The RSA is an Enlightenment organisation devoted to finding innovative practical solutions to today’s pressing social problems. Through its 27,000-strong Fellowship it pursues its mission: to help people be the people they need to be to see the change they want in the world.

The citizens of the future will need to be self-reliant, engaged and other-regarding if they are to create a principled and prosperous society. This is nowhere more true than in financial matters. The Tomorrow’s Investor project, the first stage of a prolonged RSA engagement with these issues, aims to facilitate this goal, both practically and intellectually.

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More information can be found at the RSA website: www.theRSA.org.uk
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Over 20 million people in Britain hold private pensions and other long-term savings. Taken together, these savings total over £700 billion. A large part of this money is invested in the stock market: so much so, indeed, that institutional investors, the collective saving vehicles which represent ordinary savers, own over 40 per cent of the stock market. In theory, at least, pensioners and endowment policy holders own the stock market. Yet they are not realising the true benefit of these investments.

The so-called credit crunch and the response to it are symptomatic. Where the financial institutions have prioritised short-term profits over long-term growth they have worked against investors’ best interests. They have promoted market volatility, contributing to bubbles and busts and ultimately helped worsen the financial crisis. Ordinary savers want long-term, stable growth. They are interested in absolute returns, not relative ones. And they are not getting what they want.

The level of costs and charges also demonstrate the fundamental misalignment of interests between ordinary savers and investment professionals. Long-term savers will commonly find themselves paying out 40 per cent of an investment over its lifetime in fees (a figure equivalent to roughly ten years of contributions). Fees have risen dramatically in recent years, doubling in unit trusts for example. Yet performance has not followed suit. People are paying more for less. Yet the RSA’s research shows that not only are investors unaware of the scale of charges they are paying, but that they are shocked when they do find out. This is a shocking sign of investor disenfranchisement.

The looming pensions crisis, exacerbated by the financial crisis, is one of the most pressing problems society faces. The issues are well known: a population in which not enough people are saving; where saving is declining; where investors are being let down by their representatives. Our research shows in particular the dangers inherent in the way choice and responsibility have been shifted onto a population that is not really ready for it. People are, in the words of the philosopher John Gray, “being forced to be free”.

The RSA believes that the best society is the one we create. But it recognises that there are often great obstacles standing between us and the future we aspire to. Sometimes these hurdles lie within ourselves: in our bounded rationality, for example, or our failure to commit. Sometimes they are institutional. For pensions, as for climate change or social care, both apply.

None of these problems is insurmountable. There are clouds on the horizon; nonetheless the future is bright. This report from the RSA’s Tomorrow’s Investor project imagines a future where large pension funds take full advantage of the resources at their disposal, engaging their beneficiaries to solve both business and social problems. The RSA is committed not only to analysis but to change. In the next few months, we will be working to make this vision a reality.

Matthew Taylor, Chief Executive of the RSA
Key findings and recommendations

Engagement and accountability

1 Investors are almost universally disengaged from their pensions, despite the fact that they are one of the largest and most expensive investments an average person will make in a lifetime. Many do not even know who manages their long-term savings. They are much more comfortable dealing with cash and property.

2 The financial system is not set up to be fully accountable. When the participants in the RSA’s deliberative forum tried to find out more about their investments they found fund managers inaccessible and financial institutions opaque.

3 Investor disengagement exacerbated the current financial crisis. Without the active scrutiny of ordinary citizens, financial institutions were able to take excessive risks. Any thoroughgoing solution to the financial crisis must aim to ensure that citizens are able to take more responsibility for the management of their investments.

Costs, charges and the market

4 The costs and charges of long term saving are too high. Pensioners with a private pension will typically find themselves paying out 40 per cent of their investment in fees over the lifetime of the investment.

5 Costs and charges have risen dramatically in recent years. In unit trusts, for example, they have more than doubled. Performance, however, has not followed suit. Investors are paying more but getting less.

6 Investors are unaware of the scale of charges, and they are shocked when they do find out what they are paying. They do not feel they are getting value for money.

7 Costs and charges are the most important element of private pension provision. They remain stable where returns vary. And they can often be avoided. Ordinary investors are being exposed to greater risks, especially because of the shift away from final salary pension plans. Some of these risks are inherent to investment: the risk of poor investment performance, for example. But investors are not being protected properly from the risks that stem from their own decisions: in particular, the risk that high costs might eat away at their investment.
The structure of the market does not help ordinary investors. There is choice, but it is not easy for investors to understand or access. As a result, financial institutions are not incentivised to compete to meet people’s reasonable needs.

Reforms and recommendations

The long-term savings market needs to function more effectively. It needs to offer consumers clear and simple choices that allow them to express their preferences. Standardising and simplifying investment products would be a significant step to achieving that. At present, selling and set-up costs swallow far too much money.

There is a need for a fund management strategy that is more modest in its aims. By adopting what we call a “long-term, low-friction investment strategy” and holding onto their investments, fund managers could save pension plan members as much as 20 per cent of the costs paid by pension plan members.

Fees should be expressed in a different way: as a total over the lifetime of an investment, rather than an annual charge. This would give ordinary investors a much better idea what they are paying.

Tomorrow’s investor

Ordinary investors want a high-accountability, low-cost fund that offers reasonably secure returns at a decent level of risk. Countries such as Sweden and Holland manage to provide this, so there is a strong chance that Britain could as well.

The RSA will be working to set out the conditions for establishing a new fund along these lines. In the face of the financial crisis and the looming pensions meltdown, this can offer the British savings system the innovation it needs to make sure that the investment chain functions in the best interests of its ultimate beneficiaries.
Introduction

The long-term wealth of private British savers accounts for almost half of UK equities. This ownership is intermediated through an “investment chain” of relationships which connect the ultimate owners with their investment in companies. Ensuring this chain functions stably and efficiently is of vital economic importance for productivity and long-term growth because the chain is a critical mechanism for ensuring that investment is efficiently allocated.

The chain is complex. Pension contributions, for example, are managed in the first place by pension fund trustees, stewards on behalf of pension fund sponsors and members. The trustees are advised by investment consultants; assets are in turn invested through fund managers and brokers with whom companies have crucial relationships; and companies’ financial statements are verified by auditors acting on behalf of shareholders – such as pension funds.

Perhaps because of this complexity, the investment chain has never functioned entirely as it should. In recent months it has become demonstrably clear that the financial industry is not working in the best interests of its beneficiaries. Yet the credit crisis is merely the most obvious sign of a system that is not functioning as it claims to. As more and more pensions shift from defined benefit to defined contribution, this issue becomes increasingly pressing.

The RSA’s Tomorrow’s Investor project starts with the premise that both business and society would benefit from greater citizen engagement. At present, few people engage actively with their investments. Fewer still are conscious of their role as owners. The system of long-term savings needs active involvement from ordinary investors, just as the political system needs the oversight of voters. Without it, as Adam Smith observed, “negligence and profusion” will prevail. But the current institutions do not allow people to engage in the right way. The RSA is working to change this.

RSA Research

In July 2008 the RSA conducted a deliberative forum with a small group of private investors to look at the critical issue of investor accountability from the point of view of ordinary citizens. The inspiration for the deliberative forum was the citizens’ juries that have become an increasingly common tool in political consultations. By bringing stakeholders together with the people they represent it is possible to cut through distorted representations and cases of mistaken identity, arriving at a dialogue that is fair and equal on both sides.

By law, and by tradition, companies are accountable to their owners. Yet it is not so often acknowledged that true accountability is a two-way process. It involves not only being held to account, but also giving an account. This kind of accountability only emerges out of a dialogue – one that acknowledges all points of view. Today that dialogue is based exclusively on discussions between sophisticated market participants. By introducing investors into the conversation, we hoped to hear more clearly from voices that are otherwise silent.
Twenty-four people were recruited to attend the event using a purposive sampling framework. This method was chosen in order to capture a wide range of possible attitudes, experiences and understanding. The participants were split into Active and Passive Investors. One outcome of the process was to show that these names were slightly misleading: even investors defined as Active were by and large passive with regard to their indirect holdings. Nevertheless, they reflected the difference between the two groups:

* The Active Investors were confident in their understanding of financial products and felt they took a strong interest in the day-to-day management of their investments.
* The Passive Investors had little confidence in their understanding of financial products. They tended to agree with these statements (used in FSA questionnaires on financial literacy): “I know I should be doing something with my finances, but don’t know where to start”; “I get confused about the various financial products and services on offer these days”.

The results of the deliberative forum can be seen in their raw form in the Tomorrow’s Investor Interim Report, along with more information on the sampling process.¹

The RSA

The RSA’s central belief is its faith in the power of civic action. At the heart of the RSA’s mission is the desire to bridge the social aspiration gap: the gap between the society people say they want and the way they behave. Our core challenge is to develop a dynamic, credible and persuasive account of what the future citizen needs to be if we are to deliver the world we want.

The RSA engages practitioners and thinkers in concrete practical action and the development of ideas aimed at creating the kinds of state, civic and commercial institutions we need to enable active citizenship.

The Tomorrow’s Investor project speaks to this core purpose. It aims to be a catalyst for ideas around a coming issue and starts by addressing the question of what kind of investors and owners we need for capital markets to deliver to our requirements and wishes.

Since the RSA first began working in this area we have become increasingly interested in addressing the question of whether the project can be used to generate a new model of investment, addressing what we see as a market failure.

The RSA has a history of successful projects around the theme of ethical capitalism. It has led the policy debate on personal carbon trading. And its Forum on Technology, Citizens and the Market helped companies assess their practices against contemporary shifts in ethics.

