

Leadership, collective decision-making, and pension fund governance

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Abstract. For pension funds and other institutional investors, governance refers to the resources and processes used in decision-taking. Recognising that risk and uncertainty are the life-blood of investment strategy, in this paper we develop a resource-based framework to better understand the structure and management of financial decision-making in these organisations. It is suggested that these types of institutions have three types of scarce resources: time, expertise, and collective commitment (or how groups work together to a common purpose). We explain the nature of such decisions including their sensitivity to global financial markets; we explain the resource-based framework, and; we show how and why leadership in the decision-making process is essential to best-practice pension fund governance. To sustain the argument, we rely upon our best-practice governance framework and recent research on pension fund trustees' expressed opinions regarding their preferred styles of decision-making. Lessons are drawn for the process of collective deliberation and especially the role of board leadership and its distinctive qualities in best-practice organisations.

JEL codes. G11, G15, G23

Keywords. Decision-making, pension institutions, financial markets, risk, uncertainty, pension governance

Acknowledgements. The authors wish to thank their colleagues including Emiko Caerlewy-Smith, Tessa Hebb, Lisa Hagerman, Ashby Monk and Dorothee Franzen and Carole Judd and Michael Orszag. At Oxford, research on pension fund governance has been supported by the National Association of Pension Funds (United Kingdom), the Lupina Foundation (Toronto), and the Rockefeller and Ford

foundations. The first-named author benefited from presenting the findings of this paper at a NETSPAR-sponsored event on pension governance, the Annual Meeting of the Association of American Geographers, and a CP2-sponsored conference on investment management in Boston. Ashby Monk made significant substantive revisions to the first draft of this paper and Keith Ambachtsheer and Melissa Moyer made comments on subsequent drafts. The assessment regime used in this paper to characterise decision-styles is based, in part, on the protocols developed by Diane Newell of Jericho Partners. None of the above should be held responsible for any comments or opinions expressed herein.

Introduction

The new behaviouralism in social science and in particular finance and investment is focused upon the systematic biases in human decision-making (see Baron 2008 for an overview). Rather than assuming people are rational in that they make the best possible decision in each and every instance, many analysts now begin with a radically different premise: given the cognitive limits of human beings, when making decisions under risk and uncertainty people use heuristics or short-cuts in taming complex decision-making problems even if they produce ‘second-best’ solutions (Gigerenzer 2004; Gabaix et al. 2006). For Kahneman (2003), cognitive limits are profound. For the authors of this paper, knowledge of these traits is an important first step in (re)designing decision protocols and institutions so as to improve—if not perfect--decision-making (Doherty 2003).¹

In this paper, we propose a framework with which to better understand collective decision-making in pension funds. As often observed, trustees are separately and together subject, by common law and statute, to the doctrine of fiduciary duty. Likewise, corporate boards of directors, governors of public institutions, and members of chartered organisations with long-term mandates are similarly accountable. In pension funds, though, trustees are required to make decisions about beneficiaries’ or shareholders’ best interests and are required to act in a collegial manner with respect to long-term objectives in the face of short-term market imperatives. Governance is an essential mechanism through which these imperatives are reconciled and managed; elsewhere we identify the principles of best-practice pension fund governance focused on investment management in financial markets (Clark and Urwin 2008). What is missing, however, is a plausible account of collective decision-making.²

¹/. See, for example, recent trans-Atlantic public policy interest in pension plan default settings such as auto-enrolment that take advantage of participants’ inertia as opposed to requiring an explicit opt-in/opt-out participation decision. Seminal contributions include Benartzi and Thaler (2002), Cronqvist and Thaler (2004) and Thaler and Sunstein (2003).

²/. Too often, it is assumed that the individual decision-maker is sovereign even if subject to the golden-rules of particular institutions. Theorists often invoke golden-rules such as profit maximization to cut through the clutter of individual preferences thereby reigning-in diversity and subjectivity. Clark (2004) suggests that, in many cases, rule-based decision-making disassembles into the status quo, lack of innovation, and denial of the significance of hard cases (compare with Smith et al. 1992).

We have suggested that best-practice financial institutions have well-defined governance budgets—the formal commitment of scarce resources for enhancing the decision-making process (Clark and Urwin 2008). Here, we tease-out the implications of this concept for the types of decisions that are important in best-practice pension fund management. In our view, pension fund decision-makers rely upon three different types of resources in their deliberations: time, expertise, and collective commitment (working for a common purpose). These types of resources are widely recognised by organization theorists as crucial for best-practice decision-making in all kinds of institutions (see March 1997). No institution, however well-endowed, has an unlimited supply of these decision-resources; time, expertise, and collective commitment are scarce resources and can be seen as constraints on the scope of decision-making and ultimately the performance of an institution compared to its peers.

In the next section we focus on the types of decisions that face pension funds when operating in global financial markets. Having done so, we explain how and why time, expertise, and collective commitment are so important for decision-making. This is followed by a review of recent findings in the behavioural literature regarding recognised decision-making biases under risk and uncertainty, informed by our own research on the competence and consistency of pension fund trustee decision-making (see Clark et al. 2006, 2007). These findings have implications for the size and composition of fund boards. We also report recent unpublished research about trustee differences in their preferred styles of decision-making with implications for the qualities or characteristics of effective board leadership in best-practice institutions.

In conclusion, implications are drawn for best-practice pension fund decision-making with reference to collective decision-making and the role of fund leadership. We seek to convince the reader that effective pension fund leadership is a crucial element of the resources necessary for effective governance especially given different but unacknowledged decision-styles that need to be coordinated with respect to common objectives. Too often leadership is ignored or discounted in the face of the competing interests represented on trustee boards.

