

**Facing the Financial Crisis: Questions Pension Trustees Should Ask
their Investment Managers**

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Introduction

Most pension fund trustees are struggling to understand the impact of the global financial crisis on their portfolios and the beneficiaries of their funds. The challenges they face as a result of the recent market meltdown are unprecedented, but more daunting is that as they look to the future, they are rightly concerned about what their service providers are doing to ensure that history does not repeat itself.

What follows is a list of questions for trustees to ask their investment managers and related service providers. Although trustees are not expected to do the job of investment managers, they are expected, as fiduciaries, to be able to select and monitor their investment managers in increasingly sophisticated terms.

The answers trustees receive to these questions must be sufficient to assist trustees as they reevaluate their investment managers in the aftermath of the recent financial crisis.

Many investors were caught off-guard by the collapse of world financial markets in late 2008. The performance of most investment portfolios indicates that fund managers did not see what was coming either.

In the U.S., ground zero of the crisis, legislators have acted and regulators have their marching orders. New restrictions on financial activities are intended to reduce risk, increase transparency and empower overseers, both old and new. However, experts express concerns that due to unprecedented lobbying from corporate America, the omnibus reform package does not go far enough to provide investors and with the assurances they need that it cannot all happen again.

Trustees face tough questions from their plan beneficiaries. To respond properly, they need to be armed with more than assurances that markets will eventually recover. The financial crisis requires all financial market participants to take a hard look at past investment practice and decide what, if anything, needs to change. Trustees must also be able to clearly explain to others, including fund beneficiaries, the conversations they have with their investment managers.

It is imperative that they address issues in their investment manager and other service provider relationships that contributed to the financial crisis.



Questions

The consensus view is that the financial crisis resulted from excessive risk-taking by investment professionals and investors alike. Generally, the blame is laid at the feet of the former, particularly those who peddled exotic products, pocketed huge profits, and retained little or no risk after sale transactions were finalized.

Many investors, by contrast, did not receive adequate disclosure about the investments to enable them to grasp the full measure of the risks they had assumed. In the worst cases, they did not even ask for this information.

1 *Is the current financial crisis simply an inevitable market downturn or have we experienced structural changes to the market that require investors and their investment managers to change their practices fundamentally? If the latter, where do we start?*

2 *What steps is your firm taking to improve its approach to risk assessment? What new or increased risks do investors with long-term commitments such as pension funds face today as the financial crisis continues?*

3 *What changes (if any) has your firm made to its core investment management strategies as a result of market conditions during the financial crisis? If changes have been made, are they in place permanently or are further reassessments planned? If changes have not been made, explain why your firm believes the status quo will continue to serve your clients' interests.*

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Asset owners, managers and service providers who are signatories to the United Nations Principles for Responsible Investment (PRI) commit to incorporating environmental, social and corporate governance (ESG) issues into their investment analysis, selection and management as a way to improve long-term returns to beneficiaries.

Signatories to the PRI have more than \$14 trillion in assets. The goal of the UNPRI initiative is to make ESG integration a rigorous activity pursued by all institutional investors, including so-called 'mainstream' investors, worldwide.



By examining a broader range of issues when performing due diligence and stock analysis, and by actively assuming a stewardship role, investors are better able to develop an accurate picture of the relative risk of their investments and take a more active role in mitigating risks in their portfolios.

Canadian pension trustees are asking their asset managers about the extent to which they integrate ESG issues into financial analysis and asset ownership practices. If managers are found wanting on this score, their clients are asking them to develop this more enhanced approach to investment.

4 *Is your firm a signatory to the United Nations Principles for Responsible Investment? If not, why not? How does your firm's investment process and activities contribute to sustainable financial markets? How does your firm take ESG issues into account and what resources do you devote to this?*

Most shares in public companies carry voting rights that are an asset of the shareholder. The majority of Canadian pension funds leave decisions about the exercise of these rights to their investment managers. Regardless of who exercises the fund's voting rights, trustees should receive regular reports on all votes cast.

A careful and critical approach to proxy voting is essential to protecting asset owners' interests. Depending on investment style and portfolio composition, a voting record that strongly supports management on all items of business may be an issue of concern to investors.

Every year, certain votes emerge as litmus tests that reveal whether a proxy voter views the ballot process as a largely clerical exercise or as an important opportunity to support effective boards and good practice and to oppose measures that are not in their best long-term interests. Such votes are identified in SHARE's annual *Key Proxy Vote Survey*.

For example, 'Say on pay', the right to an annual vote on an issuer's executive compensation policies and practice, is a key Canadian shareholder initiative that many Canadian investment managers supported in 2008 and 2009. A vote for the "Say on pay" shareholder proposals was typically a vote against management's recommendation. This is just one example of a proxy initiative that is creating a more active, ongoing oversight of public companies in the future.



5 *Does your fund respond to SHARE's annual key proxy vote survey? If not, why not? Has your firm's approach to proxy-voting produced greater than 90% support for management proposals or less than 10% support for shareholder proposals in any of the past three years? If yes, are you rethinking your approach in the wake of the governance failures of the past year?*

Shareholder engagement is a term widely used to describe shareholder-initiated dialogue with public companies on specific issues such as climate change disclosure and executive compensation practices.

6 *Does your firm have an engagement program? If not, why not? If yes, what are your most important recent engagement activities and results?*

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Just as corporate directors and pension trustees are facing increased scrutiny of their governance practices, investment firms must be prepared to disclose and discuss the choices they have made about such matters as conflicts of interest, oversight structure, and executive compensation. The following two questions provide your firm with an opportunity to address these issues.

7 *How is your firm governed? Describe areas where your firm has adopted governance best practices. If the firm is publicly traded, how are its conflicting obligations to clients and shareholders addressed? What is the board's mandate? What are its specific responsibilities and what responsibilities has it delegated and to whom?*

Executive compensation is now headline financial news. Pressure on investment firms, to justify the pay cheques of their executives is significant. In a recent *Financial Analysts Journal* article, Vanguard Group founder John C. Bogle wrote:

I think Wall Street's business model is broken. To rebuild public confidence, we must fix the Wall Street business model. Any system whose revenue depends on persuading investors to trade actively is, by definition, going to be focused on short-term speculation. What we want to do is build a model that is focused on long-term investment; that is the winning strategy.¹

¹ "Markets in Crisis", *Financial Analysts Journal*, January/February 2009, p. 22.

