B.A.J. **8**, I, 75-90 (2002)

THE MYNERS REVIEW AND SUBSEQUENT ISSUES

LECTURE BY P. MYNERS

[Delivered to the Faculty of Actuaries, 15 October 2001]

INTRODUCTION

An Open Meeting was held by the Faculty of Actuaries on 15 October 2001, when Mr Myners addressed his audience on a number of the issues raised in his review, *Institutional Investment in the United Kingdom: a Review*. This was followed by a discussion. The lecture and an abstract of the discussion are printed after this introduction.

A second meeting on the subject was held on 16 October. This was a joint Seminar, arranged by the Faculty of Actuaries and the Centre for Financial Markets Research, University of Edinburgh. This seminar covered a number of issues raised by the Myners Review. The purpose of the seminar was to open up to discussion a number of the issues raised by the review where there appeared to be differences of opinion amongst practitioners. In particular, the investment process, investment performance and fees, especially commissions, were discussed. Academics, investment, performance measurement and pension specialists attended the seminar.

LECTURE AND ABSTRACT OF THE DISCUSSION

The President (Mr T. D. Kingston, F.F.A.): This is a special meeting and is not in our normal format. We are to have a lecture by Mr Paul Myners, followed by an opportunity for you to ask questions or to issue challenges.

We are both privileged and delighted to have Mr Myners with us. He is the Chief Executive of Gartmore, one of the best known fund management houses, and author of the report entitled: *Institutional Investment in the United Kingdom: a Review*, more commonly known as the Myners Review or the Myners Report, which was published earlier this year. It is long, but well worth reading, and I hope that many of you have read it. There has been a response from the actuarial profession, which, also, I hope that many of you have read. This is a process that has not yet ended, as I am sure that Mr Myners will tell you. In the past couple of weeks we have had the response from the Treasury on the code for pension fund investment. We have also seen the beginnings of the Sandler Report, dealing more with individual investments, something which Mr Myners suggested be done. These are areas which are of vital interest to everybody involved, in either the investment or the savings business.

Mr P. Myners: I thank the Faculty for inviting me to speak, and for the work which members of the Faculty did in support of the review which I produced on institutional investment. They were enormously helpful, both to myself and to my assistant from the Treasury, who worked on the review.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

What I shall do now is to speak about the origins of the review; the methodology that I employed; the key conclusions; and, importantly, then to rebut suggestions that there were other conclusions (which I struggled to find in the review, but some people still think are there). I will then speak about some of the more controversial elements of the review.

To start with, why was the review established? It was established by the Chancellor of the Exchequer in the Budget of 2000, as part of an initiative within the Treasury, to seek to understand international competitiveness and productivity. The highest profile initiative to come out of this to date was the review into banking by Mr Donald Cruickshank. In total, there have been 15 initiatives under this general heading, which have included such things as: changing immigration laws to favour people with skills which are in shortfall in this country; planning permission; and the licensing and control of spectrum and bandwidth.

In the early part of 2000 the Treasury thought that it should look at whether there were issues around institutional investment. It recognised that British companies were predominantly owned by institutions. It believed that United Kingdom institutions appeared, on the surface, to be risk-averse by comparison with United States institutions. You may remember that the Prime Minister, Mr Blair, in 1999, at a seminar hosted by three of the largest actuarial firms, the BBA and the National Association of Pension Funds (NAPF), had said that the average British pension fund had 0.5% of its assets invested in venture capital or private equity, compared with the equivalent figure in the U.S.A. of 5%. I do not think that those figures are accurate, although I think that the proportionality is correct. My own instinct is that it is about 0.3% versus 3%.

So, I was asked by the Chancellor of the Exchequer if I would look into whether there were factors which were encouraging institutional investors to focus overwhelmingly on quoted securities, and to avoid investing in small and medium-sized enterprises, and, in particular, those without a public listing.

I found that, to do this, I had to step back behind the question. I had to ask: whether investment decisions were rational; whether they were well-informed; whether, if there were incentive effects at work, they were aligned to good and informed decisions; and whether there was a good, rational, and undistorted application of decision-making structures. I also had to ask whether the Government could address any issues where there was a *prima facie* case that investment decisions were not always necessarily rational and well-informed.

How did I do this? I had one full-time civil servant from the Treasury. He knew very little about investment — probably about the same as I did, but, over a period of time, we built up a good understanding of some of the issues, and I managed to bring in some external resources for brief periods of time. These included Ann Robinson, who had previously been Director-General of the NAPF. She worked for me for six weeks.

We issued a consultation document, and we conducted a series of workshops around the country, including in Edinburgh and in Glasgow. We also carried out numerous interviews with people to seek their understanding of some of the issues.

I now give the main findings of the review, and I am talking here primarily about pension funds, although the review also applied to life assurance, mutual funds, unit and investment trusts, and charities. It is, perhaps, simpler to look at it primarily as a pension fund review, and then ask how it applies to other asset classes. I have to say, first, that the U.K. pension fund industry has served the nation well. We have a higher proportion of invested assets in support of pension fund liabilities, expressed as a percentage of GDP, than almost any other economy in the world. We have a higher percentage invested in high return assets — or, at least, assets which, historically, have been high return — namely equities, and we have a higher proportion invested in non-domestic securities than almost any other equivalent economy. So, you cannot pin the charge of risk aversion on institutional investors. I found no evidence of risk-aversion. I found no evidence of running from risk. I did, however, find some areas where I felt that risk could be better managed. I often think that we should describe ourselves, actually, not as investment managers, but as risk managers. Regrettably, those in insurance have already managed to commandeer that title.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

So, this is an industry which has served the nation well, but I am a hopeless optimist, and I believe that, in a number of areas, it is possible to improve the overall performance of the key players.

I now go through my main conclusions in terms of what I found in four major groups: pension fund trustees; investment consultants (many of whom, but not all, are actuaries); fund managers; and corporate sponsors.

First, I consider pension fund trustees. The vast majority of pension fund trustees receive no training before becoming trustees. Those who do receive training receive very little, and the majority of those who receive training upon appointment receive no subsequent training. I found trustees to be short of resources; unclear as to their role; and unclear as to their own effectiveness.