Investment decision-making and resources

There has been widespread debate about the proper structure of pension institutions. As such, twenty years has seen moments of innovation wherein national pension systems were re-designed, transforming past commitments into new institutions with quite different goals and objectives (notably Chile, Australia, Sweden and the foreshadowed UK National Pension Savings Scheme). Whether these moments of innovation affect the introduction of ‘optimal’ functionally-efficient institutions (Merton and Bodie 2005) is open to dispute. Roe (2006), writing about the regulation of corporate governance, argues that in ‘reform’ political interests typically trump functional efficiency; each ‘new’ institution carries with it the compromises, lacunae, and unresolved tensions of its origins. Any reading of recent European pension reforms would surely come to the same conclusion (Clark 2003).

A brief typology

We acknowledge that pension funds and related institutions face many issues and must make a huge range of decisions. Here, we emphasize investment performance and argue that the performance of pension funds hinges on five inter-related types of decisions faced by many modern institutions operating in global financial markets (see also Ambachtsheer et al. 2007, Clark 2008, and Lerner et al. 2008).

1) Structural decision-making refers to the over-arching goals and objectives of the institution, oftentimes set externally by stakeholders or shareholders but heavily influenced by the assignment of roles and responsibilities in the institution and its service providers. The influence of a well-ordered and shared belief set governing investment principles is equally important in this respect too. A well-governed institution has a clearly-articulated set of goals and objectives closely linked to the formal allocation of the organisation’s roles and responsibilities. It forms its views about appropriate goals by board-level debate and agreement on the key investment factors governing success. By contrast, a poorly governed institution is often one in which goals and objectives are poorly specified and at odds with assigned roles and responsibilities, sowing the seeds of doubt, confusion, and conflict over the decision-making process (March 1994).

2) Strategic decision-making refers to the deliberate process of setting the parameters of institutional performance, matching its goals and objectives to long-term

investment strategies informed by experience and expectations (Campbell and Viceira 2002). While the framing of investment strategy can vary from fund to fund, in most situations the crucial decision is the strategic asset allocation. This decision comes from a combination of original analysis and prior beliefs. In well-governed organizations, the efficacy of investment decision-making is judged against these parameters. Equally, in poorly governed institutions other types of decision-making are often at odds with long-term objectives. So, for example, a board pre-occupied with operational decision-making may simply miss the strategic significance of a systematic and persistent imbalance in its asset allocation.

3) Tactical decision-making refers to the decisions taken in response to either anticipated or unanticipated market or investment manager events given previously agreed investment strategy. In well-governed organizations, investment decision-making is sensitive to the timeliness of the issues—lack of responsiveness because of institutional inertia may impose significant costs on funds in terms of lost opportunities and higher than expected return volatility (Litterman et al. 2003). This should not be construed to mean that these decisions are necessarily short-term or have a trading characteristic. We view tactical decisions as valid and measured responses to new information with appropriate decisions that adjust allocations. This suggests that tactical decisions usually involve a lower order impact on results than strategic decisions. So, for example, a pension fund may suddenly be made aware that one of its asset managers has suffered an unexpected and catastrophic short-fall in its market position requiring an immediate response by the fund.

4) Operational decision-making refers to the decisions needed in order to maintain an institution's flow of investment tasks and functions. In well-governed institutions, this type of decision is often delegated to plan executives—being subject to a priori procedures that have effectively pre-processed the nature and significance of required actions in relation to institutions' goals and objectives (Clark 2007). So, for example, a pension fund may regularly re-balance its investment portfolio to maintain its desired long-term asset allocation. This type of decision may be the responsibility of fund executives subject to reporting to the board at its next meeting.

5) Monitoring and oversight decision-making refers to the routine but nonetheless crucial mechanisms whereby the institution monitors the implementation and execution of its investment decisions. In well-governed institutions, this type of function is about ensuring compliance with stated objectives as well as compliance with respect to the contractual commitments undertaken by service providers. At its simplest level, the results of these decisions are routinely fed-back through to higher tiers of decision-making. At a more important level, though, knowledge gleaned through routine monitoring may prompt re-consideration of investment strategy if not the structure of investment decision-making.

Decision-resources

Notwithstanding the clarity of this typology, it is apparent that decision-makers often blur the boundaries between decision-types largely because they overlap and interact with one-another in practice (see Figure 1 below). But, unfortunately, in many institutions the blurring of decision-types reflects a lack of organised deliberation, priority-setting and the effective use of decision-resources including leadership. Here, we assume that any organisation has three types of resources available for affecting decision-making: (1) the available time of its staff and board members, (2) the expertise of those directly involved in decision-making and those that may advise and evaluate the decision options, and (3) the collective commitment and efforts of those involved in decision-making to achieve the institution's goals and objectives.

These three resources are, at one level, widely accepted as essential ingredients in organisational management (see O'Connor 1997). Each has its own nuances and qualities. For example, by time we mean the hours and days allocated to the management of tasks and functions and the attention paid to those tasks and functions by those responsible for the performance of the organisation. This 'resource' overlaps with expertise in that the application of task-relevant skills and aptitudes to specific types of decisions may enable an institution to effectively allocate the available time of those involved. Similarly, collective commitment may speed decision-making sustaining previously agreed protocols and responsibilities where, otherwise, distrust of the motives of those involved may delay action by amplifying the time needed to reach agreement.

[INSERT FIGURE 1 ABOUT HERE]

As indicated in Figure 1, the five types of decisions make different demands on the available resources. Operational decision-making may be time-extensive rather than time-intensive compared to tactical decision-making. Strategic decision-making may require comprehensive expertise and a level of collective commitment quite different than that needed in monitoring the execution of tasks associated with lower tiers of decision-making. As such, each type of decision has its own rhyme and reason with the likelihood of competition over the available resources (especially if some decision-makers have a preference or predilection for one type over another). Since resources like time and expertise are expensive, it is important to structure the decision-making process according to the resource requirements implied by all types of decision-making.