¹ Rowland Planthorpe and Seb Martin, “Tomorrow’s Investor: Interim Report” (RSA, October 2008)
In 1995 the RSA published Tomorrow’s Company, the role of business in a changing world, the result of a three year inquiry by business leaders into the company of the future. This led in 1996 to the creation of Tomorrow’s Company as an independent business-led think-and-do tank in 1996. In 2004 Tomorrow’s Company published Restoring Trust, an examination of the workings of the UK investment system by professionals and business leaders who work within it.

In 2008 the RSA and Tomorrow’s Company are picking up linked themes. In Tomorrow’s Investor, the RSA is looking at the role of the citizen as investor, and asking how the citizen can in future have more influence over the businesses in which he is invested. Tomorrow’s Company is looking at the changes in the ownership of companies and the implications for the leadership and governance of companies. The RSA and Tomorrow’s Company will be exchanging the outputs of their respective projects as they develop.
1 Today’s investor

1.1 Indirect ownership

The shift from direct to indirect ownership is one of the most significant investment trends of the last fifty years. It has changed completely the basis of stock-market ownership.

In the second half of the century, individual ownership was replaced by institutional ownership. Pension funds, mutual funds and insurance funds – public vehicles which invest third parties’ money – became the largest shareholders in the market.

In 1963, when the government conducted its first survey of share ownership, over half of UK shares were in private hands. In 2006, individuals held under 13 per cent of the UK stock market. The proportion held by private individuals is falling in the short term as well – in 2004, it was around 14 per cent. This is primarily the result of Government providing preferential tax rates to savings in pension funds, or via insurance policies.

Institutional investment has moved the other way. In 1963 pension funds, unit trusts and insurance companies held around 18 per cent of UK shares. In 2006, they held around 40 per cent. Between the 1960s and the 1990s ownership of the stock market was transferred from private to general control. In 1993, at the high point of their dominance, these institutional investors held over half of all UK shares.

The percentage of stock-market holdings held by institutional investors has fallen off in recent years. This does not mean it is in absolute decline. Its place has largely been taken by foreign investors, who hold around 50 per cent of UK shares. But the foreign investors are often themselves public vehicles. British pension funds have themselves moved into overseas equities, which by 2005 accounted for a larger share of assets under management than UK equities.

The stakes held by institutional investors are hugely significant. Despite ceding ground to newer classes of investors, the world’s pension funds, mutual funds and insurance funds have around ten times as much money under management as hedge funds, sovereign wealth funds and private equity put together. The Office of National Statistics reported in 2006 that shares held by institutional investors in the UK had a combined value of £762.8 billion. Of these, the largest holders were insurance companies (£272.8 billion) and pension funds (£235.8 billion).

These vast sums of money represent the combined wealth of the UK’s small investors. This is the great change from the 1960s, when companies were still owned by their founders and other wealthy individuals. In fifty years, ownership has gone mass-market.

1.2 Forms of ownership

People who own shares directly in a company have a number of ownership rights. They are able to exercise them (although they rarely do) at Annual General Meetings (AMGs), Extraordinary General meetings (EGMs) and other special meetings. 

2 Tomorrow’s Owners: Stewardship of tomorrow’s company (Tomorrow’s Company, October 2008), p.35
4 Tomorrow’s Owners, p.34
5 ONS, Share Ownership, p.7
However, while shareholders own shares – the equity in the company – it has been argued that the do not in any meaningful sense “own” the company. As the economists John Kay and Aubrey Silberston put it:

No one owns, or could own, BT or Marks & Spencer. Many individuals and groups have rights and obligations around these companies – customers, shareholders, lenders, employees, directors – but none of these claims could plausibly be described as ownership.

Using the legal theorist A. M. Honoré’s classic exposition of the nature of ownership, Kay and Silberston show that shareholders have neither the right of possession nor the right of use, nor several of the other rights we associated with ownership – unless they happen to own every single share. The divorce of ownership and control, they suggest, follows on inevitably from this state of affairs.  

People who own shares indirectly do not even have the rights granted to direct shareholders. If you own shares through your pension then you are not in any legal sense a shareholder, either in the fund or in the investee company. You are even further removed from ownership in the strict sense than the direct shareholders.

Some commentators argue that more should be done to bestow beneficial owners with the rights and responsibilities of direct ownership. Writing in the *Investors Chronicle*, Alistair Blair described pensions savers, unit trust holders, with-profits policyholders and the like as “disenfranchised”:

All institutional investors, including unit trusts, with-profits funds and pension schemes, should be required to ascertain the generalised views of their clients and beneficiaries about overarching issues of corporate governance – and to publicise those views.

Blair suggests that beneficial owners should be asked about issues such as director pay – and that the institutional investors should then vote their views at company meetings, proportionally if possible. “Fund managers’ hands would not be tied but they would be very much more accountable than at present”, he writes.

Of course, even if such provisions were made, it would still not be quite correct to think of pension members or unit trust holders as owners. Perhaps this doesn’t matter. Ownership may not be the best way to talk about investment in the legal sense, but it can be a useful heuristic – what evolutionary psychologists call an “adaptive fallacy”. In other words, it may be inaccurate, but it is helpfully inaccurate. This is the conclusion of the Tomorrow’s Company report *Tomorrow’s Owners*:

“Ownership”, while technically inaccurate or only partially accurate, is an excellent word to convey the stewardship dimension because it carries with it layers of meaning accumulated over centuries, relating to rights and responsibilities such as the duty of care.

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8 Tomorrow’s Owners, p. 22
As it is, however, people do not view themselves as owners with regard to either their direct or their indirect shareholdings.

1.3 Direct ownership
When most people think of shares, they think first and foremost of direct ownership. This is shareholding in the classic sense: you own a small stake in a company, providing it with capital and taking a share in its profits as a return.

The participants in the RSA’s research felt they had a clear understanding of direct shareholding. They knew what it meant. Direct shares were the financial holding that investors felt most comfortable being involved with on a day-to-day basis. Checking share prices and buying and selling were seen as perfectly normal, although not something most people indulged in.

Around 20 per cent of British households hold shares in this way, according to the most recent Family Resources Survey. A 2002 Mori Financial Services survey of over 1000 investors confirmed this view: 22 per cent of respondents held shares, with a median value of £5,000. In other words, around 12 million Britons hold shares directly in publicly listed companies.

This section of society was slightly overrepresented in the RSA’s research. We weighted the sample in order to get broad cross-section of view of direct and indirect investment and 14 out of 24 participants held shares.

Among the people who held shares, involvement varied according to knowledge and understanding. Passive Investors tended to leave their shares alone:

* I got my shares in a privatisation and I haven’t really looked at them since* (male investor)

This finding reflects the national trend. The *Investors Chronicle* reported in December 2005 that the number of advisory accounts held by private client stockbrokers had fallen by 200,000 in the previous five years, with a strong trend, encouraged by the brokers, for clients to move to nominee accounts where named holders hold the assets on behalf of another. Half of those surveyed by Mori held their shares in a broker’s nominee account, 12 per cent in a company nominee account. In short, many direct shareholdings are, in fact, held indirectly: control is passed to a representative.

The Active Investors in the RSA’s sample were not only more likely to have shares, but also more likely to manage them directly. All those people who had attended an AGM — just over a third of the total number — were in this group. The only member of a share club was also an Active Investor.

For almost all of the participants in the deliberative forum, direct share ownership was of no great importance. It was not critical financially. Nor did it prompt an active interest in the company with which the shares were held. Companies were
controlled by the major shareholders, they felt, and small investors were unlikely to be listened to unless they raised a specific problem and pushed hard to resolve it.

The overall attitude of the investors to direct ownership resembled attitudes towards local government. People understand the system and its function, but had neither the time nor the inclination to get involved. They wanted it to be there when they had a complaint or a grievance and they were reassured by its logic, even if they acknowledged their own powerlessness in the great scheme of things. They had a sense of agency in relation to it. Their attitude towards indirect investment was very different.

1.4 Popular disengagement

The history of the last fifty years could be written as a heartening tale of power moving away from elites and towards ordinary people. Through their pension funds, banks, brokers, fund managers, and insurers, ordinary people own the corporate system in much the same way as they do public services.

Yet the true nature of this ownership relationship has not been realised. Most people are thoroughly disengaged with their investments.

The RSA’s research showed that the level of involvement in personal investments varied considerably between different investor groups. The Active Investors took a much keener interest in the markets and the types of financial products available to them. The Passive Investors tended not to get actively involved or seek out information unless they absolutely had to.

The Passive Investors probably better represent the general population. For them, the general consensus was that:

*As long as it pays what I need at the end, I don’t need to know the details* (male investor)

Few people in the Passive Investor group expected to have a say in the management of their pension; and, in many cases, they didn’t want one. The perception here was that the ‘rules’ of the pension game meant that it was managed for you. They shared the same concerns as the Active Investors, but were much less confident in their ability to secure those goals.

The Active Investor group were less fatalistic about the management of their investments. They were still predominantly detached from their pensions however, particularly if they were part of company run schemes. Those investors who had consciously chosen to take part in the marketplace with a private pension were more likely to take an active interest, monitor it and even try to have some say over how it was being run. But they were typically far less involved with their pension than they were with their other financial holdings.
Overall, with few exceptions, participants tended to have the following attitudes towards pensions:

* A disconnected mindset:

> You hand over responsibility to someone else when you take out a pension. It stops being your money and becomes their money until it's time to reclaim it when you retire (male investor)

* An element of blind faith:

> You sign up, you hand it over to someone who knows what they are doing with it and you trust them to do a good job (female investor)

* A sense of powerlessness and a feeling that there were no alternatives:

> But what can we do? (male investor)

* A frustration at having to be involved. While the investors at the deliberative forum recognised the necessity of engagement in other areas – and acknowledged that it might be important with long-term saving – they were typically looking for a fairly passive model of investment:

> I’d rather not have to personally monitor it the whole time (male investor)

> I know I should be more involved, but I just don't have the time (female investor)

Some of these attitudes are contradictory. Investors complained at the lack of choice, but said that they would prefer not to be involved with the management of their money. This is the paradox that reformers in this area have to contend with.