These are generalisations, which are qualitative rather than quantitative. We did do some research, with which the NAPF assisted, on the qualifications and experience of trustees and the amount of time that they spent on their duties. The average trustee spent 12 hours a year on asset management issues —12 hours a year, for an industry with assets of £900 billion! Such sums are not to be managed on the same lines as a churchwarden or a scout group would do with their funds. I also found that trustees were hesitant about their role and their effectiveness.

I remember one trustee, in particular, saying to me, after we had finished our interview: "We have these quarterly meetings. First of all, the 90 days seem to go very quickly. We are into the next meeting almost as soon as we seem to have finished the last one. I am never really sure, before we go into the meeting, what it is that we hope to achieve that day. We are going to have our managers in. We are going to have the actuary. We are going to look at some liability issues. Then we look at investment performance. I am not really sure that we are clear in our own minds what we expect to achieve as a result of the dialogue with our fund managers, of whom we have three. They all come and present to us. Then we have lunch with them all afterwards. We can never remember, when we sit down, whether we are sitting next to the person who believes that inflation is going up or the person who thinks that inflation is going down. Then, every two or three years, we fire one of the managers. I am not sure that that is the right way of doing things.'' I remember this graphically, because I felt that this person spoke with real anguish about his sense of whether he was being truly effective in his role.

Investment consultants are a *prima facie* case for a Competition Commission reference. The Herphendal Index of industry concentration is about 1,800. The competition authorities generally get worried about a concentration of more than 1,000. There are four major firms of consultants controlling, or influencing, 80% of major defined benefit pension plans. It is a very concentrated industry.

The expectations of this industry are very unclear. It is an industry which embraces a number of different activities: pure actuarial advice; asset allocation advice; and managers' selection advice. There is not a great deal of evidence that the input from the consulting profession is being measured. There is not a great deal of clarity that expectations are uniform, in terms of the expectation between the client, the trustee, and the consultant. There is considerable scope for the client, the trustee, to say: "Well, we have made the appointment under the advice of the consultant'', and the consultant to say: "No, we do not give advice that far; we put up only a series of options and we leave it to the trustees.'' Performance is not usually assessed or measured. That, again, is critical to the ten principles of good investment decision making which I will come to in a moment.

The third of the four communities is the fund managers. They are often set objectives which create an unnecessary incentive to herd. This manifests itself in the balanced pension fund, which, fortunately, is going into quite rapid decline. The balanced pension fund and the peer group benchmark have encouraged fund managers to show an absence of conviction around key asset allocation decisions. Fund managers have frequently substituted the management of their own business risk for the management of their client's risk. It is also evident in stock selection. There is increasing evidence that the scatter of returns in a particular market is narrowing as more and more fund managers focus on tracking error, which is a measure of the likely differentiation of return against a core market index.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

I cite some examples of an unnecessary incentive to herd. There was the situation that, 18 months ago, almost every British pension fund had more money invested in Vodaphone than it had invested in the U.S.A. Why? I can understand how one fund manager — two, three or five — might conclude that one British company is such a stunningly attractive investment that it represents a more compelling home for money than the whole of the U.S.A., but, to conclude that some 120 or more balanced fund managers all reached that conclusion beggars belief, until you recognise the incentive effects for fund managers not to exhibit conviction in their portfolio construction. With the benefit of hindsight, we can now see how values became terribly overextended in the technology sector. This, of course, manifested itself in the lunacy following the Vodaphone merger with Mannesman. These companies were almost equal in size. It would not have been too difficult for Mannesman to have reversed the roles and to have bid for Vodaphone. As it is, Vodaphone doubled its size and became a far more significant factor in the FTSE Index, from 6% or 7% of the U.K. index to 12% or 13%, and almost every British equity manager bought Vodaphone shares, because they had to get up to the index weighting.

Where were the voices from the consulting community, the trustee world or the investment world, pointing out this folly? Capital markets are meant to allocate capital in an efficient way, based upon marginal productivity. Here, through indexation, we had a form of quasi soviet capital allocation, in which more capital was allocated to large projects and taken away from small projects.

So, I found this great incentive to herd; and I also found discouragement to manage with conviction, and a vagueness about timescales. Fund managers were not at all clear about the time period over which they were likely to be measured. That, in turn, was a discouragement for them to take what I call high conviction decisions. For example, a concentrated portfolio represents such a decision. That, in turn, manifests itself in a reluctance to intervene in investee companies when it may be sensible so to do.

What did the review recommend? At the heart of the review is a set of principles for good investment decision making. They take up two pages, and they are written in pretty plain English. I said to the Chancellor of the Exchequer that I was far from sure that they were necessarily the only ten principles. In fact, I was pretty confident that they were not right, because of the way in which we completed the process of the review. It would be arrogant, in the extreme, to believe that I had got them all right, either in terms of the phrasing of the individual principles or in terms of including everything. So, I suggested that a set of principles for good investment decision making should go out to further consultation, in order that everybody will have a chance of expressing comment. The Chancellor agreed to the suggestion.

Next, trustees should be familiar with the issues on which they make decisions. This is interpreted, by some people, as saying that Paul Myners recommends professional trustees. He does not. U.K. law says that a trustee must show the competence and judgement of an ordinary man of business. What I have sought to do is to raise the threshold of skill, to move the bar up one or two notches, and to go from a requirement to show the skills and judgements of the ordinary person of business to a requirement to show the skills and judgements of a person familiar with the issues. This applies, not to every trustee, but to the trustees in aggregate. The trustees must organise themselves so that they bring the skills and competences of persons familiar with the issues. I think that it is very difficult to sustain the counter argument; that one should be comfortable that people are making decisions on matters with which they do not have the necessary familiarity.