This framework and schematic provide support for our proposition, shared with Ambachtsheer and others, that best-practice pension governance separates board roles and responsibilities from those charged with implementing and executing fund goals and objectives. Structural, strategic and monitoring decisions rely upon collective commitment and do not normally require time or expertise in a sustained manner given the routine ways in which boards are normally managed. By contrast, tactical and operational decisions make heavy demands on time and expertise and assume those responsible, like delegated executive staff, act in ways warranted by the collective commitment and the over-sight of boards.

The ecology of pension fund decision-making

In many kinds of pension funds, trustees are assigned responsibility for the welfare of others by common law and statute and have, therefore, legal authority to act on their behalf as well as delegate to others certain related task and functions. Similarly, in many countries, statutes and regulations formally prescribe and define the powers of corporate boards of directors—the differences between countries in terms of directors' roles and responsibilities are the lifeblood of comparative corporate governance (see Hopt *et al.* 1998). But, in a number of important respects, pension funds have rather distinctive decision “ecologies” compared to corporate boards of directors

(referencing the experience of western countries and, in particular, the Anglo-American and European worlds).

March (1997, 24) defined decision ecologies in terms of “the structure of relationships among individual units” and how these relationships interact with “the behaviour of these units to produce systemic properties not easily attributable to...individual behaviour alone.” Interviews, surveys, and experience suggest that there are three ingredients in the decision ecologies of pension funds. First, by common law and/or statute, fund boards are collegial entities—board members are separately and collectively accountable for their decisions against a general standard—typically fiduciary duty. In some jurisdictions, fiduciary duty is benchmarked against common sense (as in the ‘prudent person’ standard in the UK); elsewhere, fiduciary duty is benchmarked against professional judgement in the finance industry (as in the ‘prudent expert’ system in the USA). Either way, the judgement and opinions of individual board members must be reconciled such that whatever decision is reached is defensible against these standards.

A second important ingredient in the ecology of pension fund boards is the fact that, in many jurisdictions, board members are deemed to “represent” beneficiaries and stakeholders (Clark 2007). At one level, this means that board members ought to act in the best interests of others. At another level, this could mean that stakeholders including plan sponsors, employee unions, retirees and the community have a legitimate claim to be heard in board deliberations. Notice, though, the ethic of ‘representation’ is generally consistent with the theory of representative democracy rather than the process of direct interest-group claims. This does vary by jurisdiction, by the public and private sectors, and by political culture (see De Deken et al. 2006 on continental European social solidarity). Consequently, the expertise of board members is more heterogeneous than the management boards typical of the retail investment management industry. Board members can have very different views about first-principles: the value of time, risk, the meaning and significance of probability, and the value of information (Clark et al. 2006).

The third ingredient is the significance attributed to collective commitment. Trustees accept appointment to protect the interests of beneficiaries. They do so on very

different terms than their colleagues at firms of service providers in the finance industry. So, for example, in many jurisdictions and across industry sectors, compensation is limited to token attendance fees, lost earnings, and reimbursement for the costs of attending meetings. Whether it should or should not be like this is open to debate. But it is a shared ethic that governs--either explicitly or implicitly--how board members understand proper behaviour (cf. the behaviour of people who act according to their own needs in 'normal' situations). There are two important implications that follow from this ethic. Unlike corporate entities, the link between compensation and performance in board deliberation is weak and sometimes undercut by the claims of competing responsibilities that are highly compensated (as in corporate pension funds). On the other hand, collective commitment justified as it is by the interests of others is a powerful mechanism for taming the potential costs of 'representation' and for reconciling very different views about decision-priorities.

The 'ecological' ingredients of board decision-making provide logic useful in explaining the distinctiveness of pension and retirement income institutions. The premium on collegiality indicates how and why the imposition of hard and fast rules regarding routine decision-making may be overturned--not because of objections to their functionality but because of unease about rule-bound decision-making that is not sensitive to others' views. Similarly, the equitable representation of stakeholders' interests suggests a premium on the process of consultation even if tactical decision-making demands short-cutting due process so as to garner advantage in situations where there is great uncertainty as to the long-term consequences of decision-making. While collective commitment provides a means of coordination in strategic decision-making, it need not provide a recipe for best-practice investment management. Given the heterogeneity of skills and expertise on many boards, it may simply reinforce the lowest common denominator.

In this context, effective decision-making beyond the simplest of routine issues depends upon mobilizing collective commitment in ways that sustain board members' attention and focus upon the most important aspects of institutional performance. Otherwise, in the absence of a clear purpose, time and expertise may be wasted in a search for the basis of collective decision-making. In this respect, leadership can be thought to play a crucial role in mobilizing the resources of decision-making. Here,

though, leadership may be most effective by framing the decision-making process rather than an executive-led process that circumvents the collective deliberations of the board. Basically, leadership involves the mobilisation of collective commitment to the process of decision-making and stands in contrast to leadership through the exercise of executive power (Garud and Shapira 1997).

Behaviour and collective decision-making

It is widely recognised that, by themselves, individuals are prone to a range of behavioural biases or ‘traps’: people tend to be over-confident, inconsistent, and unjustifiably risk-averse. These are just three of more than 40 “errors of judgement” identified by Krueger and Funder (2004, 317). For many psychologists, these lapses in judgement are profound in that they derive from human cognition; in play is the capacity of people to act in the super-charged rational manner assumed by many social scientists, whatever their circumstances, roles and responsibilities. By contrast, there are others including Gigerenzer (2004) who follows Simon (1956) to argue that ‘real’ behaviour as opposed to cognitive pre-disposition depends, in part, upon the environment or ecology of decision-making. Gigerenzer claims that many cognitive illusions including over-confidence and the conjunction fallacy can be resolved in specific decision-environments.³

Recognizing the temptations of over-confidence and confirmation bias, for example, financial institutions implement monitoring devices to over-see the actions of traders, using limits and thresholds to signal significant departures from agreed decision-protocols (see Clark and Thrift 2005 on the institutional management of currency trading). Likewise, pension boards have been made aware of the costs of risk aversion especially when their own predilections for minimal risk run counter to an institution’s capacity to manage much higher levels of risk against prospective returns (see Clark et al. 2006 on pension fund trustees’ awareness of individual and institutional risk profiles). Even so, the heterogeneity of board membership can be a significant constraint on board performance.