1.5 Increased decision-making

Talk of disengagement and lack of choice sound odd when set against many of the recent alterations to the financial system. Changes have been made to indirect investment to give people more choice and make them more responsible for their investments.

This has particularly been the case with pensions. Over the last decade, there has been a significant shift in pension provision: from final salary or defined benefit (DB) to money purchase or defined contribution (DC).

The move from DB to DC has changed the entire basis of pension holding. In DB schemes employees are promised a retirement income based on their pay and length of service. The employer takes the risk. In DC schemes, the eventual
pension depends on the investment performance of the fund that the employee has paid into. He takes the risk of poor investment performance.

The scale of this shift is considerable. The consultancy Watson Wyatt reported recently that the amount of money saved in DC schemes across the world will overtake the amount of money in DB schemes by 2014.11 It is also happening with increasing rapidity. UK firms have traditionally been slower to change to DC than their counterparts in countries like Australia and the United States. Yet the Association of Consulting Actuaries reported in 2005 that 68 per cent of DB schemes in this country were now closed to new members. Three quarters of FTSE 100 firms have taken this step – and, in some cases, have also closed their schemes to existing members.12

Companies’ decision to move away from final salary schemes is in large part a policy of risk aversion. Profound demographic shifts have left employers struggling to meet their pension obligations. Like the inhabitants of most Western countries, Britons live longer and have fewer children than they did in the past. By 2050, the number of British children aged 65 and over will be 50 per cent higher than it is now. Our “dependency ratio” – the extent to which the working age population supports those not working – will double in the next 40 years.13

Throughout the 1980s and 1990s, bull markets lightened the burden for companies. But the cost became hard to bear in the early 2000s after the dot-com crash. Recent events have multiplied the deficit many times – the Pension Protection Fund reported on 28 September 2008 that deficits had doubled on final salary schemes as share prices plummeted.14 For companies, financial orthodoxy dictates ditching DB schemes.

This looks like bad news for employees. But in theory they should also benefit from the shift to DC. As Donald Ross and Lester Wills, academics at the University of Western Sydney, make clear in a multi-national survey of the subject, DC pensions are arguably more suitable for a modern economy.

Final salary pensions tended to reward people who stay for a long time with a single firm. But workers today are more mobile. The average UK worker changes jobs up to six times; in such circumstances that worker could lose up to 25-30 per cent of their full service pension. Employers are unlikely to view their workers as lifetime employees. For a retirement structure to be effective today, therefore, employees need full portability of their retirement funds.

DC pensions offer more scope for member involvement. “The comparative simplicity of DC plans and the ability effectively to track account mean that members have a greater potential for active involvement in their retirement savings than members in DB plans”, Ross and Wills write.15 Yet despite this, there is little evidence from Australia and the US that members are taking advantage of the potential for engagement, The RSA’s research confirmed this finding. This is the paradox of consumer choice.

11 The Economist, “Falling short: The trouble with pensions” (12 June 2008)
1.6 Complexity and behavioural biases

The attempt to give consumers more choice has been stymied partly by the consumers themselves, who lack the knowledge and confidence to oversee the management of their money. This turns consumer choice from a strength into a weakness.

The RSA’s research confirmed people’s relative ignorance of financial matters. The Active Investors had been distinguished as such on the basis of their claim to know and understand the financial system, but none of them felt able to claim the same level of understanding as a financial professional; their knowledge was primarily local. The Passive Investors did not necessarily feel confident with their own finances.

To a certain extent, this lack of confidence reflects the reality. Financial literacy is poor in this country. And studies of investor behaviour have demonstrated repeatedly that individual decisions are subject to both bounded rationality – because certain types of problems are too complex for individuals to solve alone – and bounded self-control – where individuals lack the willpower to execute their plans.

Studies of real world behaviour show little evidence that investors – both amateur and professional – invest irrationally. They frequently hold too few securities in their portfolios, for example. And they repeatedly invest over short-term periods, placing far too much emphasis on recent past performance.

Considering the issue of investor fallibility, The Economist cited the case of Enron. When the energy company went bust, it turned out that employees had chosen to invest more than half of their pensions’ assets in the companies own shares. “A DB plan, taking professional advice, would never have been exposed like that”, the author commented.16

The participants in the deliberative forum were undoubtedly guilty of bounded rationality. In particular, they tended to judge the performance of their pension on the performance of the fund manager – a judgement assessed in the short term. As the Tomorrow’s Investor interim report put it:

Given the choice most people would like to think they are more focused on long-term growth and careful management of funds companies. In reality, they judge the performance of the fund on short-term measures.17

I suppose we tend to think in the short term really (female investor)

This short-termism matters. It feeds into the fondness for switching between funds, for example, one of the major reasons behind the high cost of long-term savings. A responsible system would act to counteract this tendency. The present one does just the opposite.

16 The Economist, “Failing short”
17 Manthorpe and Martin, “Tomorrow’s Investor: Interim Report”, p.21
1.7 Making the wrong decision

The financial system is too complex. When men like Warren Buffet cannot understand the reasoning behind the use of particular instruments, something is wrong. The complexity – embodied in the expansion of the chain of intermediaries – is preventing people understanding what the financial industry does.

Even if the financial system becomes less complex however, not everyone will understand it – and very few people will understand it completely. We will always want financial professionals – because they will have the time and the expertise to make sure the system functions correctly. There is nothing wrong with this, nor with fair levels of remuneration being offered for financial expertise, as the participants at the deliberative forum acknowledged:

*I want a management company that link the two, that look after my money and also get well rewarded for doing so* (female investor)

But relying on financial professionals is no longer enough. Like the political system, the system of long-term savings now relies on popular involvement. It does so partly because true accountability requires active oversight from all directions. On a more basic level, however, people need to be involved because if they are not it will end up costing them. The DC pension plans – increasingly common, as we have seen – are a good example of this.

Under the British system of DC pensions, individuals may be asked to take the following decisions:

- Whether to save for a supplementary pension
- How much to contribute
- Whether to stay in the occupational pension plan (OPP) or to opt-out into a personal pension plan (PPP)
- In the case of opting for a PPP, which provider to use
- The risk/reward profile of a specific investment option
- The kind of benefits (lump-sum, annuity, early withdrawal etc.)

Investment choices are always uncertain. Even if the “right” decisions are taken some risk will remain: in short, the investment may always perform poorly. But there are also considerable risks that can be avoided.

In their International Organisation of Pension Supervisors Working Paper, Ambrogio Rinaldi and Elisabetta Giacomel group these risks under a single category: “the risk of taking wrong decisions”. Investors may:

- Contribute too little, and/or for too short a period, to a supplementary plan
- Face unduly high fees and costs
Choose a bad provider, and/or opt out from a good occupational plan (often described as the risk of being exposed to misselling)

Select an inappropriate (ex-ante) asset allocation

If investors are not engaged and involved, they will feel the downside. Yet they are not in most cases capable of being that engaged. This is the conundrum for policy-makers.

1.8 Final salary mindset

Today’s investor has a final-salary mindset in a money-purchase world. He hopes — with what he strongly suspects is blind faith — his pension will provide for him in his old age. He expects his investments to be well managed. But he is unable, or unwilling, to make sure this is the case.

The final salary mindset was evidenced most clearly in the feeling among many of the investors that they had – implicitly or otherwise – entered into a contract with their pension firms, where they contributed each year in return for security in retirement.

There was widespread doubt that this contract really existed, with many participants evincing negative attitudes towards financial professionals and the investment industry in general. But they tended to feel they had no other option; so they preferred to hope for the best.

The final-salary mindset comes out in attitudes towards equities. Most of the people at the RSA’s research event knew that pensions were supported by equities, although the less-informed groups were more hesitant about the link. But no matter their level of knowledge, they tended to view direct share ownership as a form of gambling:

*You take a punt on the stock market. It’s like putting money on the horses* (male investor B)

The FSA’s survey of these issues found that only 25 per cent of people did not know that pensions were backed by equities. Our research indicates that, whether or not they know this, people still put pensions in a different mental place to direct stock-market investments.

For many of the investors, there was a sense of conflict — what one could even call cognitive dissonance — over the issue. Equities support pensions, yet most investors are convinced that ownership of shares equates to short-term speculation. This contradicted the universal view that pensions should be low-risk. Again, we see a final-salary mindset in a money purchase world.

The attitude of the investors in the deliberative forum towards pensions resembled attitudes towards climate change. They were aware on some level that it was up to

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them to take responsibility for their future. Yet they found it difficult to accept this completely. They had little faith in financial investments in general and preferred to deal with property or cash. Yet they continued to hope that things would turn out for the best.

1.9 Limited solutions

Given the deep-seated constraints on action, solutions to the problems of long-term saving are limited. In an ideal world, intelligent consumers would achieve an optimal pattern of decisions and the highest level of welfare that their endowments allow. The role of policymakers would only be to encourage the provision of information. Unfortunately, we are far away from that point.

Education

Low levels of financial literacy are undoubtedly responsible for many of our problems – but education, so often the black box into which difficult issues are thrown, is not a remedy for this, at least not in the short term.

The teaching of financial literacy has frequently been poor. Like sex education, it is too often framed abstractly, giving students little opportunity to relate lessons to their own lives. For most people, financial know-how is a disposition, rather than a skill. It is a craft and its technique, not a test of know-how. The FSA’s use of the phrase “financial competency” reflects this better than talk of financial literacy.

