

The Governance of Pension Funds: Bad Investments Decisions Dictated on Behalf of Individuals?

Application for funding from EPRN

By

*Steffen Andersen, CEBR & CBS
Kasper Meisner Nielsen, CEBR & CUHK*

Background

Occupational pension funds in most western countries are either directly managed or indirectly influenced by the labor market parties. In the spirit of labor market tradition, both employers and employees are represented on the board of the pension fund, and both sides typically nominate the leader of their organization to the board. Thus, employers allocate their designated seats to experienced business professionals, whereas unions typically nominate their leaders to the board. In the public sector, where the central or local administration is the employer, local politicians are nominated from the employer side. As a consequence the boards of pension funds are comprised by a mix of individuals with little experience or no formal education in making investment decisions.

Meanwhile the board is responsible for determining the investment strategy of the pension fund subject to regulatory provision aiming at protecting pension savings from excessive risk taking. In practice, the board makes crucial investment decision regarding the portfolio allocation between safe and risky assets, and thereby provides investment mandates to professional money managers that the pension fund engages to carry out the actual investment. The apparent lack of financial knowledge and expertise *as well* as the possible differences in preferences between members of the board and individual stakeholders of pension funds raise the concern whether investments are governed in the best interest of pension savers. Although such concerns might be alleviated by hiring external advisors, there is ample anecdotal evidence to suggest that pension funds have diverted from optimizing the risk-return tradeoff on their portfolio. Examples include attempts to save the Danish shipbuilding industry in the 1980s to save workplaces and maintaining a high ratio of domestic assets in the portfolio despite a well-documented benefit from international diversification.

In a preliminary study of the portfolio allocation of pension funds in Denmark, we find compelling evidence of the influence of the governance of pension funds on the investment decision and the probability of making investment mistakes. Pension funds with a board dominated by local politicians and union leaders maintain much higher exposure to domestic equity. We hypothesize that this reveals a political preference for domestic investments due to a desire to maintain domestic employment at the expense of pension savers. In this project we therefore aim at providing an analysis of how governance affects investment decisions, and moreover analyze how the individual characteristics of the board members dictate possible improper decisions.

Objectives

This research proposal has two main objectives:

1. To analyze whether the governance of pension funds affect investment decisions. In the wake of the recent financial crisis, there has been an increasing focus on the governance of financial intermediaries, although the focuses is directed entirely towards uncovering recent malpractice in bank, insurance companies and investment funds. Surprisingly, there are no existing studies of the governance of pension funds despite the fact that these in many countries are the backbone of the private pension system and a substantial share of private savings. A better understanding of the governance of pension funds will help us understand whether the traditional organization of pension funds is beneficial to individual pension savers.
2. To understand how important individual characteristics and competences of board members are in maximizing the pension savers risk-return tradeoff. One immediate concern with the current organization is that many of the board members are nominated for other reasons than their financial expertise. If financial expertise is important we should expect pension funds with qualified board members to achieve a higher portfolio return. Alternatively, if external expertise is a perfect substitute we should expect to find no difference in the investment performance across different pension funds.

Description of methodology and data

A significant part of this research proposal is to develop a comprehensive dataset that combines data on the governance and investment decisions of pension funds on one side with detailed both background and behavioral data of the individual board members on the other side. The research proposal utilizes the fact that the Danish legislation since 1995 has obligated pension funds to make public a wide set of information on their investments into different asset classes. These data on the pension funds investment decisions have to be collected manually from the pension funds' annual reports, which are available only in paper form from *Erhvervs- og Selskabsstyrelsen*. From the pension funds' annual reports we can collect time-series of investment flows and returns by type of assets and level of international diversification. In addition detailed information about the nomination of board members needs to be collected from the pension funds bylaws. To identify the board members a combination of information from the annual reports and the official registry of board members at *Erhvervs- og Selskabsstyrelsen* is needed. The latter source allows us to obtain the CPR-number of all board members, and through Statistics Denmark's extensive IDA-database obtain background information on the expertise, the educational background as well as the individual investment behavior of all board members.

Together, these datasets will form an internationally unique dataset on the governance of pension funds and their investment decisions. These data will enable us to assess the organization of pension funds in greater detail and further evaluate the potential impact on investment decisions and outcomes.