In an open letter to the Chancellor of the Exchequer and the Secretary of State for Social Security in November 2000, at the time of the pre-Budget review, I was asked whether I would say something on the Minimum Funding Requirement (MFR). I produced quite a long letter which went through the history of the MFR, and pointed out what people believed that it did and the reality of what it did. There was a considerable mismatch between the two! I looked at alternatives, and I concluded that the MFR should be abolished, and that it should be replaced by scheme-specific benchmarks, and greater transparency and accountability. I think that that changed the focus of the debate.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

The Faculty and the Institute had produced an excellent report on improving the MFR, but they had not been invited to say whether the MFR, in itself, was sound, or whether there was something better than the MFR. I believe that the MFR is the equivalent of the Dangerous Dogs Act — it was a flawed piece of legislation in response to 'Maxwell'. At the heart of 'Maxwell' was a man who stole from the pension fund. The MFR does nothing to stop people stealing from pension funds. It is a funding standard. Ironically, it could be argued that the Mirror funds were extremely well funded, and so were more attractive to Robert Maxwell as a source of theft than if they had not been.

The Government, in accepting that the MFR should be abolished, 'augmented' that proposal with some proposals of its own. Those were, in particular, putting a duty of care on the Scheme Actuary to members of the scheme, and the right of preference in liquidation. In due course, we will see legislation to abolish the MFR, and we have already seen some easing around the implementation of the MFR while it remains on the Statute Book.

I also recommended that there should be an explicit duty for fund managers to intervene in companies in the shareholders' interests. Of the capital of the top 200 U.K. companies, 80% is owned by institutional investors: 50% by U.K. investors; and, interestingly, 30% by foreign investors. Institutions have power, but they do not use this power; it is not a commercial objective. However, by virtue of their commercial success, they begin to have the power of responsibility as owners of corporations. Indisputably, they have to accept that there are circumstances in which those responsibilities require certain actions.

The Company Law Review, which devoted much more space to this particular issue than I did, expressed considerable concern at the reluctance of institutions to intervene in the case of companies which appeared to have flawed strategies, or flawed implementation, or a lack of accountability by management to the owners of the business. There was a strong sense of conflicts of interest, which meant that the clients of the investment manager were not receiving priority in terms of attention. I said that the law should make clear that there is an obligation to act if it is believed to be in the best interests of the clients of the fund manager so to do. The Government accepted that, and recently said that it was going to introduce legislation on that point, probably as part of the Companies Act.

I also made some specific recommendations relating to private equity. I said that all reasonable asset classes should be considered by trustees. I went no further than that on private equity. I did not get myself into a situation where I became a super salesman for private equity. I did not say: "Every British pension fund should have more money invested in private equity, because it is either good for the pension fund or good for the national interest.'' It is simply not possible for it to be expressed in those terms. What I did say was that it was unreasonable for trustees to make one of three responses when I say to them: "I notice that you do not have any private equity in your portfolio.'' These three standard responses are: "Nobody suggested it''; "It is a very risky asset, is it not?"; "We tried it ten years ago. It was a disaster.'' I can understand all three answers, but I do not think that they are really acceptable answers. So, what I have said, as part of my ten principles, is that trustees should consider all reasonable asset classes.

What I did not recommend was any increase in regulation; any increase in bureaucracy; or any increase in compulsory training or examinations for trustees. In fact, I say positive things about lay trustees, and merely state that, in aggregate, the trustees need to organise themselves on the basis that they are familiar with the issues on which they are making decisions.

I do not think that there is anything in my report which increases costs. In fact, I think that the cost and efficiency of funds might be improved by greater investment flexibility, particularly after the abolition of the MFR. There is the potential to improve returns, or portfolio efficiency, by considering new asset classes such as private equity and hedge funds, and there will be greater scrutiny of the total expense ratio.

The ten principles of good investment decision making are expressed in a 'Cadbury-type' context. 'Cadbury' is a code. It does not say that you have to do what Cadbury believes to be right. It merely says that, if you do not do it, then please explain why. Cadbury does not say that you cannot combine the role of Chairman and Chief Executive; it does say that it is generally

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

advisable that you should not, and that, if you do, then please explain. I, quite shamelessly, copied that approach, and said that I am suggesting a Cadbury-style, voluntary statement of compliance.

The recommendations include:

(1) Decisions should be taken only by those with the skills, the information and the resources necessary to take them effectively. Trustees will have to make a statement that they believe that the way in which they have organised themselves, either to take the decisions themselves, or to subcontract to others, is such that those decisions are being taken by people with the skills, the information and the resources necessary to take them effectively. This, of course, parallels the change in trust legislation, which I have recommended to the Government, by increasing the obligation on the trustee of being a person familiar with the issues, rather than merely exhibiting the skills of the ordinary person of business.

(2) The performance of all advisers and managers should be measured and assessed. This addresses the issue that there is uncertainty as to who is responsible for what. Here, I do not just mean the performance of the investment managers, but I also mean the performance of the consultants, and, importantly, the performance of the trustees. The trustees make very important decisions. Recently I was in Belfast, speaking to a group of trustees. A trustee from a scheme in Londonderry said: "We do not take investment decisions." I replied: "You do. You set benchmarks." He said: "Yes, we are in the CAPS survey. We just want to outperform the median." I said: "That is an investment decision. You have made an investment decision. In my view, it is almost certainly a flawed investment decision, because how your pension fund does versus other pension funds in a balanced universe has no recognition or acknowledgement of the uniqueness of the circumstances of your particular scheme. Nevertheless, it is undoubtedly an investment decision. Also, you have made an investment decision about your manager arrangements and about the appointment of your manager." So, I believe that the performance of the trustees should be capable of being self-assessed.

(3) Decision-makers should consider a full range of asset classes. Again, I think that it is quite difficult for trustees to say: "We just do not bother to think about private equity, quite frankly." Maybe you could put that in your 'Cadbury-style' compliance statement. I do not think that it would reflect well on the trustees of the scheme. I think that it is entirely acceptable for trustees to say, for instance, in the context of the maturity of the scheme, the strength of the sponsor, or their perception of unattractive valuation options, etc., that they are not investing in private equity or in hedge funds. At least, I think that they should go through the process of evaluating and accounting for their failure to invest in such asset classes, or indeed others, such as property and real estate.