Advice

Providing customised advice to members of pension plans would seem like an excellent way of offering a combination of information and education. If it is done properly, it can avoid the necessity of providing information on all the various options, permitting greater focus on the quality and personal relevance of the information.

The UK currently relies heavily on advice as a way of getting round ordinary people’s lack of knowledge. This does not work. The system of Independent Financial Advisors (IFAs) is notoriously poor and is vitiated by commission-selling, despite some recent reforms. Moreover, and perhaps more damagingly, the requirement of advice leads to high costs, damaging returns directly. By encouraging investors to switch between pension plans, for example, something they are incentivised to do, IFAs actively pass higher costs onto the consumer.

The issue of advice is a Catch-22 for collective saving vehicles. Investors want low costs and high returns, but products require marketing and advice, which inevitably raise costs. Tomorrow’s funds of the future will need to find a way around this.
Regulation limiting individual choice

This can take different forms. The most obvious examples are mandatory or quasi-mandatory membership (as in Australia), and regulation that favours membership of the occupational plan arranged by an employer.

This sort of regulation risks limiting the opportunities available, damaging the system by reducing competition. It might also improve matters by radically cutting decision costs.

The Turner Report suggested that decision costs had been reduced in Australia, but that “high marketing costs to attract individuals to specific institutions and asset allocation choices have offset the cost saving resulting from compulsion”\(^{20}\). At present, moreover, introducing compulsion would be politically difficult to introduce. Regulation limiting individual choice, therefore, is fraught with difficulties.

Regulation limiting financial professionals

Regulation of financial professionals has become a hot topic since the credit crunch, as the 2008 Queen’s Speech demonstrated. And some regulation is needed. Informed observers have suggested that there might be a role in the UK for some sort of cap of charges and fees. “For”, as Rinaldi and Giacomel put it in their IOPS paper, “even in the presence of adequate transparency, it might be argued that individuals are not careful enough to spot the cost differences across the plans available”.\(^{21}\) Regulation, however, is not a panacea. Stakeholder pensions, which imposed just such a cap, have proved largely unsuccessful. The cap has been shifted from 1 per cent to 1.5 per cent and far less people than expected have joined the scheme.\(^{22}\)

We cannot depend on regulation. First, because it is the creation of bounded rationalities and will therefore be bound to have unintended consequences. Second, because people will always find a way around it.

We need to acknowledge that some level of trust must exist in the system, as Robert Shiller argues in The Subprime Solution.\(^{23}\) Trust and generosity must become part of the market’s institutional framework for it to function effectively. There needs to be mutual respect between financial practitioners and between consumers and their agents.

1.10 Rational apathy

The question of trust is crucial to understanding why people do not put money aside for their retirement. It is easy to put the final salary mindset down to financial ignorance or behavioural defects. But the participants in the deliberative forum were also rationally apathetic.

Failures of savings vehicles, from Equitable Life onwards, have fostered a distinct lack of trust. The mis-selling of pensions products has also been frequent enough, and widely-enough publicised, to erode faith in the market. Current financial difficulties have only served to exacerbate this feeling.

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\(^{21}\) Rinaldi and Giacomel, “Information for Members of DC Pension Plans”, p.8

\(^{22}\) Independent, “Government criticised over stakeholder pensions flap” (23 November 2002); Telegraph, “Government scraps 1 per cent cap on stakeholder pensions” (15 June 2004)

Some of the participants at the deliberative forum had been stung by previous bad experiences:

I don’t trust IFAs, because I had a bad one. You can only trust yourself, and I don’t have time (male investor)

I was with Equitable Life and that really put me off (female investor)

But the lack of trust went beyond concern about scandals. There was a widespread feeling among the participants that none of the savings vehicles currently on the market were able to give investors what they wanted: security; high returns; low costs; and, where possible, an ethical approach.

When the structure of the market is combined with this institutional failure, the disengaged final salary mindset seems perfectly explicable.

1.11 Clear and simple choices
Again and again, the participants in the deliberative forum emphasised the importance of clear and simple choices. They felt disempowered and they wanted to be able to register their preferences in a way they were comfortable with, without feeling stressed or pressurised.

You’ve got this money and you’ve got to invest it, and that decision that you make, normally quite quickly, is the one you are left with for the rest of your life (female investor)

I think a lot of people bought something they didn’t really want or didn’t fully understand (male investor)

They wanted the choices to be ones they understood and could have faith in.

This potentially offers a solution to the problem of the disengaged final salary mindset. If investors are given simple and easy to make choices regarding their investments, and they can see clear and tangible benefits to those choices, then they can and will exercise choice and enforce change in the markets. Finding a way to do this can make the difference to the problems of corporate governance.

1.12 Cognitive overload
Moves have been made to improve consumer choice. Instead, they disempower investors. One key reason for this lies in the provision of information. The final salary mindset would seem at first glance to stem directly from financial illiteracy. The RSA’s deliberative forum challenged this assumption. The fact that the mindset was present even among the active investors suggested a different cause.
There is a consensus emerging slowly in research on pensions: that giving people more information does not necessarily help people make better decisions, particularly if those providing the information are not independent. Reformers in this area should also start thinking that flooding people with information may actually have a detrimental effect. In other words, it may encourage them to make worse decisions.

The behavioural economist David Laibson has conducted two sets of experiments with undergraduates in the United States which show that information can actively hinder decision-making. In the first set, he asked the students to remember a three-digit number, then gave them the choice between a piece of fruit and a big, sticky chocolate bun. Most chose the piece of fruit. In the second set, he gave them the same choice, but this time asked them to remember an eight-digit number — a number right at the limit of our cognitive capacity. The students overwhelmingly chose the chocolate bun. When our brains are stretched, our primal selves override our rational selves. Laibson showed that, when the students chose the piece of fruit, the area of the brain associated with long-term thinking was active. When they chose the sticky bun, it was the hungry, animal side that lit up.

The drive to make people more responsible for their investments may well be having a similar effect. By asking us to make ever more decisions, it is reducing us to a state of cognitive overload. When this happens, our mental biases — shaped by years of evolution — take over. In the primal jungle, time horizons were short. Only the distant future mattered. When we are placed under stress, we are returned to this mindset. This is why the traders in the City are so susceptible to the call of the herd. This is why people fail to save for their retirement.

The issue of cognitive overload makes the comparison to climate change an apt one. The problem is not information provision — it is information surfeit. A consensus is growing on this in the sector. One recent survey ended by asking “whether the provision of information to members is truly successful in empowering them to take appropriate decisions”. A recent FSA report came to the same conclusion.

In this environment, what are needed are simple choices that are easy to make. The RSA’s work on personal carbon trading aimed to make this a possibility with greenhouse gas emissions. It wants to do the same thing in the field of investment.

1.13 The pensions market
The structure of the current market also contributes to investor disempowerment.

Long-term savings products are neither accountable nor transparent; on the whole, they actually discourage involvement. The participants in the deliberative forum were asked to complete a share-tracking exercise as preparation for the day.

25 Rinaldi and Giacomel, “Information for Members of DC Pension Plans”, p.28
contacting their pension firms to ask them where their money was being held. This is not always an easy question to answer: investments by funds change daily. But fund managers are not set up to answer such questions – even to the people whose money they are investing. None of the participants had any success – and several were rebuffed peremptorily.

The inherent complexities of long-term savings products make it difficult to ensure an effective competitive process in the industry. But a number of factors exacerbate the issue. These are particularly relevant for pensions, given their economic importance.

* A high degree of complexity, in the number of products, their practices and their charging structures. The presentation of these facts to investors is couched in technical language that is hard for most ordinary people to understand.
* Considerable opacity. Price and performance are generally hard to compare and are often not even identifiable at all. Both are disclosed in misleading fashion which encourages short-term thinking.
* A lack of free will in the market. Individuals are usually directed to a particular pension scheme by their employer. Decision-making is removed from the process.

Again and again, the participants in the deliberative forum emphasised the lack of choice in pension provision – both in the initial purchase and in the final decision to retire.

_You don’t really have choice anywhere along the line (male investor)_

It may be that this explains why savings are reduced in DC schemes (5.8 per cent compared to 14.2 per cent of payrolls as of October 2007, according to one study). When people do not feel they are actively choosing, they do not commit, behavioural studies have shown. The psychologist Robert Cialdini has studied this phenomenon and his work shows that once people have committed they tend to stick by their word. By prompting an active decision, therefore, it should be possible to improve pension contributions.

The final-salary mindset, which encourages people not to take responsibility for their investments, hampers the functioning of the current system. This does not mean we should give up hope. In Section 2, we shall investigate the problem further and in Section 3 we shall suggest some solutions.
2 Drivers for change

2.1 The credit crisis

The current financial crisis is a crisis of corporate governance. It is a crisis of the investment chain.

The proximate cause of the credit crunch was the inappropriate sale of subprime mortgages. Put simply, this came about because there was no bank manager who “owned” the mortgages, and hence was concerned for their security.

The long-term cause of the credit crunch was the risks taken by the banks. Shareholders did not know what their representatives were up to. They permitted fund managers, and bank directors, to take excessive risks with their money. They assumed, wrongly as it turned out, that regulators would ensure the system was stable.

In other words, the separation of ownership and control – endemic to the Anglo-American version of stock market capitalism, where executives get paid a salary for running companies on behalf of a multitude of scattered, anonymous shareholders – is at the heart of the crisis. The principal-agent problem is the root cause of the credit crunch.

The financial journalist Chris Dillow has made this point by looking at the role of hedge funds in the credit crunch. In the lead-up to the crisis, we were warned repeatedly about unregulated hedge funds. In the event, the biggest shocks to the financial system came from heavily regulated banks and stock market-quoted companies.