Policy implications

On the national level we expect this study to achieved significant attention in the media and business community as the current research project may have a number of policy implications:

1. Given the longstanding tradition of letting the labor market parties arrange the private pension system there is a strong need to understand the implications for pension savers. The current research project will be able to both quantify and qualify whether this system is costly for pension savers.
2. In a Danish context, the regulation of the pension funds' portfolio choices has already changed – allowing individuals to have some say on their investment decisions. If the governance of the current system is suboptimal, increasing the individual say on investment decisions will provide an internal pressure to reform and professionalize the system.

Deliverables and expected results

If we obtain the grant, we expect to deliver the following before December 2010:

1. A working paper on the influence of governance on pension funds' investments decisions, aiming at publication in a top economic or finance journal.
2. A working paper in Danish that evaluates the governance of Danish pension funds, their investments decisions, and discusses the potential need for a reform of the system aiming at publication in *Nationaløkonomisk Tidsskrift*.

Budget

We apply for the amount of kr. 370.000 to cover: i) Wage buyout for KMN (FSE levels); ii) data purchases (DST); and iii) a part-time research assistant to (manually and labor intensive) collect data, and iv) travel expenses for collaboration between participants

Wage (KMN, 2 Months)	88,333 kr.
Data expenses	95,000 kr.
Research assistant (App 560 Hours)	75,000 kr.
Travel expenses	50,000 kr.
Overhead (20% of 308333)	61,666 kr.
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Total	370,000 kr

Participants

Steffen Andersen, Copenhagen Business School and CEBR.

Kasper Meisner Nielsen, Chinese University of Hong Kong and CEBR.

STEFFEN ANDERSEN

Contact

Department of Economics
Copenhagen Business School
Porcelænshaven 16A, 1
DK-2000 Frederiksberg
Denmark

Phone: +45 3815 2591

Fax: +45 3815 2576

E-mail: sa.eco@cbs.dk

Web: <http://staff.cbs.dk/sa>

Education

- Ph.D. (Economics), University of Copenhagen, Denmark, 2007.
- Master of Economics, University of Copenhagen, Denmark, 2004.
- Bachelor of Economics, University of Copenhagen, Denmark, 2001.

Employment:

- Associate Professor, Department of Economics, Copenhagen Business School, Jan. 2009 – present.
- Assistant Professor, Department of Economics, Copenhagen Business School, Mar. 2007 – Dec 2008.
- Research Fellow, Centre for Economic and Business Research, Copenhagen Business School, Denmark, Mar. 2007 – present.
- Research Assistant, CEBR, Copenhagen Business School, Denmark, June 2000 – Mar 2007.

Other Academic Experience

- Assistant Research Professor, Laboratory for Experimental Economics, Department of Economics, University of Copenhagen. Sep. 2007 - present. Contact: Professor Jean-Robert Tyran.
- Visiting Scholar, Department of Economics, University of Chicago, USA, Sep. 2005 - Jul. 2006. Contact: Professor John A. List.
- Visiting Scholar, Department of Economics and Finance, University of Central Florida, USA, Jan. 2004 - Feb. 2004. Contact: Professor Glenn W. Harrison.

Publications

1. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., “Behavioral Econometrics for Psychologists”, *Journal of Economic Psychology*, Forthcoming.
2. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., “Preference Heterogeneity in Experiments: Comparing the Field and Lab,” *Journal of Economic Behavior & Organization*, Forthcoming.

3. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., "Eliciting Risk and Time Preference," *Econometrica*, 2008, 76(3), 583–618.
4. Andersen, S.; Bulte, E.; Gneezy, U., and List, J. A., "Do Women Supply more Public Goods than Men? Preliminary Experimental Evidence from Matrilineal and Patriarchal Societies," *American Economic Review (Papers and Proceedings)*, 2008, 98(2), 376-81.
5. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., "Lost in State Space: Are Preferences Stable?," *International Economic Review*, 2008, 49(3), 1091-1112.
6. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., "Valuation Using Multiple Price List Formats," *Applied Economics*, 39(6), 2007, 675-682.
7. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., "Elicitation Using Multiple Price List Formats," *Experimental Economics*, 9(4), 2006, 383-405.