(4) This is a controversial recommendation for the actuarial profession. I have said that contracts for actuarial and investment advice should be competed for separately. Generally speaking, one firm provides all types of advice: the actuarial advice; the asset allocation advice; and the investment manager appointment advice. One of my questions about industry concentration was: "What can be done to encourage other people to come into this sector, and, incidentally, to boost underlying revenue?" One of my observations, which I highlight in the review, is that the total fee base of the consulting industry in the U.K. is around £80 million. This is a very small industry, but it exercises a huge influence over how institutional assets are managed. I should like to find a way of addressing the concentration by encouraging other people to come into this industry. One of the ways is to put an obligation on trustees to compete separately for actuarial and investment advice. That, again, is not to say that they cannot, at the end of the process, appoint one firm to advise in both areas, but, at least, I am trying to force them through the decision process, since these are very separate and distinct functions.

(5) I have suggested that fund manager performance should be evaluated over an agreed timescale. This is to try to tease out the argument that we kept on hearing back from the fund managers: "We really cannot take strong convictions in our portfolios, because we

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

have a constant fear that our appointment is going to be terminated after several quarters, or a couple of years, or three years, of bad performance.'' You might, justifiably, argue for passive manager termination after a few months of significant tracking error, but, if you are expecting managers to show real conviction, real interest in the companies that they have in their portfolio, then I think that this is more likely to occur against a backdrop where there is greater security of tenure. So, this is not an obligation that says that you cannot fire fund managers; it is just an attempt to establish a more appropriate, mature and professional dialogue between trustees, consultants and fund managers about what can, realistically, be expected of a fund manager. How we find talented fund managers is an enormous challenge. Again, in the consulting profession, I found little evidence that anybody had yet managed to establish real, sustainable capacity to identify managers with a capacity to outperform. If we did think that we could find truly talented managers, then I think that that talent would be more productively employed in an environment in which they had more security of tenure than under the present regime, where all appointments are terminable, or generally terminable, on 24 hours' notice.

(6) This is a point that I am particularly keen to emphasise. When I said that I wanted a voluntary 'Cadbury-style' approach, there were doubters within Government as to whether this would be sufficient. This is an industry which is quite timid, does not like change, and does not encourage people to do things differently. There were those within government — defined in its broadest sense, to include both elected politicians and civil servants — who feared that my proposal did not have sufficient steel. They felt that a voluntary code of compliance was insufficient. So, what the Government has said that it will do is to undertake a public assessment of the effectiveness of the principles in bringing about behavioural change in 2003. In other words, if there is not evidence that these principles are being adopted by pension fund trustees, and that they are making voluntary statements of compliance, and are taking the principles seriously, then the Government reserves the right to introduce legislation around the principles. I have a sense, at the moment, that the industry is not responding with as much drive and passion to the challenge and opportunity as it should. There are individual examples of good practice: the Tameside Council fund and the Sainsbury pension fund are approaching it with a real passion. There are also non-pension funds, like Wellcome, which are looking very enthusiastically at the principles. However, there are other trustees who, I think, are just saying: "We will look at it two meetings after the next one.'' Time is running out.

I made a number of other proposals around pension funds, and I do not intend to dwell on any of these for very long. I suggested that trustees should have more in-house support from the corporate sponsor or the local authority sponsor. Another consequence of 'Maxwell' was a general sense that too close an involvement between the sponsor and the pension fund was something which should be treated with some ill ease. I believe that trustees could, and should, reasonably expect more support from the sponsor. I think that FRS 17 will ensure that that happens. I should like to see a greater sense of community between the sponsor and the trustees. The sponsor is the fourth stakeholder in my list, which also included trustees, consultants and fund managers.

I suggested that there was an argument for paying trustees. This is just what we do, anyway, in business if we find that we are not attracting the right people or enough of the time of the right people. Economically, our standard approach is to reward, encourage and induce. Many pension funds pay their trustees, and I do not see anything fundamentally wrong with that. I think that spending sufficient time on the function is actually more important than paying, but I do think that there are arguments that paying trustees is a wise and sensible thing to do.

I have suggested that the Law Commission should look into the thorny issue of the surplus, and the Government has followed that through. I am not sure that the Law Commission will be able to throw a great deal of light upon it, but it certainly is an area where I could not find anything terribly clever to say.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

Data collection for defined contribution schemes is woefully inadequate in certain areas: on contributions; on choices; and on education and information models. I have said that the Government really needs to be aware of this issue, and that it needs to keep the level of contributions under close review. There is a serious mismatch now developing between the rate at which people are contributing to defined contribution schemes and their expectation about the level of pension with which they will be able to retire.

I pointed out to the Government that it was increasingly untenable to have a tax on securities transactions in the U.K., but not an equivalent in Europe. An example that I used to give was that, if you bought Marconi shares in the U.K. you had to pay 0.5% stamp duty. If you bought Siemens in Germany, you paid no stamp duty. That is not a very good example now, so I now use the Royal Bank of Scotland and Banco Santander as my examples.

I also pointed out that the European Commission Directive on defined pension plans is going in exactly the opposite direction to the U.K. Government on the MFR. The directive introduces proposals which are very prescriptive.

The industry's response to the review was generally supportive — qualified, but generally supportive. They gave me six out of ten. The area that prompted further discussion was MFR replacement. I think that many people thought that it was not going to happen, but when the Government announced that it was going to replace the MFR, I was suddenly out on a limb. People began to become concerned that, if we did not have 'nanny' to look after us, how were we going to look after ourselves in a world of greater freedom and accountability?

Some people said that I was the final straw for defined benefit pension schemes. I just cannot see how they drew that conclusion, because I did not put more burden and weight on defined benefit pension schemes.

Fund managers were concerned about activism and the cost of compliance. I find this quite interesting, because I was quite lazy on activism. I pointed out that the U.S. Department of Labor, in 1994, had issued some very good guidance on activism which applies to all U.S. pension plans. Most British fund managers manage money for U.S. pension plans. They already have an obligation for activism, therefore, under their mandates. It is not, therefore, a great addition to extend that to U.K. clients, but there were concerns about cost and compliance. There was also some concern about potential disadvantages for smaller schemes.