For Dillow, this is a failure of a particular form of ownership: one where dispersed small shareholders have little control over their representatives. “In hedge funds”, he writes, “things have been different. Very often hedge fund managers invest their own money and take key decisions themselves, or at least closely watch those who do. Their incentives to take huge risks have been smaller”. 29

This is also the lesson of demutualization. Not a single building society that demutualized in the 1990s now survives as an independent company. Bradford and Bingley, having lived for 149 years as a mutual company, lasted only eight years as a quoted firm. Halifax survived 144 years as a mutual company, just 11 as a quoted company. Northern Rock lasted 157 years as a mutual, 11 as a quoted. The demutualized firms were unlucky. They were also reckless. The larger issue was the principal-agent problem: that, once they had become quoted companies, the mutuals erased the connection between ownership and control.

This is not to say that shareholders are not culpable. The search for “shareholder value” was a major contributing factor in the credit crunch, as John Kay has noted. “The pursuit of shareholder value damaged both shareholder value and the business”, Kay wrote in the Financial Times, talking about his time as director of the Halifax. 30 Trading in short-term money market instruments was prioritised at

29 Chris Dillow, “Why aren’t hedge funds failing as fast as banks?”, The Times (17 September 2008) (http://www.timesonline.co.uk/tol/columnists/guest_contributors/article4768564.ece)
the expense of long-term stability – in part because institutional investors like the pension funds pushed for it. This is why people’s pension plans ended up invested in hedge funds, being used to short sell companies.

Dillow believes that we should abandon our current model of public ownership, mimicking instead the corporate structure common at hedge funds, which place ownership and control in the same hands. Other commentators have voiced similar opinions.\textsuperscript{31} In essence, they want to return to an older form of capitalism, the one popular before the rise of public companies in the mid-nineteenth century.

This move is curiously out of temper with the times, where the trend has been towards more accountability by business and government, not less. It also ignores both the potential of public companies and the dangers of privately-owned ones.

Forms of private ownership like hedge funds and private equity may not survive in the same way now credit is no longer freely available, but prior to the collapse they were hardly saintly in their conduct. Hedge funds participated in the short-selling frenzy that precipitated the collapse. Private equity firms loaded debt onto companies in order to minimise their own risk.

Private ownership can be the business equivalent of freeing politicians from the tyranny of opinion polls and allowing them to make sensible long-term decisions. It can also be profoundly undemocratic. Hedge funds and private equity firms are financial autocracies. They may be more effective at growing quickly, but – as with national economies – they might be more likely to crash in the long run.\textsuperscript{32}

The idea of the joint-stock company still has merit. But its structure is in need of renovation. Instead of short-term advances, companies should pursue stable long-term growth.

This may not fit in with the current notion of “shareholder value” – which essentially means the share price. One of the problems of previous engagement processes is that they have focused on direct shareholders, who have an interest in seeing one company profit at the expense of another.

The greater mass of indirect shareholders – those who hold shares through their pensions and insurance policies – have an interest in seeing steady, long-term growth throughout the economy. We need to start taking their interests into account.

\subsection*{2.2 Universal owners}

Beneficial owners are – in aggregate – universal owners. This explains why it is in their interest to see steady, long-term growth.
Universal owner theory has its antecedents, but it has only been properly formulated in recent years, first by Robert Monks and Neil Minow, then by James Hawley and Andrew Williams. The concept is complex and aspects of it are disputed. Its central principles, however, provide a clear rationale for the investment choices made on behalf of beneficial owners.

The universal owner is the financial institution which finds itself effectively owning the entire economy. This is what happens to large institutional investors – most notably the largest of the public and private sector pension funds – when they amass investment portfolios that comprise a very extensive cross-section of financial assets. Their holdings are so diversified that they have an interest in the economy as a whole rather than specific companies or industries. In short, they embody the public interest:

The fundamental characteristic of a universal owner is that it cares not only about the governance and performance of the individual companies that compose its investment portfolio, but that it also cares about the performance of the economy as a whole.

A universal owner might initially benefit from an investee company externalising costs, but they will ultimately experience a reduction in market and portfolio returns as pollution or environmental degradation adversely affect returns from other assets. This changes their outlook. They have an incentive to reduce negative externalities (such as pollution and corruption) and increase positive ones (such as sound corporate governance and effective education and training) across their investment portfolios.

These two strategies are dramatised by the economist Albert Hirschman as “exit” and “voice”. According to Hirschman, members of an organization – whether a business, nation or any other form of human grouping – have essentially two possible responses when they perceive that the organization is demonstrating a decrease in quality or benefit to the member: they can exit (withdraw from the relationship); or, they can voice (attempt to repair or improve the relationship through communication of the complaint, grievance or proposal for change).

Size and indexation strategies have compelled institutional investors to engage with companies instead of trading in and out of the market. But they have not yet found their voice. Nor have they put much effort into helping their long-term beneficiaries find theirs: when the costs of switching long-term schemes make “exit” as difficult for the individual as it is for the institution.

Recent institutional changes have increased the accountability of companies. Corporate governance structures have been changes to allow shareholders to vote for directors. Levels of participation at corporate elections have risen from around 20 per cent to over 60 per cent. New agencies have arisen to support these activities, notably voting and engagement services, such as Risk Metrics, F&C and Hermes. New sources of independent information have sprung up: institutions such as the Global Reporting Initiative, or the Extractive Industries Transparency Initiative. Fund

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35 Albert Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (Cambridge, MA., 1970)
managers have, slowly, begun to accept their responsibilities as owners, in initiatives such as the United Nations Principles for Responsible Investment.

But as Hawley and Williams remark, universal owner “consciousness” is a long way off. Neither the institutions nor the practices live up to the theoretical model. As Raj Thamotheram and Helen Wildsmith put it: “factors like these [corporate governance, research and development] are likely to have a long-term effect on business results, but seldom get integrated into investment decisions, irrespective of whether they are part of the research process”.

The financial crisis is only the most egregious instance of this.

2.3 Costs and charges
The financial crisis shows all too clearly that the interests of beneficial owners have not been being taken into account. Symptoms of the breakdown have been around for quite a while.

The most obvious sign of malfunction was excessive remuneration, decoupled from performance. In the lead-up to the credit crunch executive pay spiralled irrationally, until it was rewarding failure and promoting excessive risk. Between 2002 and 2007 the total earnings of FTSE 100 executives doubled, well above wage settlements for the economy as a whole. The system of bonuses, intended to link pay to performance, instead ended up incentivising risk.

Pay settlements, however, are merely the sign of a deeper malaise. Over the last fifty years the costs and charges of financial institutions have increased dramatically, far beyond any reasonable expectations. This was made possible because of the disconnect between companies and their clients.

In a paper for the RSA, the financial journalist Alistair Blair examined charges in unit trusts. Charges here are generally higher than those paid by pension funds. Nevertheless, the big picture is the same across the private provision industry.

Blair describes how, when the UK unit trust sector first got going in the 1930s, its annual fee was fixed by regulation to 0.5 per cent. Had this charge stuck, he notes, “then 70 years of advances in investment indexes would have made the unit trust industry as rich as Croesus. Instead, it ended up much, much richer”.

Unit trust fees were increased to around 1.25 per cent, despite improvements in technology, and despite increases in the size of funds. “It takes hardly more manpower to run a £500m fund than a £50m fund”, Blair writes. “Yet at half a per cent a year, the larger fund brings in ten times the management fee”. At 1.25 per cent a year, the profits are even greater. Hence the rise in executive pay.

The same cost inflation applies to private equity. This industry has retained its base level fee of 2 per cent even as the scale of capital being raised and

38 Alistair Blair, “Costs and charges in unit trusts”, (RSA, December 2008), p5
invested has multiplied many times. When the fund were smaller and fixed costs had to be supported by smaller asset bases, high base fees were understandable. When $10 billion funds were a very real possibility, they were far less easy to justify. The executives of private equity firms received million dollar salaries whether or not they performed for their clients. As one commentator remarks, “private equity appears to be an industry where economies of scale do not exist”.39

Investors are largely unaware of the scale of costs and charges. At the RSA’s research event, fund manager David Pitt-Watson told the participants that the fees of 1.5 per cent per annum on their pensions amounted in the end to roughly 40 per cent of the total pension over the lifetime of the investment (a figure equivalent to roughly ten years of contributions).

A pension lasts 50 years. So an average pound invested in the pension is there for 25 years. 1.5 per cent is paid in fees, on the balance of the fund every year. 25 times 1.5 per cent is 37.5 per cent, or approximately 40 per cent.40

None of the investors had done this calculation. All were shocked by it:

*I can’t believe the amount of my pension I lose through charges … I knew charges were high but I didn’t think they were that high* (male investor B)

*We’re getting charged a lot for not very much work* (female investor)

*I haven’t got a clue what fees are* (male investor)

In part, this is the result of financial ignorance. “Savers are only dimly aware of the arithmetic behind financial returns”, Blair writes. “Vanishingly few grasp the beauty of compound interest – how 8.6 per cent, on the face of it not that much more than 3 per cent, can produce a result 1400 times better”.

But this ignorance is no accident. It is created by the way costs and charges are presented to the investor.

*It’s not explained to you very well … most of the information is very confusing* (male investor)

True accountability involves not only holding to account, but also giving an account. We suggest a specific solution for the reporting of fees in Section 3.

2.4 Fund mismanagement
Excessive costs and charges show clearly that the interests of the universal investor are being ignored. Why are they so high? The answer lies in part in the practices of fund managers.


40 David Pitt-Watson, personal email (22 October 2008)
A fund manager has two principal tasks: asset allocation and stock picking. There is strong evidence to show that in both these areas the interests of the managers have been being placed above those of their clients.

