The Governance of Pension Funds:

Bad Investment Decisions at the Expense of Pension Savers

Research proposal for PeRCent

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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 traditions, both employers and employees are represented on the board of pension funds, 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 savers from excessive risk taking. In practice, the board makes crucial investment decisions regarding the portfolio allocation between safe and risky assets, and they provide investment mandates to professional money managers that are engaged 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 the pension savers. Although such concerns might be alleviated by the hiring external advisors and professional managers, 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 well-documented benefits 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 investment mistakes.
**Policy implications**

On the national level we expect this study to achieve 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 labor market parties arrange the private pension system, there is a strong need to understand the implications for pension savers. The current research proposal will be able to both quantify and qualify whether this system is costly for pension savers.

2. In a Danish context, the regulation of pension funds’ portfolio choices has already changed – allowing individuals to have some say on their investment decision. If the governance of the current system is suboptimal, increasing the individual say on the investment decision will provide an internal pressure to reform and professionalize the system.