Radical reform of pension fund management is well overd...

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I wrote a blog post on Wednesday called 'Where's the debt?' and another yesterday called 'That hit a nerve'. I have to say I am returning to the theme, precisely because both received so much negative reaction from those who are obviously financial market insiders who have not been slow to hurl abuse as a result.

The blogs had related themes. The first suggested that I was surprised that pension funds have now largely abandoned gilts and have moved towards investment in much riskier corporate bonds, about which many very informed commentators have considerable concern, as Marco Fante noted.

The second, noted the near hysterical reaction and added this comment:

And I do not claim to be a market expert: I just use my sense to work out there is very real risk based on a) systemic issues b) experience c) knowledge of economic modelling and d) risk aversion that I think pension funds should share. This also means that I very, very much doubt that the risk has been priced appropriately.

Despite this, those commenting seem to think I claim to be a market expert. Their ability to read is seriously in doubt, it has to be said.

I also noted that I use heuristic logic and that:

And if you want to know what that heuristic says right now, the actual answer is hold cash, even though you will lose in the short term.

Despite this, I was accused of being completely dedicated to gilts. Again, this just shows an incapacity to read. It also happens to be wrong since my own pensions are quite big on cash at present. But why let what I say get in the way?

What I did realise was that I did have quite a lot more to say on this issue, so extreme is the commentary that has been offered by those who have posted from the so-called investment management profession. My comments have three themes. Firstly, I discuss my investment logic. Second, I suggest that this logic actually has some merit to it, despite what the investment managers say. And third, I consider why they have got quite so hysterical, and what factors can underpin what I think to be their quite illogical conclusions.

So, to turn to my investment logic, I think it only fair to note at the outset that I am a Quaker. I do not make a big deal about this. But, it does mean that I have an aversion to gambling. And because like most Quakers I do not have a particularly materialistic outlook, and seek to live what I would like to think is a relatively simple lifestyle, then I am probably not in conventional terms an income maximiser, and am entirely happy about it. This probably also suits my own risk aversion. I accept this is real, unless I am investing in my own activities, where I appear to have completely different traits. Finally, and perhaps most significantly, the Quaker quest for truth means that I am unwilling to turn a blind eye to the consequence of actions. So, for example I have a fairly long list of things that I would not be happy investing in, and in general I'm fairly unhappy about investment in anything that is heavily dependent upon advertising to generate an excess return for the benefit of a few at a cost to many. So, whilst I'm not at all opposed to the existence of markets, very many large companies that operate on the basis of quasi-monopolistic, and almost certainly oligopolistic, power undertake activity which I find fairly alien to my own ethical principles. I ask no one else to subscribe to my views, but I see no reason why I should be criticised for having them.

What I would suggest is that there are likely to be more people who are interested in this type of use of their investment funds than the pension industry and other sectors reflect. It is a complete scandal that the vast majority of members of pension funds have not the slightest idea where their funds are reallyinvested and that the law does not require them to be told, or require that they be positively consulted on a regular and informed basis. Nor are they ever asked how their pension fund manager should seek to engage with those companies in which they are invested. The idea that we have a shareholder democracy based upon this complete removal of the rights of those for whom pension fund, and other investment managers, actually act is a travesty of natural justice and is one of the themes that I hope the Corporate Accountability Network can address over time. Nothing less than a revolution is required in this area.

Now I admit that it does so happens that this personal investment profile that I have does incline me to think that investment in government securities is a benefit even if I do not make an immediate or obvious return as a result. I am well aware MMT appears to argue otherwise in some situations, but the fact that my savings can help support socially beneficial activity by investing in a government savings mechanism does seem to me to matter: the simple fact is that the vast majority of what the state does appears to me to be of much greater value to society than much of what large companies do. I am willing to pay a price to engage in a socially useful activity. Investment managers who do not realise that there is a connection between the return that they make and the activity that generates it have, in my opinion, utterly failed in their duty.

They will, no doubt disagree. And I have no doubt that many will mention the term ' fiduciary duty' whilst forgetting that in practice this has now been completely redefined so that an investment manager is not obliged to maximise return at whatever the social cost of doing so. That was the case and it no longer is.

I may take what some might think to be an extreme view on this issue, but I can also say with considerable confidence that the vast majority of those who are offering opinion on this blog at present do represent the polar opposite extreme. And I think their views ones that I find very hard to accept. Their apparent belief that if 'the model says yes', where the model is based solely on a quantitative analysis, then 'they say yes' happens to undermine any role whatsoever they might have in their employment, because they can be entirely replaced by artificial intelligence. I also do hope (without much expectation) that it leaves them with little sleep at night.