³/. In fact, this is a rather contentious claim; witness the counter-argument of another decision-theorist Hogarth (2001, ix-x) to the effect that “context tends to engulf the mind. The effect is that people quickly forget abstract principles and react to the context in which they find themselves.”

In Figure 2, we report the results of an on-line survey of the self-assessed competence and experience of pension board members utilizing a series of tests of competence and consistency. These tests have been codified into workbooks to test skills and governance procedures across relevant institutions and jurisdictions.⁴ Here, we focus upon trustee opinions about their preferred decision-styles and the skills of their colleagues. This approach is augmented in the next section by a brief case study of pension fund organisation and management that utilizes ethnographic techniques first applied to investment institutions by O’Barr and Conley (1992). In terms of the pie-charts presented below, it should be stressed that these data are not meant to be definitive in any sense—the sample size of 30 is just too small to be statistically significant. Rather, the pie-charts are used to illustrate our belief that the co-existence of unacknowledged differences in decision-styles can give rise to significant problems in realising the potential of collective commitment.

The data summarized in the pie-charts were generated from the online survey instrument known as Workbook 4. By design, respondents were faced by scaled response options or dichotomous choices that required completion of each question before a respondent could exit the Workbook. They combine the 2007/2008 responses of members of a US public sector pension investment board with a group of Dutch pension board executives and members having found no systematic differences between these two groups. Here, we begin with the views of respondents as regards the competence of their colleagues summarized in Figure 2.

[INSERT FIGURE 2 ABOUT HERE]

Distinguishing between investment training and experience, our respondents were quite doubtful of their colleagues’ competency. In both cases, 25% of respondents indicated that their colleagues did not have the appropriate training and experience, while the fact that about 40% of respondents indicated that their colleagues had, for the most part, sufficient skills is also not particularly encouraging especially where only 10% of respondents were definitely of the opinion that their colleagues had

⁴. In developing Workbook 4 we were greatly helped by Diane Newell of Jericho Partners who shared with us her experience in leadership consulting. The scope of the governance project is summarized at <http://www.geog.ox.ac.uk/research/transformations/projects/governance>

sufficient training while 25% were definitely of the opinion that board members had sufficient experience. In some jurisdictions, including the UK, it is believed that commonsense combined with experience can compensate for a lack of training. However, in Clark et al. (2007) it is shown that the consistency of UK trustee decision-making with respect to investment-related problems is correlated with trustee formal education and training; experience is not a robust predictor of individual decision-making consistency or competence.

The survey results presented here show that board members do not entirely trust the judgement of their colleagues. If so, it may be difficult for fund boards to come to informed and shared decisions without an agreed process of reconciliation and the active involvement of skilled and knowledgeable board chairpersons and advisors.

It is widely recognised that there are many problems associated with collective decision-making (Raiffa 2002). In the academic literature, and without regard to institutional structure or decision-ecologies, three common causes of poor collective decision-making are identified as follows: (1) the structure of decision-making is not adequately focused upon agreed goals and objectives; (2) the nature and scope of the decisions to be taken are either at odds with one-another and/or lack an agreed order or assigned priority; and, (3) those involved in decision-making have very different styles of deliberation such that there is often unacknowledged and unresolved conflict over the means of finding common agreement.

Lack of focus in collective decision-making is owed to the separate and incommensurate interests of those involved; that is, they come to the process of decision-making without prior agreement on the purpose of deliberation. With respect to pension fund decision-making it is presumed by many that the purpose of collective decision-making is obvious: the maximization of beneficiaries' welfare. Indeed, it is arguable that collective commitment is a robust resource for just this purpose—it cuts through separate interests to a legitimate point of common concern. But, as we have seen in case studies and academic research, this rule is often too abstract to be an effective device for governing decision-making (Clark 2004). The governance of pension funds is complicated by the interests of several stakeholders, notably the sponsor, making the investment mission more subtle than is generally

credited. At best, we suggest collective commitment is an umbrella principle for negotiation over target-setting prior to decision-making; at worst a rhetorical device used to block decision-making. We have suggested elsewhere that target-setting is an essential component of governance best-practice (Clark and Urwin 2008).

The nature and scope of decisions combined with the variable complexity of those decisions often overwhelms the process of collective deliberation (Goldstein et al. 2001). Without an explicit order of deliberation, and prior agreement on the significance of the five types of decisions to be taken, decision-makers may face cognitive and communication overload. As a consequence, there is a temptation to settle on the simplest issues, or allow those with strong views to take others to poorly-reasoned conclusions. In the context of pension fund governance, there are resources at hand to manage temptation including time and expertise. But, as noted above, time is scarce and expertise is expensive. Consequently, agenda-setting and the use of sub-committees to process the most complex types of decisions are crucial elements in best-practice governance. However, when collective commitment is combined with unqualified deference to the views of others, however informed or otherwise, there is a temptation to blur distinctions between the types of decision-making and to ignore prior agreement about the notional order and significance of types of decisions. In these circumstances, there is a temptation to use time to effectively wash-away dissent from executive opinions and judgement.

Most problematic, however, is the prospect that there are unacknowledged differences in individual styles of decision-making embedded in collective deliberation. Different decision-making styles can prompt disagreement amongst decision-makers and misunderstanding of one-another's actions so much so that the process of collective deliberation breaks down under the weight of mistrust. This is believed to be particularly important as the numbers involved in deliberation grow and intimacy and collective commitment is replaced by formality and decision-protocols.⁵ To illustrate, Figure 3 summarizes how our respondents prefer to act and plan. Not only did our

⁵/. As is well-appreciated in the academic literature, the numbers of people involved in decision-making is a crucial element in coordination (Sunstein 2005). Insights gleaned from experimental economics and psychology, and common practice suggest, that the costs coordination (time and attention) dramatically increase beyond 3-4 participants (Camerer and Knez 1997).

respondents evince different styles of decision-making, distinguishing between being decisive and being spontaneous, they evinced two very different ways by which they prefer to plan decision-making, distinguishing between being prepared and simply responding to events. It could be that some respondents were inconsistent in their answers (switching from acting in a planned manner to being spontaneous).