What else did I recommend? I recommended the Sandler Review! I found, while I was looking at the engine under the bonnet, so far as retail investment products were concerned, that there were some quite serious issues around with-profits, around governance in that area, around sales methods, and around the importance of commissions in driving sales, etc.

I also made some recommendations about securities commissions, which led my colleagues at my firm to dissociate themselves from my conclusions. The *Financial Times* said that I had been hit by friendly fire. It is entirely right that my colleagues should form their own views. They were not party to the review process. They received the review at the same time as everybody else.

At the heart of the issue is a sense that the present model, where the fund manager initiates a transaction which leads to the payment of a commission, which is then charged to the client, is flawed. I found that very few clients were really aware of this practice. I asked them about their manager arrangements. They said: "We have one fund manager at 0.4% p.a. and another at 0.6% p.a. for managing the fund.'' I said: "What about benefits?'' They said: "We pay our administrator £12 p.a. per member for the benefit of administration.'' "Brokerage?'' They said: "We use our IFA for insurance.'' I said: "No, securities brokerage?'' They said: "What do you mean?'' I said: "Well, you pay securities brokerage.'' They said: "Do we?''

There really was considerable ignorance. In many cases the securities brokerage being paid by the client was greater than the investment management fee. There was no scrutiny, no transparency, and no accountability. There were also some dysfunctional consequences, in particular an artificial bias to the fund manager to outsource. It was simpler for the fund manager to use research resource from a broking house, paid for by the client, than to bear that cost himself. So, provocatively, I have suggested that the answer was all-inclusive fees. This led

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

to a mighty uproar. It was a page and a half in the report, towards the end, and it took most people about three days to find it. It was a ticking bomb, but when the sell side and the fund managers found that it was there, they suddenly got very alarmed.

The consequences of my proposal would be greater transparency and accountability. Multiple business models would be fostered, in which the provision of external research would not be solely linked to the execution of a transaction. I think that this is a flawed model, because of the inducement to transact. The proposal would encourage more independent and objective research, and I think that it would also encourage enhanced corporate governance. It would mean that there would be less encouragement for the fund managers to sub-contract research to broking houses. They would do it themselves. They would be more involved in the process, and they would be closer to corporate management.

The approach which we ended up with is one based around greater transparency. The key to this is that transaction costs are important; trustees have a legal obligation to take care of all the assets in the scheme; and that requires them to be able to account for all expenditure. The fact that many looked at me and said: "We are not really aware of transaction costs'', implied a very significant weakness in their ability to stand up to the requirement to be truly accountable.

I have suggested a list of ten questions that trustees should address to their fund managers around transaction costs. I have also said that I would expect others, particularly from the consulting community, to produce their own questions, to augment or to modify my questions.

The effectiveness of transparency relies on trustees becoming informed. It will not work if the trustees only ask the questions, but do not ask the right supplementaries. That requires them to have the appropriate skills and information. It requires them to be persistent, because the current system of soft commission is a clear example of where trustees have not been as persistent as they should have been in understanding what are indisputably kickbacks. Soft commission is a process which is not replicated, so far as I am aware, in any other professional arrangement between a principal and an agent, where the agent, the fund manager, incurs a charge for his principal which is of benefit to a third party, the broker, who then gives back a benefit to the fund manager. There are disclosures, but they do not receive sufficient attention. I have done my very best to encourage the ending of soft commission.

I end with two quotations, the first from Giuseppe di Lampedusa: "If we want things to stay as they are, things will have to change.'' I am not saying that this industry is fundamentally flawed. I always feel embarrassed at this point, when I have given a catalogue of areas where I think that more can be done. This is a tremendously good industry, which has done much of which we can be proud. However, I am saying that, if every participant in the industry stretched a little further to do a little more, to be more professional, to be more inquiring, to be more precise, and to be more businesslike, then we would get substantial, individual, personal and national benefit. Adam Smith's hand would be seen to be working, if we do a little more in these areas where, I believe, there is scope for improvement.

Then, perhaps more controversially, my second quotation is from Mao Tse Tung, in 1957: "Let a hundred flowers blossom, a hundred schools of thought contend.'' The consequences, I think, of the Myners Review, if it is voluntarily implemented, would be: much more diversity; the end of the balanced pension fund; the end of peer group benchmarks; the multiplicity of management models; a breakdown of the industry concentration in consulting; a breakdown of the industry concentration in fund management; trustees more actively involved, more inquiring, more professional, and securing much greater intrinsic reward from the work that they are doing; and — right back to the beginning — conceivably, a little more money flowing into private equity in the U.K.

The President (Mr T. D. Kingston, F.F.A.): Mr Myners, thank you very much indeed. I have great sympathy with your work. Having spent my lifetime in some form of fund management, three years ago I became a trustee for the first time, and joined the other side, so to speak. It is a very curious industry as, in many respects, it is a mixture of a very sophisticated industry and a cottage industry.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

What Mr Myners is saying is that we have to eradicate much of the cottage industry parts, otherwise it is a mixture which will ultimately cause us trouble.

Mr Myners has given a very good exposition of the thought process that led him to these recommendations. I am sure that this is an opportunity for any of you either to offer your opinions or to challenge what he has said.

Mr D. F. Campbell, F.F.A.: One of the consequences of your suggestions about educating trustees better could be a greater understanding of risk. One of the problems that we face in consulting is that there are so many different risk issues, that trustees are confused about which particular risk issues they are dealing with at any point in time. I suspect, in the U.K., that there has been more concentration on the risk of capital loss, or inadequate hedges against inflation, without sufficient concentration on the underlying nature of the pension scheme's liabilities.

Perhaps a better understanding of those issues would result in a move from equity investment to bond investment by trustees generally. Is this something that would cause you concern, since the amount of risk capital invested within the economy, generally, would reduce?

Mr Myners: I think that you are right. There is considerable confusion about risk, and there are different types of risk. They are not always pointing in the same direction. From the perspective of private sector companies, the sponsors must risk budget. They must choose where they take risk. Do they take the risk in the pension fund or do they take the risk in their businesses? The most important thing is that they should be aware that they have options; they should think them through carefully; and they should account to various stakeholders, to shareholders and members of the pension scheme, for the decisions that they have taken.