I do then seek to make good returns, but in ways that these managers clearly cannot comprehend. This is, then my second point. My logic makes complete sense when taken as a whole. It does not to fund managers solely because they are viewing one small part of the equation (which they then reduce to an equation) in isolation, and that is a substantial error on their part, which explains all too well why so much of the UK pension industry so grossly fails those who are forced to participate in it, frequently against every judgement that they would exercise on their own part. And this is why, although I am happy for people to be encouraged to save, enforced enrolment in pension schemes that require, for example, investment in the types of funds that these people manage is to me wholly unacceptable, and most especially when those managers are almost entirely unaccountable for their actions.

So let me move to my third point. Why is it that the fund managers can apparently act in this ethical void where all that matters is a quantitative return wholly divorced from its real-life social, economic, ethical other consequences? And how is it that these managers, from their consistent comments made, appears so utterly indifferent to the risks that informed commentators right across the media recognise exist?

The answer on investment management culture is easy to provide: this is, of course, the logic of the undergraduate economics degree, and the whole logic of the business school. Neither teaches students to have any real relationship with the world and they instead base almost all their teaching upon the learning of quantitative methods. A lot of research has shown that this has deeply unsavoury consequences on the mindsets of those who participate in such degrees, and I am sure that this is perpetuated in their subsequent employment in the types of activity that those who have commented here undertake.

However, there is something else much more significant to consider as well. That mindset was revealed by those who said it made no sense to invest in gilts when cash provided a better return and was also guaranteed by the government at the level which many individuals might hold. That's the clue: what these people have entirely removed from their consideration is the possibility of a risk of real loss i.e. of failure. And that is because as a result of 2008 they believe that any loss that arises as a result of their poor decision-making will, effectively, and always be underpinned by a government guarantee or backstop. This is available to banks, who are too big to fail; it is available for many cash deposits and, of course, it is inherent in the pension bailout arrangements that are now in widespread use. There is not a shadow of a doubt that a government would have to underpin this if there were really catastrophic failures. These investment managers are suffering what might be best described as extreme moral hazard. The upside of any decision they make is all there is to take in their opinion, whilst the downside will always eventually belong to someone else, and in the last resort to the government. There is a capitalist upside for them in their logic, and a socialist downside and I suggest that this deeply implicit assumption is one that has become so commonplace that they are either unaware of it, or refuse to acknowledge it.

So what can and should be done to deal with this situation?

First, the decision as to how any pension fund should be invested for any pension fund member should belong to the member in question. Yes, I know they are collective: but it is simply unacceptable that funds should not now be accountable to those in whose interests they are run. So a member should have the right to be ethical, and risk-averse, and have that view respected, even if it means that they might on occasion appear to have a lower return as a result.

Second, the days when pension funds do not prepare accounts to send to the people that they represent, detailing precisely what their activities are, in what they're invested, what their churn might be; what the risk profile of their investments is, and how they have incurred costs on the member's behalf, should be consigned to history. We need to radically transform pension accounting and make fund managers responsible for what they do, which is the last thing that they are present. This form of accounting should be extended to all who invest their own retirement directly with a company. It is scandalous that the information provided on such important returns is so poor.

And third, pension funds must have their own version of a living will. If banks need these then so too do pension funds. The possibility of being dependent upon bailout should be seen as the absolute last resort: the obligation of the company to meet its liabilities as they fall due should be paramount, and if it cannot be met then a charge over the equity in issue of the company that has promoted the scheme should be put in place: no shareholder of that concern should be able to extract value until the obligation to the members has been met.

Yes, I know that this might reduce apparent pension returns. But let's be quite clear, these are hopelessly over-inflated right now as a consequence of QE and any informed fund manager should know that and be taking action to mitigate that risk. But it is apparent that they are not. And that is precisely because they do not think that they have to, which is what a living will arrangement would change: these would tackle head on the issue of moral hazard.

I am well aware that these suggestions are radical. I also stress they are in outline only: the truth is that they deserve a much more thorough treatment but this was written in an hour or so. But they exist independent of my own investment preferences: they are required so that all can assess their well-being in this most crucial of areas where at present pension fund managers can extract considerable reward for usually failing to even match the market and yet claim their actions are wholly rational.

I am bored by such abuse. And what I suggest would tackle it.

Are those reforms possible? Of course they are. Are they relatively straightforward? I’d suggest that they are. But will they be resisted tooth and nail? I guarantee it. And I can tell you why. The fund managers will lose the right to abuse by extracting rents from pension fund members that are scandalously high in the UK. And that has to stop.