**Stock picking**
Choosing between shares in different companies is the secondary task of a fund manager. Yet in recent years it has assumed a great deal of importance. Jonathan Ford has explained what happened:

Think of our fund manager as a tuxedo-clad croupier at the roulette wheel. Given fixed returns for the house each time the wheel spins, how can he increase its cash takings? Easy. So long as he knows the same amount will be staked each time, he spins the wheel more frequently.41

The figures support Ford’s thesis. In 1965, the annual turnover of British equities was worth 10 per cent of nominal GDP. By 2004, it had risen to 200 per cent. Most of this increase took place in the last fifteen years. Between 1990 and 2006, UK stock market turnover more than tripled.42 All of this activity took place without exposing fund managers to any significant risk. The gamble was, essentially: “heads I win; tails you lose”.

Even while the market boomed, stock market activity did not improve value for beneficial owners. Although there are a very small number of star fund managers who are skilled at picking winning equities, the evidence shows conclusively that the most professional fund managers produce negative returns from active fund management. Between 1986 and 1994, for example, the average pension fund did worse than the market average by 0.45 per cent a year, even before the fund manager’s fee was taken into account.43 Consumers are paying more for poorer performance.

The scale of this problem can be seen in the fees that pension schemes pay for investment. In February 2008 investment consultant Watson Wyatt published a report showing that the average pension fund pays 1.1 per cent of their assets in fees, a significant cost when considered in the long term. What is more, the problem is getting worse. In 2002, the average pension fund was paying around 0.65 per cent in fees. Charges have doubled, but with no noticeable improvement in performance. “Clearly this is a very good deal for managers”, Watson Wyatt comment, “but not for investors”.44

In his paper for the RSA, Paul Lee catalogues the various frictional costs that erode value for institutional investors and hence for their ultimate clients:

- High base management fees, unrelated to performance
- Differences in investment time–horizons between fund managers and clients that lead to value destruction for clients
- A preference for excessive trading which brings no benefit to clients
- The failure of fund managers to intervene at underperforming companies

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41 Jonathan Ford, “A greedy giant out of control”, Prospect (November 2008)
42 Tomorrow’s Company, Tomorrow’s Owners, p. 38
A list which shows a system geared to the interests of managers rather than their ultimate clients.\textsuperscript{45} We tot up the true extent of frictional costs in Section 4, and suggest a simple remedy for them.

**Asset allocation**

The fund management structure that encouraged this kind of trading is excoriated by Sir John Banham, former Director-General of the Confederation of British Industry, in his polemical paper for the RSA. Sir John accuses the fund management industry of a “reckless caution” in its asset allocation: the distribution of capital among various classes of investment vehicles (such as stocks and bonds).

Over the last ten years, UK pension funds have attempted to eliminate risk both by allocating a significant portion of their portfolio of assets to index trackers and by opting for bonds over equities. Yet, paradoxically, they have increased risk. Secure in the knowledge that the greater part of their portfolio is safe, pension funds have invested in high-risk alternatives: currency trading, private equity, hedge funds commodities and derivatives (which Warren Buffet called “financial weapons of mass destruction”).

Banham’s point is that the lack of ownership means worse companies. By diversifying, investors avoid one sort of risk: relative performance. But they create another sort of risk in the process: absolute performance.

Banham wants to see risk being managed, not avoided. As he correctly notes, such a solution could hardly be more critical:

> This is a time when the outlook for the ultimate clients of Britain’s financial services sector – Britain’s pensioners – has seldom been bleaker… The combination of lower maturity values and lower annuity return means that someone retiring today after twenty years of contributing £200 a month into a ‘with profits’ pension plan would receive a pension of £4,600 a year, compared with £20,500 a decade ago.

The looming pensions crisis makes getting fund management right more important than ever.\textsuperscript{46}

**2.5 Risk and reward**

The fund management industry has pursued inappropriate strategies. But it has also been a prisoner of its incentives. The deeper structure of the system has also been working against investors’ best interests by prioritising short-term profits over long-term growth.

The failure of active management is well known. It arises partly from the way in which the profits of trading fall into the hands of practitioners as they pass

\textsuperscript{45} Lee, “Long-term low friction”

\textsuperscript{46} Sir John Banham, “Producing decent returns for pensioners in turbulent times”, (RSA forthcoming)
through the system. But even if this happened less than it does, the practice would still not work. As Paul Lee and Sir John Banham show, the costs associated with market transactions mean that any gains are lost even as they are being made.

There have been successful fund managers in recent years. But almost all the success stories are hollow at their core. As Nassim Nicholas Taleb describes in *The Black Swan*, what successful strategies actually see is a series of small gains wiped out by one huge collapse, which gets written off as an exception.\(^47\) Volatility and complexity inevitably lead to crashes, but are never factored into investment strategy.

Myopia is institutionalised in the corporate and financial sector. Yet its most important clients are long-term savers. All too often, they end up feeling the cost while the fund manager does not. This needs to change.

The rise of institutional investment in the 1970s brought with it new systems of performance management. Insurance bosses and pension fund trustees encouraged their fund managers to improve returns by pitting them against a benchmark return, such as that on the FT All-share index. They concentrated on relative performance, to the detriment of absolute performance.

The time span of performance management deal means that incentive pay has focused on the wrong period. Traders who are incentivised annually do not need to worry about the long-term value of the instruments they use and create. Over the last twenty years, many traders have made lots of money on deals which over time were shown not to be profitable. As the credit crunch has bitten banks have lost huge sums on transactions for which they have already paid out bonuses.

The focus on short-term measures has been a historical mistake. But — until recently — the financial sector has been largely unaffected. The real cost has been passed into clients. Performance fees have been introduced in many financial institutions, but with little effect.\(^48\) As we have seen, the overall trend in the sector has been towards higher costs and lower performance.

Corporate strategies over the last twenty years have promoted an environment of high market volatility, where merger and acquisitions contribute to bubbles and busts. The interest of the universal owner should be in steady, long-term growth, not volatility. They are interested in real returns, not nominal ones.

The risk/reward balance in the financial sector has become totally asymmetric. Financiers benefit from the upside and the client faces the downside. What is needed is a new investment strategy: the one Lee describes as “long-term, low friction”. We deal with this in detail in Section 3.


\(^48\) “Performance fees: a question of purpose”, Grant Thornton, August 2008, (http://www.grantthornton.co.uk/publications/performance_fees_a_question_o.aspx)
2.6 Selling and switching
The fund management industry is responsible for some of the costs borne by long-term savers. But in large part the costs and charges come from the structure of the system, which encourages both selling and switching.

A major source of costs in collective savings vehicles is the selling and setting-up of policies. Some of these arise per scheme, and some per individual, as the Turner report showed. For Lord Turner, the two principal sources of high costs were clear:

* Up-front costs involved in setting-up and selling pensions.
* The costs created by non-persistency of individuals, which shortens the time providers have to recoup the up-front costs. This is driven by the common practice of people setting up new pensions when they start a new job, as employers find it administratively burdensome to send contributions from different employees to different pension providers.

Some of the up-front costs come from the need to give individual advice for fear of selling the wrong product. Some come from the need to sell products to consumers. These are worryingly intractable problems, but not irresolvable ones. Section 3 considers a solution.

The issue of non-persistency is more difficult to resolve. At present, agents such as IFAs are paid to sell, so they encourage people to hold policies for shorter and shorter time periods. This works against people’s best interests. But investors also conspire against themselves, as we have seen, by going in search of short-term fixes. This myopia stems in large part from lack of trust in the industry. People need to feel they are with a fund that can look after them for life. Section 3 considers how this might become possible.

2.7 The future of costs
Costs are the most important element in long-term saving schemes. They are usually borne by plan members and have a direct, significant impact on benefits.

People often focus on returns. The participants at the RSA’s deliberative forum were occasionally guilty of this:

I’m worried about the bottom line. I want to see high returns (male investor)

But returns can and will fluctuate over time, whereas costs are usually stable. Costs are also prone to non-disclosure. Hidden costs – such as when pension plans invest in mutual funds that apply management and other fees, causing cost duplication – are difficult for investors to see through; they have been increasingly common in recent years.

49 Turner, A New Pension Settlement for the Twenty-First Century, Appendix F
The Pensions Regulator regards costs as the key issues for trustees: they should ensure that members receive value for money. This has clearly not been happening. A central reason for this is that the ultimate beneficiaries are unaware of what they are being charged.

The gains to be made from reducing costs are enormous, and not only for current policy-holders. As Lord Turner put it in his report:

> We find that only 17 per cent of those currently not contributing to a pension would be profitable to the insurance industry despite the fairly high levels of contributions we have assumed … These results also show that at income levels below £20,000 it is difficult profitably to sell pensions. 50

Given that roughly 45 per cent of those in work were not contributing to a private pension (46 per cent in 2003/4, an increase in those not contributing of around 400,000 people since 2002/03), a genuine reduction in costs would be a truly significant social gain.

Happily, the strategies that might do so would also contribute to the stability and accountability of the financial system, perhaps even helping to prevent a crisis of the sort we are currently facing.

50 Turner, A New Pension Settlement for the Twenty-First Century, Appendix F
3 Tomorrow’s investors

3.1 Market failure

The system of long-term savings needs active involvement from ordinary investors, just as the political system needs the oversight of voters. Without it, as Adam Smith observed, “negligence and profusion” will prevail. But the current institutions do not allow people to engage in the right way. What is needed is not more choice and information, but the right kind of choice and information.