The MFR adopted a uniform approach to risk. It pointed you in a certain set of directions, which may be appropriate for many schemes, but are not appropriate for all. We return to the issue of ensuring that trustees have the skills, the expertise, and the time to understand the issue as it impacts their scheme. In turn, this goes back to my point about support between the sponsor and the scheme. We have tended to seek to persuade ourselves that there is a gap between the two, and there is not. I think that the two touch each other constantly, or should be encouraged to touch each other constantly.

Mr S. Bell (a visitor; Deutsche Asset Management)**:** I was struck by the contrast between your review, which has been widely reported, and the Treasury/DSS (as it then was) response. I have seen no reference to that in the press. Your report was all about openness and transparency, which we all welcome, but the Treasury/DSS response was very prescriptive, and mentioned the words 'whistle-blower' several times. It sounds restrictive and legalistic — very different from your approach.

We are seeing more and more litigation, in all areas, and it seems to me that your code will be followed very closely, because trustees will be most concerned about being sued in years to come.

I understand that pension funds cannot give their trustees legal indemnity, and that one of the few defences that trustees can make, if something goes badly wrong, is that they are unpaid, and cannot be expected to have the same expertise as professionals. If I was advising a set of trustees about what they should do, sadly, the main concern has to be to avoid some accident that, in the future, might cause them to appear in the High Court.

Do you think that this is nonsense? Is there anything in your code to avoid such a scenario, or do we need to do more?

Mr Myners: I noticed that the NAPF, in its submission on the original publication of the ten-point code, on the issue of paying trustees, raised the point that, if trustees are paid, then they have increased their legal obligation. I find myself very uncomfortable with that. If people are not willing to accept the responsibility, then they should not be trustees. It is not an issue about whether they should be paid. I would say this, would I not, but the best defence for trustees must

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

be that they followed carefully the guidelines set down by the Myners Review, and that they organised themselves in a professional and businesslike way. Where they did not have the skills and did not think that they could achieve those skills, then they went to another model. For instance, in a newspaper article, it has been suggested that trustees will increasingly limit themselves to appointing somebody to put together management programmes. That fits with my Mao Tse Tung quotation. It is another idea contending; it is another flower blossoming.

So, I think that there are good and proper ways, and professional and constructive ways, in which trustees could address this issue. Thus, they may, as a consequence, be less exposed to liability going forward than they have been in the past. They have not been aware of it in the past, because they have been helped out by a phenomenal bull market.

I know that you will be speaking tomorrow at the Faculty/Edinburgh University seminar on costs, execution and commission. The Fund Managers Association commissioned two academics to produce a report in this area, and it has just appeared. It is a wonderful report, because it is capable of being construed as being supportive of every position. So, I will state that it is a vindication of my express concerns about the lack of transparency and accountability in this particular area.

What struck me more than anything else was that they estimated that, for a U.K. equity institutional scheme of £200 million, the management fee would be 0.3% p.a., that is 30 basis points. However, the total cost of managing the portfolio would be 130 basis points p.a. when account commissions, stamp duty, market effect and custody are taken into account. If we are in an environment in which equity portfolios are not going to produce compound returns in the mid-teens, as we have experienced for the last 20 years or so, but an environment in which we would expect equities to produce returns of 700-900 basis points, then an annual management cost of 130 basis points is a lot. Stamp duty is one of the big things. Perhaps the industry should have focused more on producing credible arguments to convince the Government that stamp duty should be abolished, rather than devoting all its efforts to undermining my proposals on commission.

Mr A. S. Acheson, F.F.A.: I am also talking about fees at the seminar, and, therefore, I will leave my comments on that subject until then. In general, I accept that you did not explicitly put down any extra bureaucracy or any extra requirements on final salary pension schemes, but I cannot believe that you think that it is not going to result in that. All of the extra work that people will have to do in terms of educating themselves, the extra governance budget that is going to be required from the trustees, from the plan sponsors, and from everybody involved, is going to involve extra time and extra commitment. Basically, you are deluding yourself if you think that it is not going to cause a significant extra burden. I cannot believe that, at the margin, it is not going to push one or two smaller pension funds into the position that they are going to wind up their final salary schemes. I think that this is a risk.

If we are going to try to avoid this, then we have to convince people of what you started to talk about at the end of your presentation; namely, that the benefits will outweigh the extra costs. We need to really concentrate hard on the consequences of not doing it, and the benefits of doing it, rather than say that there is not going to be any extra hassle.

Mr Myners: I said that there would not be any extra 'hassle', although trustees will have to spend more time on these issues. There are areas in which my review will lead to greater cost, but that is only part of the story. On the other side there is the removal of the MFR.

I deny any responsibility for FRS 17, which, incidentally, we would, as an industry, have fought against much more vigorously if we had believed that MFR was going to be abolished. FRS 17 is going to become a big issue for pension funds and corporations over the next two years, far more significant than is generally recognised. We are beginning to see some significant decisions driven by FRS 17.

The abolition of the MFR, the opening up of trustees to a broader range of asset classes: property, which is now, effectively, a fixed income; hedge funds, which are, potentially, very

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

interesting additions to portfolios in terms of improving efficiency, because they are a non-correlated asset to long-only strategies; and private equity; are all factors which have the potential to improve portfolio efficiency, and, in aggregate, will be far more beneficial than the 'hassle' factors.

If we focus on the costs of management and of transaction — they have to reduce. They are just too high. In the context of compound returns for equity portfolios of 700-900 basis points, to see 230 basis points going in agency and tax is simply too much. The balance is in favour, but I do accept that there are some costs.

Mr G. L. Henshilwood, F.F.A.: I have two points. The first is on asset allocation. The problem that I have is that, while I can find no intellectual justification for the average fund, if a typical pension fund uses the average fund as a benchmark, it is quite difficult for me to conclude otherwise. I suppose that there might be a more efficient benchmark for that fund, and I might use some asset/liability modelling to come to the answer, but, frankly, it all depends on the assumptions made. You mentioned the potential efficiency of hedge funds and the potential attractions of private equity, but these are terribly sensitive to the assumptions that you make. I have not seen any convincing data which give me a solid framework for making such assumptions.

