the emphasis must surely be on ensuring that the scheme uses voting and engagement activity to pursue its objectives in respect of responsible investment.

We would encourage PADA to look at the record in practice of providers who offer services in this area. For example, there have been an increasing number of shareholder resolutions addressing ESG issues filed at company AGMs in recent years. Typically in such a situation the filers are seeking to encourage investors – and particularly those who offer responsible investment services – to consider a particular issue. Whilst, as noted above, there is no 'correct' way to vote, client ought to be able to expect that responsible investors give such initiatives a fair hearing. However, in our experience some investors routinely oppose shareholder proposals on ESG issues. We believe PADA should review voting on such resolutions.

In addition voting can also be used to draw attention to social and environmental concerns at investee businesses by other means. For example, some investors will use the vote on a company's report and accounts as a way of expressing concern at a lack of reporting on a material issue. The Personal Accounts scheme could develop a similar approach to ensure that it maximises the influence of its shareholder voting rights.

In respect of engagement on social and environmental issues again, for the reasons cited earlier, we would advise PADA against simply delegating responsibility for this to appointed fund managers, or turning this over to a third party as part of an 'off the shelf' service. As we state below, we believe that the scheme should develop an in-house resource in respect of responsible investment. This will make it possible for the scheme to engage on its own behalf with investee businesses over its own issues of concern. For example, given its potential membership, the scheme might want to consider engagement with financial services companies which take advantage of low-paid workers. In addition an in-house resource would enable the scheme to play an active role in any collaborative engagement undertaken.

7.2 Should responsible investment be a matter for the default fund alone, or for all fund choices, as far as it is practical and relevant?

As we understand it, the intention is that the scheme will offer access to a specialist SRI fund or funds. PIRC believes that it is right that such an option is available, and it may be the case that a screened option would be most suitable here. For some investors it will be more important that they do not derive income from certain companies or industries than that they may lose investment income and that this could affect the value of their fund. Whilst PIRC is a proponent of engagement as opposed to screening as a way to achieve change in respect of companies' behaviour, we believe it is right to offer investors a choice where this is possible.

However more broadly we believe that the scheme should apply a responsible investment policy – based on engagement - as widely as possible. Clearly ensuring

that a strategy is in place for the default fund is the priority as this is where most scheme members will end up, and as such will also account for the bulk of the scheme's assets. But we do not see why a policy ultimately could not be applied across all the scheme's funds.

Once again we would stress that there is no 'neutral' option here. To not apply a scheme policy to funds effectively means accepting the appointed fund manager(s)' views on the importance, or otherwise, of social and environmental issues. It does not mean that a stance on such issues will not be taken in respect of those assets.

7.3 How should the trustee corporation interpret its fiduciary duty in relation to responsible investment while maintaining a commitment to low charges?

Clearly the trustee corporation should have regard to costs throughout its investment functions and practice. There are no unique costs to developing a responsible investment strategy that are not found with all types of investment management strategy and style. Asset manager performance evaluation through the recent financial crisis in global capital markets will provide valuable insights as to whether costs incurred by asset owners were 'value for money', and this is not unrealistic criteria for the corporation to consider when developing responsible investment strategies either, but it would be a short-sighted decision to use only such a criterion.

The various elements in the corporation's cost base reflect a broad range of responsibilities and to identify 'fiduciary responsibility' as involving specific additional costs doesn't seem to be based on any relevant evidence.

7.4 If responsible investment is pursued, will the members be best served by building in-house capability or outsourcing?

Once again we believe that in the long term the scheme should develop an in-house capability. The advantages of this would be two-fold. First this means that the scheme would be able to assess the implementation of the investment strategy and performance of the specialist ethical or SRI fund(s) that members are offered, in order to ensure that they remain suitable. Secondly, looking further ahead, having an in-house capability would enable the fund to develop its direct engagement with investee businesses over social and environmental issues to mirror engagement activity undertaken in respect of governance issues. In our experience those pension funds with in-house resource are more active and are taken more seriously by the rest of the market.

Further information

PIRC would be happy to discuss the points we have made in our submission in more detail. Please contact:

Tom Powdrill
Head of Communications
PIRC Limited
Cityside
40 Adler Street
London E1 1EE
Tel: +44 (0)20 7392 7887
Fax: +44 (0)20 7247 2457