[INSERT FIGURE 3 ABOUT HERE]

Perhaps the self-assessed differences in styles of decision-making noted in Figure 3 can be explained with reference to the larger debate in cognitive science about the significance of intuition (Kahneman 2003). Notice, in Figure 4 it is apparent that these same respondents were almost evenly split in their reliance (or not) on others in working-through important decisions. Respondents often rely on colleagues they trust; however, some are suspicious of others' motives and beliefs. One implication is that the degree to which a board commonly engages in decision-making is determined ex ante by the trust and mutual respect amongst colleagues.⁶ For almost as many respondents, however, collegiality is not a significant factor in how they assess their own opinions and the opinions of others when considering issues to be resolved. When confronted with the choice set, a significant group of respondents emphasized their own analytical skills when they come to consider shared problems.

[INSERT FIGURE 4 ABOUT HERE]

We recognise that both approaches could produce desirable outcomes. Indeed, throughout, we make no normative claim about what should be seen as the 'proper' response in each and every instance. Decision-styles are best thought of as intuitive best-guesses about what respondents believe they would do when faced by issues that are domain-specific, are constrained by the issues at hand, and require immediate response (Hogarth 2001). Our point is that the co-existence of quite different styles of decision-making could derail the process of decision-making unless steps are taken to

⁶/. See Kihlstrom and Cantor (2000) on the significance of what they term as "social intelligence" for effective decision-making. They note the distinction made in the literature between "understanding the behaviour of others" and being able to "cope with the behaviour of other people" arguing that these cognitive traits are not necessarily widely shared in the community. As such, perhaps our results reflect the diversity of social intelligence found amongst respondents.

manage the process of decision-making in a deliberate and constructive manner that retains collegiality.⁷

On these grounds, we would contend that both the structure and the management of the decision-making process are essential ingredients in driving the performance of pension fund institutions. Whereas decision-making can be managed through the application of time and expertise, leadership through agenda-setting and recognition of the extant styles of decision-making is integral to sustaining board members' commitment to the decision-making process. In this sense, best-practice pension fund leadership respects styles of decision-making; leadership is an important decision-resource.

Expertise, leadership and decision-making

From Figure 1, it is apparent that each type of decision makes different demands on the available decision-resources (the 'governance budget'). In particular, strategic and tactical decisions make heavy demands on the available expertise whether applied to fund performance in financial markets (contingent) or applied to long-term planning with respect to fund goals and objectives and fund liabilities (in the defined benefit environment). We have also argued that there is a close relationship between contingent market performance and long-term investment management: operating in the risk domain, exploiting opportunities while constraining impulsiveness, and being innovative in the face of the competition for returns challenge the effective governance of pension funds (Clark and Urwin 2008). These challenges require a level of expertise that is domain-specific; being conversant with the practice of investment is insufficient given the fact that the 'real-life' of investment management is often poorly defined, lacking essential information, and subject to great uncertainty about the proper course of action (Wagner 2000).

Reviewing the cognitive science literature, Wagner (2002, 57) concluded that "the development of expertise is a process whereby broader abilities are honed to sharper ones in which extremely high levels of performance are manifested in extremely

⁷/. It is arguable, of course, that the co-existence of different modes of decision-making could dampen extremes including the over-confidence of experts (Hilton 2003).

narrow domains.” So, for example, having shown that pension fund trustees vary in terms of their competence and consistency of decision-making, and having shown that their performance in the application of probabilistic reasoning to investment-related problems is correlated with formal education and training (Clark et al. 2006, 2007), Wagner would take these observations a step further: the repeated use of these acquired skills enable qualified decision-makers to become financial experts. In essence, expertise is non-transferable between decision-domains—being a ‘professional’ is not necessarily a strong indicator of being able to acquire financial expertise. Since probabilistic reasoning makes heavy demands on cognitive ability, financial expertise on pension fund boards is rarer than often acknowledged.

Wagner (2002) also observed that experts have four traits or habits of mind: they spend more time assessing the problem at hand than solving it whereas non-experts do just the opposite; they evaluate problems against background principles whereas non-experts concentrate on the “surface features” of problems. Consequently, experts are able to quickly process large amounts of data and integrate short-term and long-term patterns relevant to problem-solving because of their “superior” memories. In Figure 5, we report our respondents’ views on a set of two related questions. Beginning with the right-hand pie-chart, it would seem that a little more than one-third of respondents gave an opinion consistent with Wagner’s notion of how experts process information. With respect to a choice between detailed information as opposed to the ‘big-picture’ respondents’ views were, perhaps, more encouraging unless those committed to the ‘big-picture’ included those content with a superficial view of the matter. Again, these results are not definitive; rather, they are indicative of the stresses and strains embedded in collective decision-making.

[INSERT FIGURE 5 ABOUT HERE]

By our assessment, drawing upon experience in the industry and interviews with pension fund trustees and plan sponsors, Wagner’s type of expertise is in short supply on many boards. For example, Monk (2008b) recently illustrated the significant shortfall in governance among US pension funds. Moreover, our recent experience suggests that many pension funds do not effectively govern their advisory relationships.

Effective leadership

Our research and experience suggests that effective leadership positively affects fund performance whatever the inherited structure of the institution (cf. Lerner et al. 2008). Given the nature and scope of pension fund investment in the context of risk and uncertainty, and given the possibility of significant unacknowledged differences in board-members' decision-styles, we would also contend that board chairs and investment committee chairs carry greater responsibility in leading their funds in relation to agreed goals and objectives than that which generally applies to the chairs of corporate boards of directors.