The “consumer model” of the investor is one practical way to drive change in the market. It is unrealistic to believe that beneficial owners will be able to vote on every company they own. The aim should be, therefore, to produce criteria for a standardised ‘package’, or set of packages that would give simple and transparent choices to investors. A limited range of reliable off-the-shelf products would produce far better results than a multitude of tailored options, even if those products did not fit their recipients perfectly.

Ron Sandler’s Review of Medium and Long-term Retail Investment offered a similar solution. It drew a comparison with the automotive industry, which it said showed many of the same features as the long-terms savings industry:

Market pressure towards product proliferation and competition on the basis of the product features; the requirement to service over many a stock of vehicles no longer in current production; and increasingly stringent regulatory and environmental gains.

The difference was that the automotive industry has achieved substantial efficiency gains in recent decades; while the long-term savings industry has stood still. Product simplification and standardisation would help reduce costs, the review noted, but instead “producers have benefited from introducing further product complexity and by innovating around product features, with new product variants generally supported by dedicated systems”. That was six years ago. Little has changed since then.51

The car is the paradigmatic standardised consumer product. Here, as in all mass industries, the competitive pressures among large producers have tended to result in a convergence towards a limited number of standardised products that differ in detail rather than basic function.

As John Scott puts it:

There is a limited number of basic car types, and each producer comes up with slight variations on these types: styling, colours range, accessories, etc, but the most striking feature of the market is that the fundamental choice is between small car, family car, people carrier, sports, off road, etc. Consumers easily choose which type of car they want and can then make informed decisions about whether to go for a Ford, Toyota, Honda, or whatever on the basis of very superficial and functionally unimportant differences.52

51 Ron Sandler, Medium and long-term retail savings in the UK: a review (HM treasury, July 2003), p.20
52 John Scott, personal email, 21 September 2008
The same applies in all major industries: soap powders, beers, electrical goods and so on. There are standard products where feature addition does not significantly affect cost. This means that, even if people cannot make perfect choices, their selections are “good enough” choices in most cases.

Of course, choices are manipulated through advertising, but advertising concentrates on precisely the minor differences rather than the big differences of type: advertising doesn’t try to persuade someone to buy a sports car rather than a family car, but does try to persuade people to buy a red Toyota with a CD player rather than a silver Ford with air conditioning.

In large areas of the financial service industry standardised products are the norm. Travel insurance, house insurance and car insurance all operate on very standardised and uniform models, allowing consumers to choose on the basis of price, ease of payment and to use simple price comparison services. But in pensions, ISAs and other savings plans this is not the case. “The lack of effective competitive pressure has blunted the incentives to adopt them”, the Sandler Review explained.53

The reason normally given for product variation in the long-term savings industry is the great variation in people’s circumstances. In their Pension Institute paper, David Blake, Andrew Cairns and Kevin Dowd address this question with reference to another transport industry: commercial airlines. They conclude that the design of pension plans could be much simpler: “There are trade-offs to be made, but these trade-offs are much fewer and more clearly defined than you might have realised”.54

Blake, Cairns and Dowd argue that pension plans can be designed, like aeroplanes, with a specific goal in mind. Instead of reasoning from the specific circumstances of the plan member’s life, they suggest designing from back to front: from desired outputs to required inputs. The aim should be to give pensioners an adequate targeted retirement income with a high degree of probability:

Once a few key parameters about the plan member are known (the shape of the career salary profile, the desired retirement income profile, the planned retirement date, the degree of risk aversion and the bequest intensity), the pension plan provider can be left to do what is needed to get the plane safely to its destination… There will still be risks, of course, but these will be as well understood and as well managed [as those for airliners].

In short, Blake et al propose that DC pension plans should look just like direct benefit plans: offering a promised retirement income, but without the guarantees implicit in the DB promise. This is their solution to the problem of the “final salary mindset”.

The problem of enforcing change in markets without intelligent consumers who know what they want is a very troublesome one. As the participants in the RSA’s deliberative forum suggested, the solution may involve reducing choices until they are clear and simple. The solution offered by Blake et al may be a step too far in
this direction, ignoring the difference between Virgin and BA, for example, or Gatwick and Heathrow. But it does show that what is currently complex could be made far simpler.

### 3.2 Long-term, low-friction

Reducing costs will require a new fund management strategy. Writing for the RSA, Paul Lee outlines what such a strategy might look like. He calls his approach “long-term, low-friction”.

Long-term, low-friction investing relies on two basic principles, Lee explains:

- First, on believing that it is worth retaining and not trading items [shares] with which we have been endowed. Second, on seeing investment not as trading in tokens representing companies but as part-ownership of companies themselves.

In other words, fund managers should work to avoid the transaction costs that make investment activity unprofitable: the “frictional costs” described in Section 2.

Long-term, low-friction is not a complex strategy. Like Warren Buffet, Lee says that investors’ first instinct should be to do nothing and that they should wait until there is a favourable opportunity before they act. “Buy and hold – and hold again”, he writes. In this simple tactic there is the potential for enormous gains.

Frictional costs matter a great deal. They are important for institutional investors. But they are more important for the individuals whose investment needs these organisations aggregate. Over time, the costs become very significant.

As we saw in section 2.5, Watson Wyatt estimate that the average pension scheme pays 1.1 per cent of its assets in fees (the median earner aged 40 in the present Stakeholder Pension system, pays 0.10 per cent of fees from a total of 1.30 per cent, Lord Turner calculated). So fund management costs hit people in the pocket.

Assuming a standard 7 per cent return, someone who saves £5,000 a year should generate a pension pot of £472,000 over a thirty year period. Instead, based on the Watson Wyatt figure, they will get £383,000 – because of frictional costs. That is before the trading costs of the fund manager are added in, reducing the pot yet again. Nor does it calculate the cost associated with poor accountability of companies.

Lee believes that a long-term, low-friction fund which worked to minimise frictional costs could reduce the annual fees paid for investment activities to around 0.35 per cent. He calculates that, at return rates of 5 per cent, long-term, low friction funds will provide a pensioner who had previously expected a pension of £20,000 with one of £24,000. In other words, every pensioner will get a pay rise of 20 per cent for the rest of their life.

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55 Turner, A New Pension Settlement for the Twenty-First Century, Appendix F, p.229
Lee sums up the situation with clarity and passion:

Pensioners who are better off by some £4,000 a year is surely something, which, in an ageing society, we should be aiming for. That added value across the whole aging population would also drive a far healthier economy. Long-term, low-friction investing is a very significant opportunity for us all.

3.3 Improving reporting

True accountability involves not only holding to account, but also giving an account. Yet far too often the information given out by many companies is impenetrably written and self-serving, using metrics that are at best crude, at worst downright misleading.

The Guardian’s recent series on green claims made this clear. They used the example of Manchester airport, whose owners pledged last year to make the airport carbon-neutral. There was only one caveat: the target did not include flights\textsuperscript{56}

Financial institutions are also at fault, according to the same piece. They frequently claim to be approaching carbon neutrality, as if all that mattered was whether they offset executive flights or put double glazing in the boardroom. It is their investment decisions which really make the difference, and they should be honest about them.

The participants in the deliberative forum were not happy with the way the information about their pension plans was presented to them:

\textit{They should give you more information, how much you have in, how much they are charging you, how that is going to impact on your final total. They send out information and glossy brochures that totally exaggerate how good the funds are} (male investor)

And their total ignorance of costs and charges was particularly revealing:

\textit{I can’t believe the amount of my pension I lose through charges… I knew charges were high but I didn’t think they were that high} (female investor)

It suggests that the current method of reporting fees is not working.

In \textit{Nudge: Improving Decisions about Health, Wealth and Happiness}, Richard Thaler and Cass Sunstein describe how the presentation of information drastically alters the way people see it. If people are told that a sausage is ‘90 per cent fat-free’, they say, then they are far more likely to buy it than if they are told it is ‘10 per cent fat’.\textsuperscript{57} This is exactly what is happening with the costs and charges of long-term savings.

Pension fund statements express charges as an annual percentage of the funds being managed. They present a small number: somewhere around the 1 per cent mark. This is the equivalent of claiming to be ‘90 per cent fat-free’.

\textsuperscript{56} Lucy Aitken,”Wiping out ‘greenwash’”, Guardian (November 19 2007) http://www.guardian.co.uk/media/2007/nov/19/mondaymediasection.climatechange
\textsuperscript{57} Richard Thaler and Cass Sunstein, \textit{Nudge: Improving Decisions about Health, Wealth and Happiness} (Yale, 2008)
The reality of charges is only really visible when it is expressed as a total cost over the lifetime of the investment. As we have seen, this will be a large number: somewhere in the region of 40 per cent. This is the fat. Consumers should know about it.

3.4 Scrutiny and performance

Tomorrow’s investor needs to make sure that he is getting value for money. But intelligent consumers are not only needed to force companies into better practice. They can also improve results, as FairPensions campaign director Duncan Exley makes clear in his RSA paper:

Greater public engagement could have significant benefits for institutional investors … Scrutiny acts as a means of improving performance. Organisations which believe that they are under scrutiny tend to practice greater self-scrutiny and self-discipline … Pension funds and fund managers recognise the psychology behind this human trait, utilising it for the companies they invest in.58

An analogy to the scrutiny-performance link is the correlation between governance practices and financial performance, as Exley points out. This is well-attested. A meta-analysis carried out in 2007 by Mercer, a consultancy, showed that investors who take environmental, social and governance issues into account benefit from an increased ability to monitor and manage risks and opportunities.59 A recent report by Business in the Community demonstrated the strength of the link.