The second point is a question, which is: "You have clearly been through a number of funds which have adopted a fixed benchmark following an asset/liability study, following consultation among trustees, sponsor and the asset managers. I wonder whether you think that this is an effective process? Is it the sort of model that you see going forward?'' I am a little uneasy. I think that asset allocation is used in your review in different contexts. I am not always clear if you mean strategic asset allocation, tactical asset allocation, or something in between.

Mr Myners: I primarily referred to strategic asset allocation, and that is at the heart of the transparency statement about how the long-term disposition of assets is likely to achieve the meeting of the liabilities at the current contribution rate. I make the point that academic evidence suggests that asset allocation is infinitely more significant than stock selection, yet it receives much less resource than stock selection. The whole focus of attention in the fund management industry tends to be around stock selection. It is less so around asset allocation. Indeed, asset allocation in the U.K. is largely thought of in terms of deviation from the average allocation for the balanced pension fund, going slightly underweight, slightly overweight, versus where other fund managers are.

Those who have been involved in performance measurement at WM, CAPS and other organisations have been inundated by calls from fund managers, saying: "What is the current average allocation to a particular market? We have our policy meeting tomorrow, and we want to know whether to go 0.2% overweight or 0.2% underweight.'' This is the herd-like approach which current models have encouraged.

I know that what I am going to say sounds stupid, but I am going to say it, because I want to force greater clarity of thought about what it is that you are trying to do for your pension funds. You should never be allowed to be told what other pension funds are doing. What other funds are doing is irrelevant. It is irrelevant that you have done better than another fund, if all funds are producing returns which are inadequate against the expected return that they need to produce in order to meet their liabilities at that contribution rate. This is information which is noise; it is, in some ways, unhelpful. What a fund should do is to look at what is unique to its circumstances, its relationship with its members, its relationship with its sponsor company, and, going back to what we were talking about earlier, risk budgeting and determining where to take the risk.

One of the big FTSE companies has moved nearly all of its pension fund into fixed-income, and it has done that because it argues that it will take the risk in the business, and not in the pension fund. I think that that is an entirely defensible model to take. It is not the right answer; it is just a sensible and well thought through answer in their circumstances.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

So, the issue is about strategic asset allocation and asset/liability modelling. I think that one of the limitations of asset/liability modelling is extrapolation of past returns. This is not very amenable to new asset classes, which is really quite a serious problem. How do you build, for example, long and short strategies into asset/liability modelling? It is not without difficulty, but that is where, in the end, we should move on from extrapolation into judgement and discourse. Some research has been done, suggesting that the vast majority of trustees do not actively engage at all in the asset/liability modelling process. They do not challenge or debate the assumptions. Again, going back to the 'hassle' factor, I encourage trustees to get more involved in this area, and their advisers to help them become more involved in it.

Mr D. S. Isles, F.F.A.: I am interested in the practicalities of investing in private equity, with particular reference to the resource required, the expertise required, and the costs.

Mr Myners: By Chapter 14 of the Review, we had written about 160 pages, and we remembered where we were meant to have started from. I go through the taxonomy of private equity, the different types of vehicles, and why the limited partnership has become the preferred model. I point out some weaknesses in limited partnerships, and, in particular, to the need to improve and modernise partnership law. At the end, I give some simple answers on private equity. If you conclude that it is a sensible asset class, and if I contrast that with some of the other alternative asset classes, my sense is that private equity is not a risk diversifier. If anything, it is a performance enhancer.

Practical experience tells us that the right thing to do is to make a long-term strategic allocation to this asset class, and to build up to that allocation over an extended period of time. All the performance data tell us that the volatility of return in private equity is far higher than for conventional marketable equity. They also tell us that the scatter of return, between the top decile and the bottom decile, is far greater than for marketable securities. Those observations lead you towards spreading your money across a number of limited partnerships, and making an annual commitment to invest in the area, rather than saying: "Gosh! We have made a terrible error. We should be 5% in private equities, and we will do it this year."

There may be some scope there for manager of manager arrangements, which is a model which is frequently used in the U.S.A. The consultants need to take a lead. I think that most of them would say that we have not given as much attention to private equity in the past as we probably think that we ought to be doing in the future. It is a very complicated area to research. It is far more complicated to understand, where the sources of competitive advantage lie in hedge funds and private equity rather than in conventional long only marketable securities. Consultants, if they are going to invest resource in this area, need to be paid more. This is an industry which needs a bigger revenue base in order to bring to bear their analysis to new asset categories.

Mr M. R. Brooks, F.F.A.: You have said that investment consultants should be assessed on the advice that they give, but, essentially, the only advice that they are giving is long-term advice on asset allocation, etc. Do you have any ideas on how that can be assessed in any sort of meaningful timescale?

Mr Myners: It can only be assessed over the long term, surely, and over the very long term. Managers' selection advice could be measured more precisely over still fairly long, but not as long, time periods. The fact that it is not being done at all at the moment is my principal concern.

What I found, when I spoke to consultants about manager selection, in particular, was that I received a great deal of emphasis upon inputs, but not on outputs. They count how many managers they visit, and talk about how much work they do on understanding their processes and philosophy. I have moved on. I have reached a point where I have some real concerns that the fund management industry is focusing too much on process and philosophy, and not enough on naked talent.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

Mr Brooks: Is there a danger that asking the trustees to assess investment consultants at all might get them to assess their consultants over a short-term period? Would this be inappropriate?

Mr Myners: Yes. This would, therefore, expose the consultants to the same pressures that some fund managers complain of. That is why we have to have rational dialogue and mature discussion. That will occur only when we move on to people really understanding that these are very difficult areas. It is conceivable that expectations are too high. Some fund managers will not have the capacity to produce the returns that their clients expect, and that is why, I think, we get one in three of all U.K. pension funds making a manager change each year. That does not mean that one-third of fund managers get fired, because many have multiple managers. There are unreasonable expectations at work here.