In the context of fund governance, effective leadership includes the following points, the first three being unique to the boards of investment funds:

- strong personal respect, derived from industry reputation and commitment to the institution
- an ability to structure decision-making particular setting priorities and establishing the time devoted to crucial decisions
- an ability to articulate and mediate between the various decision-making styles existent on the board.
- sensitivity to managing stakeholder expectations, having regard to both soft and hard considerations
- competency with the internal staffing of the fund, and the framing of and implementation of outside delegations
- expose the board to a culture and practice of accountability and measurement, both as regards board operations and the performance of the executive team
- an ability to build the culture of the organisation, and promote this to others

While we note that the performance impact from successful leadership is clearly increasing, there are two points that make this leadership challenge harder in today's investment conditions and circumstances. First, talented leaders are in short supply because of competing demands for experienced and talented professionals in the global financial industry. Poor levels of compensation typically offered by pension

funds compound this difficulty. Second, increasing complexity in investment management and performance has made the leadership significantly harder to sustain within normal time parameters that govern pension fund institutions. In this respect, effective board chairs have seen their responsibilities become more like the responsibilities of executive chairs of major corporations than ever before.

The role of the Board chair in mobilising board expertise and attention in ways that sustain the five types of decision-making is obvious. This conclusion begs the question: how should the available expertise in any fund be mobilised and applied in the most effective manner? To illustrate, we turn to a case study summarised in Clark (2008) and noted in Clark and Urwin (2008) that provides a best-practice ‘recipe’ for the mobilisation and application of expertise in ways consistent with the inherited structure of fund institutions.

This case study was of a large North American multi-employer public sector pension plan managed by a board dominated by elected and politically nominated members. Given a challenging annual target rate of return set by the state legislature, the fund has sought ways of managing the decision-making process such that short-term market opportunism (tactical decision-making) is consistent with its long-term funding objectives (structural and strategic decision-making). Leadership has been crucial, given past crises of confidence in performance. The board is chaired by the state treasurer, supported by the CEO who came to the board with an outstanding industry reputation (and is remunerated accordingly). Agenda-setting for board deliberation is a joint responsibility; meeting quarterly, the board reviews fund operations and approves the time-sensitive decisions of the investment sub-committee against the target rate of return and the long-term solvency of the fund. The investment sub-committee brings together a small number of board members with ex-officio external experts and is staffed by the fund’s CIO and investment managers.

In effect, expert judgement about market movements is located with the investment sub-committee and is communicated to the board in terms of the ‘big-picture’. This process of decision-making is acceptable to the board on three grounds. First, the board is ruled by a collective commitment to the objectives of the fund. Sustaining collective commitment has been an important goal of the board chair (the state

treasurer). Second, the board trusts the CEO; the CEO's reputation combined with superior market performance over the past 5 years has reinforced his authority. Third, the sub-committee system has been very effective, underwritten by the reputations of external experts, collegial relationships between board participants, and the skills of the fund executives.

Decision protocols and leadership

The behavioural revolution led by Kahneman and Tversky (1979) has had far-reaching effects on the social sciences including economics and finance. Whereas the rational-actor thesis dominated theories of market performance and institutional structure, it is increasingly clear that so-called 'behavioural anomalies' like risk aversion are systematic and deeply-ingrained in human behaviour. For some theorists, notably Kahneman (2003), this is characteristic of the human condition; for others, including Gigerenzer (2003), the existence of cognitive biases has prompted research on coping strategies and effective decision-heuristics. The argument here is that conscious recognition of cognitive traps is a first step in designing decision-protocols including institutional procedures to ameliorate or mediate their worst effects.

The brief case-study illustrated that investment management can be designed in ways that sustain collective decision making and guard against behaviour that is self-defeating. This confirms the central theme of this paper: the quality of collective decision-making is a function of available decision-resources including fund leadership. As such, we conclude the paper with a series of institutional solutions to the problems of collective decision-making noted in this paper. Our approach is resource-based rather than structure-idealist, following previous argument about the significance of a governance budget for underpinning the decision-making process (Clark and Urwin 2008). In short, we contend that best-practice pension fund governance depends upon recognition of the following 'facts-of-life'.

- First, time, expertise, and collective commitment are crucial resources impacting the nature and quality of collective decision-making. These are elements that define an institution's governance budget. Moreover, the availability of these decision-resources should be considered when planning asset allocation strategies and target rates of return.

- Second, in many funds rather different styles of decision-making co-exist without being recognised as constraints on the effectiveness of collective decision-making. It appears that these decision-styles need not map onto pre-existing attributes or affiliations of board decision-makers (although expertise may be a factor differentiating decision-styles). These types of decision-styles appear to be deeply embedded in individual perceptions and experience (even cognitive capacities).

- Third, an essential ingredient in best-practice pension fund governance is leadership—the equitable application of skills and expertise in ways that build a collective sense of commitment and responsibility. Too often, leadership is believed to be threatening, a point of contestation amongst rival interests represented on boards. As a consequence, it is often neutralised rather than given the role it should have in welding together the complementary elements of best-practice decision-making.

- Fourth, leadership in funds is most often expressed through the role of the Board chair. Here, successful chairs exhibit seven particular virtues, all of which are challenging. They have
 - An unchallenged industry reputation
 - An apparent and systematic commitment to the institution
 - An ability to structure the decision-making process and, in particular, set priorities and the time devoted to decisions
 - An ability to articulate and mediate between the various decision-making styles existent on the board
 - A willingness to bridge the interests of professional staff and the interests of stakeholders.

Those advocating institutional ‘solutions’ to dealing with governance limitations or behavioural biases do so believing that investment management can be designed in ways that perfect collective behaviour. Whereas the poor governance of many DB pension plans has proven to be an issue of some significance in the decline of this institution around the world (Monk 2008a), increasing expectations as regards the

roles and responsibilities of the governing bodies of defined contribution (DC) plans adds weight to the argument that close scrutiny of the comparative decision-making performance of both types of institutions is an essential component of pension policy. In that regard, close attention to the decision-ecologies of these institutions is an essential step in the successful evolution of these institutions.