Working Papers

1. Andersen, S. and Nielsen, K. M., "Why do people shy away from stocks?," March 2009.
2. Andersen, S.; Fountain J.; Harrison, G. W., and Rutström, E. E., "Estimating Subjective Probabilities," March 2009.
3. Andersen, S.; Harrison, G. W.; Hole, A. R., and Rutström, E. E., "Non-Linear Mixed Logit and the Characterization of Individual Heterogeneity?," February 2009.
4. Andersen, S.; Fountain J.; Harrison, G. W., and Rutström, E. E., "Estimating Aversion to Uncertainty?," March 2009.
5. Al-Ubaydli, O.; Andersen, S.; Gneezy, U. and List, A. L. "For love or money? Comparing the effects of non-pecuniary and pecuniary incentive schemes in the workplace," February 2007.
6. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., "Dual Criteria Decisions,"CEBR Discussion Paper No. 2006-16.
7. Andersen, S.; Harrison, G. W.; Lau, M. I., and Rutström, E. E., "Dynamic Choice Behavior in a Natural Experiment,"CEBR Discussion Paper No. 2006-14.

Awards

Young Elite Research Prize, 2009, Ministry of Science, Technology and Innovation

Ad Hoc Refereeing

Journal of Political Economy, American Economic Review, Journal of Applied Econometrics, Journal of Environmental Economics and Management, Journal of Economic Behavior and Organization, Southern Economic Journal, Experimental Economics, Economica, Oxford University Press, Review of Economic Studies, Land Economics, Agricultural Economics, Economic Journal, Scandinavian Journal of Economics.

KASPER MEISNER NIELSEN

Contact

Department of Finance
Chinese University of Hong Kong
Fung King Hey Building, Office 214
Shatin, New Territories
Hong Kong SAR, China

Phone: (+852) 2609 7443

Fax: (+852) 2603 6586

Email: kn@cebr.dk

Web: www.cebr.dk/kmn

Education

- Ph.D. (Economics), University of Copenhagen, Denmark, 2005.
- Master of Economics, University of Copenhagen, Denmark, 2002.
- Bachelor of Economics, University of Copenhagen, Denmark, 2000.

Employment

- Assistant Professor, Department of Finance, Chinese University of Hong Kong, 2007 – present
- Research Fellow, Centre for Economic and Business Research, Copenhagen, 2005 – Present
- Assistant Professor, Department of Finance, Copenhagen Business School, 2005 - 2007

Other Academic Experience

- Visiting scholar, Department of Finance, Stern School of Business, New York University, Academic year 2003–4

Publications

1. Morten Bennedsen and Kasper M. Nielsen, "The Causal Effect of Board Size in the Performance of Small and Medium-Sized Firms," *Journal of Banking and Finance*, 2007, 32 (6), 1098-1109.
2. Kasper M. Nielsen "Institutional Investors and Private Equity", *Review of Finance*, 12: 185-219, 2007.
3. Morten Bennedsen, K. M. Nielsen, F. Pérez-González and D. Wolfenzon, "Inside the Family Firm: The Role of Families in Succession Decisions and Performance," *The Quarterly Journal of Economics*, 2007, 122 (2), 647-91.
4. Morten Bennedsen and Kasper M. Nielsen, "The Impact of a Break-Through Rule on European Firms," *European Journal of Law and Economics* 17 (3), 259-83.

5. M. Bennedsen, T. Dam and J. Herby and K. M. Nielsen, "Consequences of Harmonizing the Company Laws in Europe: Should Dual Class Shares Be Banned?," (in Danish) *Danish Journal of Economics*, 2003 (1).
6. Morten Bennedsen and Kasper M. Nielsen, "Swedish Corporate Governance under Pressure: Effects of the Harmonization of the Company Laws within EU" (in Danish). *Swedish Journal of Economics*, 2003 (2).
7. Morten Bennedsen and Kasper M. Nielsen, "Boards in Closely Held Corporations", (in Danish). *Danish Journal of Economics*, 2002 (2).
8. Morten Bennedsen and Kasper M. Nielsen "Ownership Structures and Control Allocation in Danish Closely Held Corporations", (in Danish). *Danish Journal of Economics*, 2001 (3).

Working Papers

1. Andersen, S. and Nielsen, K. M., "Why do people shy away from stocks?," March 2009.
2. Kasper M. Nielsen, "The Return to Pension Funds' Private Equity Investments: New Evidence on the Private Equity Premium Puzzle", February 2008.
3. Morten Bennedsen and Kasper M. Nielsen, "The Principle of Proportional Ownership, Investor Protection and Firm Value in Western Europe", February 2008.
4. Morten Bennedsen and K. M. Nielsen and D. Wolfenzon, "The Family behind the Family Firm: Evidence from Successions in Danish Firms", May 2004.

Ad Hoc Referee

European Financial, Management, Journal of Banking and Finance, Journal of Corporate Finance, Review of Finance, and Scandinavian Journal of Economics.

Awards:

The Tuborg Foudation's Business Economics Prize 2003