I am trying to encourage a more informed and mature debate. That requires greater engagement than has been the case in the past, and certainly greater engagement than comes from spending one hour a month on investment issues.

Mr G. Gemmell (a visitor; Baillie Gifford)**:** You talked a lot about trustees and how they need to be more professional and make more decisions. There was clearly a job for trustees at the time of 'Maxwell'.

You have not spoken much about plan sponsors. I think that if you are talking about risks in a pension scheme, might it not be the plan sponsor who should really be making the judgements? These are people are more used to making decisions. Pre-IMRO and pre-Pensions Act, typically it was a senior manager who was chairman of trustees, much more willing and able to make such decisions. Is it not going to go back to that? The company is really the risk taker in a final salary scheme, and that is where the risk judgement should be made.

Mr Myners: I agree with you. That is what I am trying to do, to turn the clock back to pre-MFR. That is why I talk about more support to the trustees, more involvement by the sponsor company, and why I endorse the model which Boots has followed, where it has said that it is defensible to say that the company will not take risk in the pension fund. So, I do think that there needs to be very active involvement by the sponsor. Also, the sponsor will presumably continue to have influence over the nomination and selection of a majority of the trustees. Member-nominated trustees will represent one-third or so of the trustees. The sponsors are still absolutely engaged, but I should like them to feel more comfortable to go back to a model where they were closer to the decisions than they have become over the past ten years.

Mr R. D. Bertram (a visitor; David Hulme Institute)**:** I put a question to you in my own capacity as an outsider, who has nothing to do with pension fund management or the actuarial profession. I noticed that you have been much bolder — at any rate, much crisper — than the Company Law Review had been on the question of 'interventionism'. You mentioned it in your talk. It is rather interesting that nobody has responded to it.

Would you enlarge a little on what form you think that interventionism would take? What is to prompt it? Is it going to be the share price? If it is not, where is the information, other than the share price, that is going to give an indicator as to where to intervene? What further questions does it prompt about the *structures* of the companies in which you will intervene? I could see very readily how you would intervene in a German company of the classic kind; you would do it with a nod and a wink, because you would know to whom to nod and where to wink. However, in the U.K., are you going to intervene with the non-executives, or are you going to intervene with the executives? If the executives tell the non-executives: "This is the City, as usual, not understanding what we do," and thereby gain ready sympathy from the non-executives, what will then happen?

I think that this is quite an intriguing question. I have a feeling that the Government is going to take it up and run with it.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

Mr Myners: I think that I had three or four pages in the review on what I describe as activism. I wish that I had not described it as activism, because I think that that has connotations of more macho engagement than I really wanted to capture. I probably should have used a softer term like 'responsible share ownership'. What form can it take? At the very minimum, institutional investors must be more interested than they are currently tending to be in the constitution of the board of directors. That must be the first point, in particular, on the choice and selection of non-executive directors. It is desperate that even now, after Cadbury and Newbould and PIRC and everything else, that less than half of the U.K. institutional votes are cast at meetings of shareholders.

I think that the next level of engagement obviously comes through the regular discourse between institutional investors and corporate management. It is around strategy and around the implementation of strategy. I think that good activism, as Jonathan Charcombe says, is often simply saying: "get a grip''. It is identifying companies where the board and management do not seem to have a grip. They do not have a grip on strategy or they do not have a grip on implementation. Too often we leave it too late, for example in the cases of Marconi and Marks and Spencer. Institutions seem to be so uncomfortable with the responsibility of ownership and so under-resourced and under-skilled, that we respond only when it is too late. This simply cannot be acceptable. Yet institutions, on the whole, are not geared up to become more involved.

I said to a journalist that my instinct is, in the top 200 British companies by market capitalisation, that there are probably three, four, or five at the maximum, where institutions ought to be asking quite serious questions about strategy and implementation. I think that the interesting thing is that, if institutions were told, privately, to write down the names of the four or five, anonymously, and then we opened the envelopes, we would find a remarkable uniformity about the companies that had been identified. Yet, very little happens until it is too late. So, Railtrack now has a shareholder action group. It did not have a shareholder action group three or six months ago. It has one now. I do think that there is a challenge here, and that the Government clearly believes that something has to be done.

We have to think more creatively. I have come up with an idea about rewards for failure, which is that the compensation which people are paid when they are fired, should not be expressed in monetary terms, but expressed in share terms. So, if you have an executive appointed on a salary of £300,000 a year with a one-year notice period, and the share price of the company is £2, under the conventional approach, at the moment, he gets £300,000 in cash if he is fired. I would say that he should get 150,000 shares, and if the share price falls by 90%, he gets shares worth £30,000. This seems to me to have a great symmetry and alignment between the interests of the shareholder and those of the institution. I am sure that it has big disadvantages, which I have not been able to think about.

We have to become more engaged in this area, otherwise I think that you are right, and the Company Law Review and the Government will become more interested, and put more pressures on us. I repeat that I have deliberately used a form of words to which most U.K. fund managers are already subject, if they are managing funds for U.S. pension plans. It is not an additional burden; it is merely applying it to British accounts.

The President (Mr T. D. Kingston, F.F.A.): Thank you very much indeed. I am sorry to draw this to a conclusion at this point, but I think we have prevailed upon Mr Myners for long enough.

I have found this a very valuable meeting. I found it a very valuable process, because I think that what Mr Myners has done is exactly as Giuseppe di Lampedusa was saying: "If we want to stay where we are, we will have to make changes.'' The type of changes which we are going to make are clearly not agreed. The value of a meeting like this is that, at least, we are provoked into thinking about them, and the value of the seminar that we have tomorrow will be to take that thinking on further.

In all of this we are particular grateful to Mr Myners, that, over the last 18 months, he has

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press

invested a great deal of time in exposing some of these issues. We do not have to agree with them. We do not have to accept everything that he says, but, at least, we have to be grateful to him for bringing out the issues. We are particularly grateful to him for coming to us and speaking about them. Thank you very much indeed, Mr Myners.

https://doi.org/10.1017/S1357321700003639 Published online by Cambridge University Press