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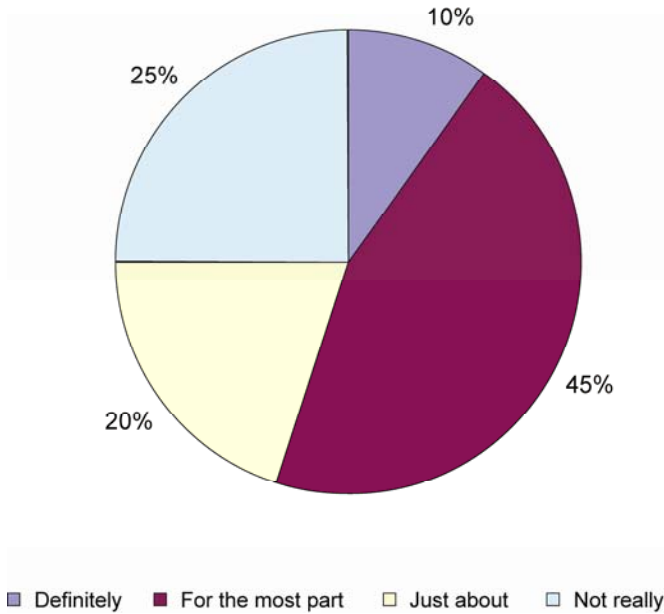
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Figure 1. A resource-based typology of pension fund decision-making

		Type of decision-making				
		Structural	Strategic/ upper-tier	Tactical/ lower-tier	Operational	Monitoring
Resource	Time	- Infrequent once design is complete	- Periodic - Time - extensive	- Event-specific - Time intensive	- Regular recurrent - Time intensive	- Regular - Not necessarily time intensive
	Expertise	- Diverse competency	- Investment specific competency	- Deep investment specific competency	- Moderate investment/diligent competencies	- Wide-ranging competency model
	Collective	- Overarching process - Stakeholder empathy	- Inclusive process	- Individual accountability model	- Delegated model	- Critical for accountability - Allows adaptation
Source: Clark and Urwin 2008		Key: Ideal resource allocation		limited	material	critical

Do you consider that you and your fellow trustees have had sufficient training in investment decision-making?



Do you consider that the other members of your board have the relevant experience to make first-rate investment decisions?

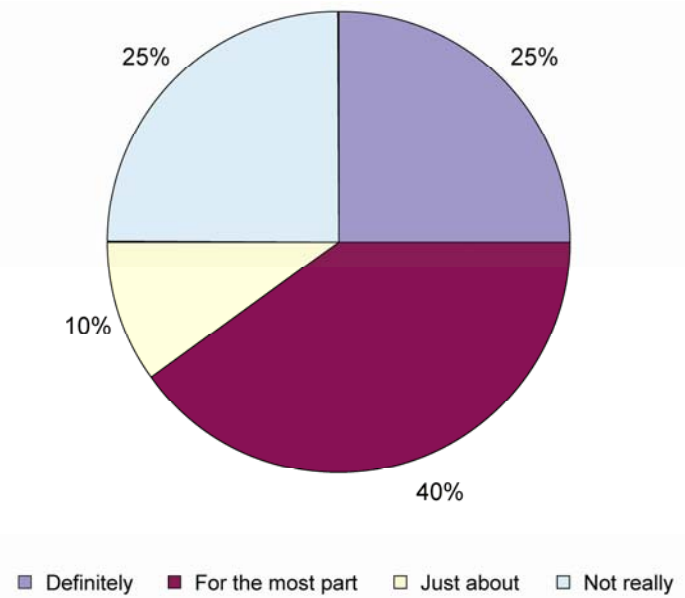
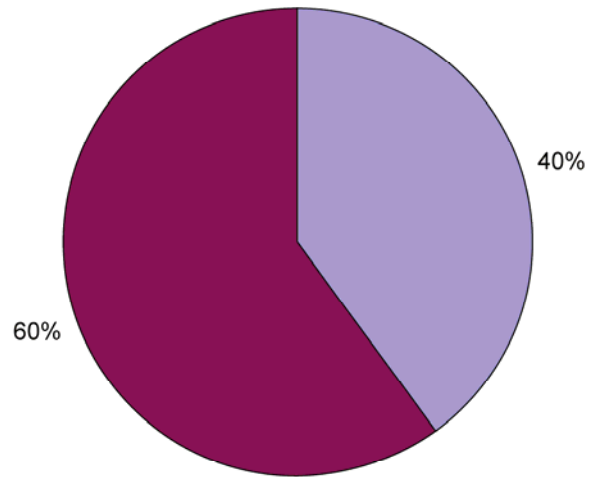


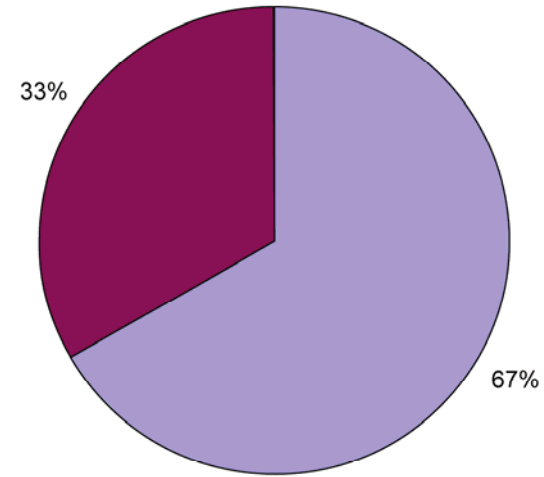
Figure 2. Self-assessed competence of pension board.

How do you prefer to act and plan?