Business in the Community compared the 33 listed companies that participate in their Corporate Responsibility Index to both the FTSE All-Share and FTSE 350 Groups. On Total Shareholder Return, the CR Index companies outperformed both the All-Share companies and the FTSE 350 every year between 2002 and 2007. The CR Index companies were also found to be consistently less volatile than their peers. “Higher levels of performance in the management and integration of environmental and social issues and associated governance factors … are associated with lower levels of stock price returns volatility”, the report commented.60 It is highly likely that increased public engagement would have a similar effect.

Greater involvement would also increase pension funds’ legitimacy. In his book The Battle for the Soul of Capitalism, John Bogle describes how pension they often lack – or feel they lack – the legitimacy needed to use their influence with confidence.61 If more members were involved with their investments this would have the additional benefit of addressing the widespread concern that governance improvements are needed in the sector.

3.5 Shareholder activism

An active investor population may well improve returns and diminish volatility. But it also has its dangers. To a certain extent, we have got the corporate system we deserve. The case of shareholder activism shows this clearly.
Individual shareholders have a difficult task making themselves heard. “It is very difficult for a shareholder with a very modest holding to attract attention and change a company’s strategy … unless they can join a wider group of shareholders, small holders may not be able to achieve anything”, one response to the Myners review considered.62

This phenomenon is chronicled by Stephen Davis, Jon Lukomnik and David Pitt-Watson in The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda, who contend that “a population of new capitalists is seizing influence over the corporate agenda … awakening to citizen investor power around the world”. They see the potential for a civil economy growing in power and sweeping the corporate system.63

Things are not always so easy. In practice, it can be difficult for financiers to tell the difference between genuinely public-spirited activists, and those who are simply intent on shifting the share price for their own ends. As two sympathetic observers put it recently:

Pension funds have understandable concerns about being co-opted by vocal minorities and campaigners who typically encourage members to focus on issues which often have more to do with NGO and political campaigns than priorities for institutional investors.64

Most commonly, this sort of action has been the preserve of the green and political left, but right-wing groups have also sought to advance their agenda on issues such as abortion by persuading institutional investors to engage with companies. Further, as Thamotheram and Wildsmith note, “concerns about union and corporate capture of public sector funds, through appointment of union or business-friendly trustees, are also relevant”.65

Caution does not need to indicate pessimism. The input of shareholder activists has the potential to improve both business and society. But we need to be realistic about the challenges. This includes acknowledging that the so-called new capitalists may well own the majority share in our companies, but those who become active campaigners will only ever make up a small section of the population.

The lessons of politics are useful when considering this issue. In many ways, politicians face the same problem as financial executives: a disengaged mass capped by a frantically active minority. Politicians often see the minority as the “usual suspects”. They don't like them: they take up their time; they push them off course. And in practice, participatory groups are often dominated by those with an axe to grind. But this is a function of the system: when engagement is so hard to achieve, only the most dedicated slip through the net. By lowering the bar a little, there is real possibility here. This is why the authors of The New Capitalists emphasise the importance of accountability right the way through the system.66

The clash over the future of British mutuals, a feature of the late 1990s, illustrates this conflict perfectly. The “carpetbaggers”, who bought policies with mutually-owned

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64 Thamotheram and Wildsmith, “Increasing Long-Term Market Returns”, pp.446-48
65 Ibid.
66 Davis, Lukomnik and Pitt-Watson, The New Capitalists, pp.198-200
building societies in the hope of making windfall profits from their conversion ended up pushing companies like Standard Life into demutualisation by persuading shareholders to vote for it. This was shareholder activism, but its interest was extremely short term.

The mutuals found it difficult to resist the carpetbaggers because most of their members were disengaged, as the Observer described at the time:

The controversy over demutualisation meant that a couple of hundred people turned up for last week’s Standard Life annual meeting but that is a pitiful attendance given that it has 2.3 million members. But how many of these policyholders know they own the company, let alone have an idea of how to recognise these rights?67

This lack of involvement may well have allowed people like Fred Woolard, the principal carpetbagger in the Standard Life case, to claim policyholders had been underpaid for years. Trust was eroded by lack of involvement and it became difficult to persuade people that mutual policyholders would benefit when the value of their policy matured. Woolard did not succeed, but his campaign played a role in Standard Life’s eventual demutualisation.68

In an article for Prospect magazine, Paul Skidmore explained essential ingredients of political participation:

First, securing and strengthening people’s right to participate. Second, making sure that participation counts when it comes to real decisions about resources and priorities. And third, ensuring that the right checks and balances are in place to preserve accountability.69

Companies would be well served by observing these same principles. Perhaps the first thing that needs to happen, however, is a culture change in business, so that all shareholders are encouraged to engage, rather than kept at arm’s length. This will make for a self-policing “civileconomy”, instead of one where a few loud voices are heard above all others.

3.6 Infotopia
Shareholder activism has its difficulties. It can also be costly. And, as we have seen, it is too much to ask to expect ordinary investors to behave like engaged activists. The funds of the future should therefore look to add simple structures of engagement onto their core functions in much the same way that changes in colour and air-conditioning are added onto a car: at low cost, and without detriment to the overall safety of the product.

In his book Infotopia: How Many Minds Produce Knowledge, the legal philosopher Cass Sunstein talks about a series of methods currently being used to aggregate widely dispersed knowledge. None of them are new, but they are all being used in new ways.70

67 Observer, “Beating the carpetbaggers” (April 30 2000)
http://www.guardian.co.uk/money/2000/april/30/personalfinance

http://news.bbc.co.uk/1/hi/business/3585255.stm

69 Paul Skidmore, “Disengaged democracy”, Prospect (December 2006)
http://www.prospect-magazine.co.uk/article_details.php?id=7954

Sunstein is particularly excited by prediction markets, such as those used for gambling. These are astonishingly accurate. The Hollywood Stock Exchange, for example, predicts Oscar winners nine times out of ten. Yet they are rarely used in business.

Google use prediction markets to help forecast its own development, predicting dates for products, new office openings and a range of other outcomes of importance to the economy. Using virtual money, Google employees invest in particular options, creating a price that reflects a probability. Their predictions have proved extremely helpful for company strategy.

The computer manufacturer Dell has also used prediction markets to good effect with their Dell IdeaStorm. Users of the IdeaStorm website can add ideas, promote and demote them, as well as adding comments. This allows Dell to gauge which ideas are most important and most relevant to the public, and has resulted in several changes of company policy.71

The financial companies of the future should take a similar approach. They should look to find ways of capturing dispersed knowledge. If they do they can engage people in a fun, active way. They can see what the gaps are between the public at large and the perceptions of managers. They can also gain a competitive advantage.

In her study of US investor clubs the sociologist Brooke Harrington found evidence that mixed-gender clubs did better because they drew on the different insights of men and women as workers, citizens and consumers.72 Sunstein comes to the same conclusion. Mob psychology and groupthink are always going to be problematic, he says, but in the right situations many minds are better than one.73 Financial institutions have many, many minds at their disposal. By heeding this advice they can improve their results even while involving and engaging their customers.

### 3.7 A new fund

The long term savings sector needs to become more like the automotive one. Not in all its aspects; but certainly in the way it approaches design and customer relations. Innovation is not an unmixed good in financial markets, as the current crisis demonstrates. Yet if we are to work our way out of the impending pensions meltdown, then we need new ideas.

In the next stage of its Tomorrow’s Investor project, the RSA wants to incubate the right sort of innovation. As RSA Chief Executive Matthew Taylor put it at a recent speech to the UK Social Investment Forum:

> After the deliberative forum, we held an expert seminar – I can see some of its members here. One of them – I’m afraid I cannot remember who – compared the current state of British fund management to the British car industry in the 1970s, when we were always told that it was impossible to combine reliability


73 Sunstein, Infotopia, pp.223-25
with value for money. Either you had a car that didn’t work, or you stumped up the cash. That was the deal.

Then the Japanese came along.

That is the RSA’s ambition: to be the Japanese in this sector.74

There is a gap in the market – a market failure, even – when it comes to products that are both low-cost and high-accountability. This gap need not exist to the extent it does.

The RSA’s initial work suggests that could well be possible to create a delegated structure along the lines of best practice in other countries. Institutional investors in Sweden and Holland are able to provide the primary elements of a fund – including fund management, fund administration and basic ownership responsibilities – for less than 0.5 per cent per annum. This must surely be possible in this country.

Any new fund would need to be trustworthy. The participants in the RSA’s deliberative forum were not unusual in their lack of faith for financial institutions. Their apprehensions will only have been confirmed by recent events. Could a fund be set up as a social enterprise, rather than a private one, in order to foster trust? Might it associate with a widely-known and trusted public body?

In order to be worthy of trust, any new fund would need to be accountable and responsible. Openness about costs and charges is its own guarantor of trust. This would be one way ensure good faith between beneficiary and fiduciary.

Above all, a new fund would need to be low cost. Lee’s work on fund management, and the examples of Sweden and Holland, show that low costs can be achieved. The selling, set-up and persistency costs identified in Section 2 would remain. But these can be removed by structures like the automatic enrolment one created in Personal Accounts, the national pensions scheme that emerged from the Turner report.

The conception of Personal Accounts is a giant step forward, but the scheme may have a tricky birth. If the Personal Accounts Authority (PAA) can deliver the goals outlined, that would improve matters immeasurably. It is a government body, however, and while we wait for the full details of the Pensions Act to become clear, it is likely that the PAA may be constrained: by the requirement that it only serves people on lower incomes, for example, or by the fact that it will not be able to test its fund management structure.

The tradition of the RSA is a civic one: it takes society and its actors, rather than the state, as the main agents of change. Given the issues at stake here, the PAA’s task is of immense importance. To strive to make Personal Accounts a success would be a worthy aim. This might involve supplementing PAA’s work; it might also involve innovating beyond regulatory constraints. In the next stage of Tomorrow’s Investor, the RSA will look to help as best it can.

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