- I prefer to work in a planned way - I feel stressed by working under pressure and I want to make sure I am finished in good time
- I often prefer to leave finishing things until the last minute, I find I do much better, more creative work when there is pressure from a deadline

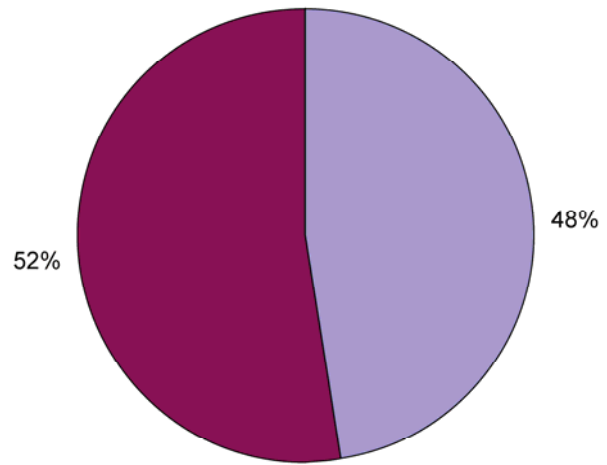
How do you prefer to act and plan?



- I am reliable and decisive
- I am spontaneous and flexible

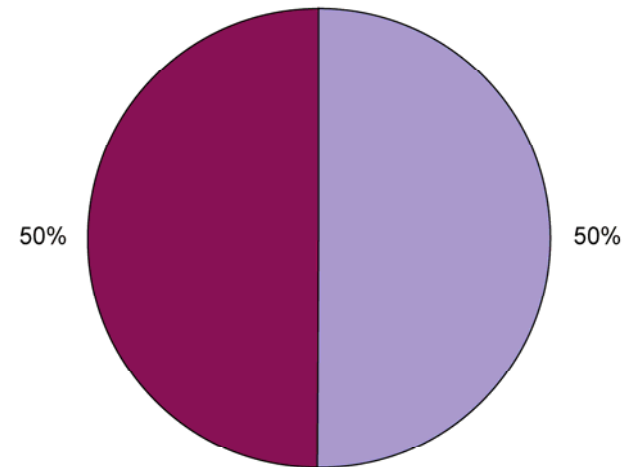
Figure 3. Self-assessed preferred mode of action and planning in decision making.

How do you prefer to focus your attention?



- If I have a problem I need to think it through for myself before I talk about it with others
- If I have a problem I like to talk it through with people I trust, talking it through helps me to get things clear in my own mind

How do you prefer to reach a decision?



- When I am evaluating the information someone has given me, I like to check for any flaws or gaps in their argument
- To really understand a situation I want to get a feel for the motivations and values of the people involved

Figure 4. Self-assessed confidence in personal and collective decision-making.

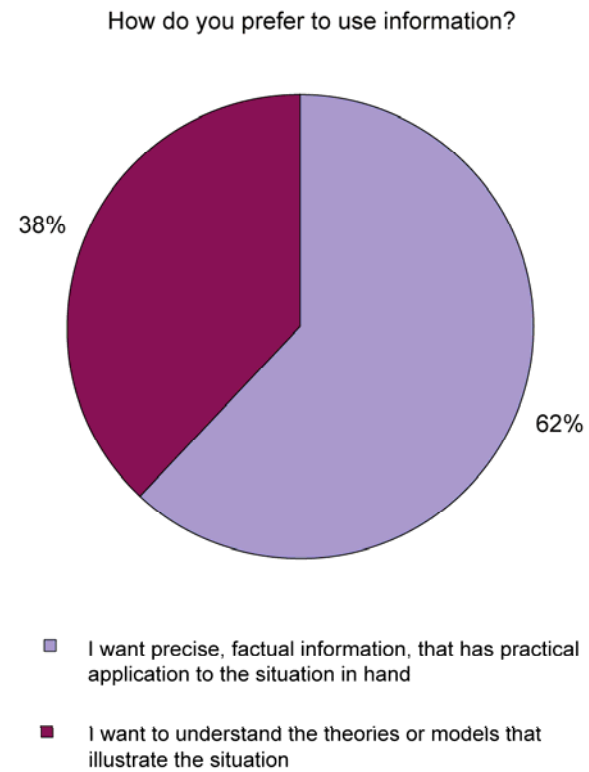
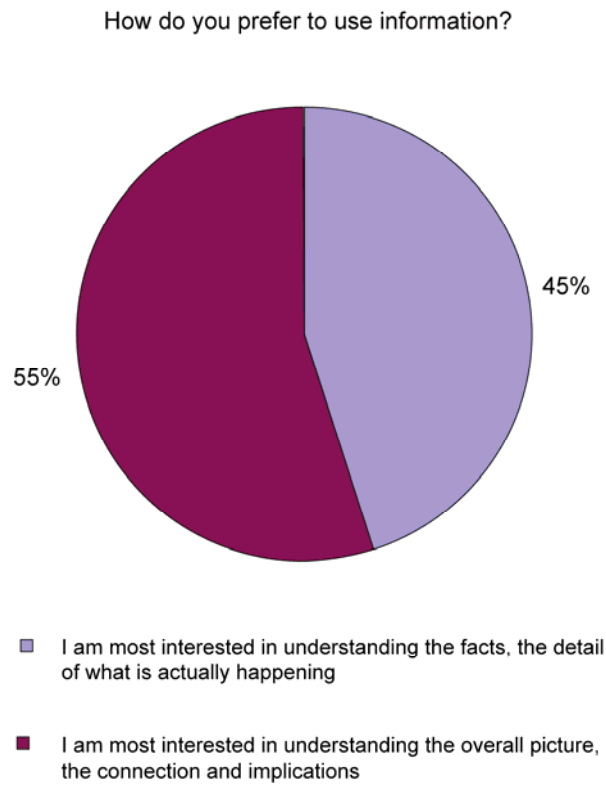


Figure 5. Self-assessed use of information in the decision-making process