Civic Capitalism

RSA

Tomorrow's Investor

Producing decent returns for pensioners in turbulent times

Sir John Banham

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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.

More information can be found at the RSA website: www.theRSA.org.uk

Contents

Abstract

The dismal performance of the UK fund management industry is one of the main reasons why the outlook for pensions and pensioners is distinctly cloudy. The underlying cause of the problem seems to be a typically British insistence on seeking to avoid risk, rather than a determination to manage it effectively. This has produced yet another case study in the laws of unintended consequences. These are being compounded by a 'little Englander' attitude to the way investment funds are allocated to different classes of assets, ineffective regulation of Britain's major financial institutions, a yawning gap between the ultimate owners of UK public companies and their managements, and perverse incentives for those managing other people's money

The recent financial turmoil has made it more critical that all the institutions concerned abandon their conspiracy of silence and denial, and put themselves in the shoes of their ultimate client: People saving for their retirement. These need the very best, world class, financial advice that is now only available to the super rich. That is what the project "Tomorrow's Investors" is all about.

Disclaimer

The views expressed in this article are his alone and do not necessarily reflect those of any organisation with which he has been associated. It was written as a personal contribution to the RSA project: Tomorrow's Investors.

About the Author

Sir John Banham is the Chairman of Johnson Matthey PLC (ranked number 2 in the 2008 Management Today", league table of Britain Most Admired Companies) and the senior independent director of Invesco Ltd. Since 1992 he has chaired five major UK PLCs and has significant experience of venture capital as Chairman of Westcountry Television, ECI Partners and Cyclacel Pharmaceuticals. The compound return to investors from this portfolio of public and private companies during his tenure as Chairman has exceeded 20% a year from August 1992 to March 2009.

Sir John was the first Controller of the Audit Commission (1983-1987), Director-General of the Confederation of British Industry (1987-1992), and the first Chairman of the Local Government Commission for England (1992–1995)

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.

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.

Currently, the RSA is in the second stage of this project. Having done initial research which showed that investors were particularly concerned about the high level of costs over a life time of a pension (which they tended to massively underestimate) and concern over how hard it was to get accessible information about their funds, let alone engage in any meaningful way, the RSA core challenge is to create the policy, market and business case for a new low cost, responsible pension fund with high transparency and accountability pension fund that delivers long term returns in all economic times.

Decent Pension Returns in Turbulent Times

So that's alright then! The US Congress has, finally, agreed the Stimulus Bill of $ 790 billion and American taxpayers will now take on over $2 trillion (The Economist, February 14th, 2009) of Wall Street's liabilities. Meanwhile the British Government has injected further billions of UK taxpayers' money into the banking system and acted as midwife to the merger of HBOS and Lloyds TSB without troubling Parliament. While governments across the euro zone have take action to stabilise their banking systems.

There are of course no laws to prevent the lethal cocktail of greed, myopia, arrogance and stupidity that caused the present crisis and has already destroyed ten leading British building societies – and with them an effective and low risk system of housing finance. Although some high profile scalps will be claimed on the other side of the Atlantic by laws that proscribe fraud, false accounting and market manipulation.

In the US the former Masters of the Universe, who presided over the dot.com boom, are likely to generate over $2trillion of write-offs on sub-prime mortgages and leave millions of people facing the prospect of negative equity and of losing the roof over their heads.

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What is clear is that it will be many years, decades even, before it will be "glad confident morning again" on Wall Street or for highly leveraged hedge funds and private-equity backed companies. The era of Casino Capitalism, with less than 25 per cent of the equity of most companies quoted in New York or London in the hands of institutions with an interest in the long-run success of the business, is over. Sir Winston Churchill's description of the 1930s seems all too apt in respect of the last decade: "Those were the years that the locusts ate".

However, blame and retribution against greedy and incompetent bankers and ineffective regulators cannot become an end of itself. All concerned need to understand what has gone wrong and what now needs to be done in the short, medium and long-term. The UK Government and major financial institutions have presided over an horrific misallocation of resources, not to mention a culture where epic payments for failure seem endemic. Taxpayers and pensioners will be paying the price for years to come. The challenges and prescription were clear over a decade ago:

"The new era of low inflation, low growth and increased competition [from China and India particularly] demands a new agenda: better government, a culture of saving and investment in place of one of speculation and spending, and a renewed emphasis on manufacturing."

The Anatomy of Change: Blueprint for a New Era, 1994

But sadly, like the Titanic where the revellers missed the impending tragedy, not enough people in positions to avert catastrophe seemed to have been listening.

Now, with debt much more expensive and difficult to obtain, the costs of "absentee ownership" are set to rise steeply: the "takeover hope" in the share prices of underperforming companies will disappear and – as we are already seeing - banks will no longer be prepared to finance them.

So, the ultimate owners of publicly quoted companies in Britain - pension holders and those managing their savings and investments - must step up to the responsibilities of ownership, confront the challenges ahead and begin to address some major questions:

* Why is the FTSE 100 Index over 40% lower than it was a decade ago, while the British economy has grown by some 45 per cent in the meanwhile? Indeed, (see Chart 1) over the last quarter of a century, the average UK household made more from home ownership than it did from owning shares in Britain's largest companies, recent falls in house prices notwithstanding.

* Why are most UK pension funds holding shares in every bank in the FTSE 100 Index, at a cost after the latest St. Valentine's Day Massacre of almost £250 billion since early 2007?

* Why have the Boards of the world's largest banks been so ineffective in protecting their shareholders' interests and their banks' reputations for competence and integrity? Incredibly, last year, many bankers found themselves being forced to scuttle around the Middle and the Far East raising expensive capital to repair balance sheets ravaged by sub-prime lending, only to pay out more in bonuses than they succeeded in collecting.

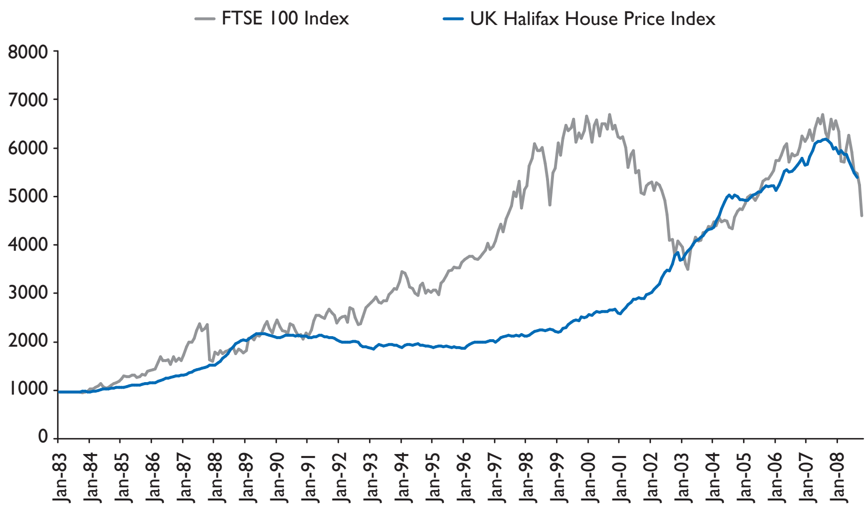
* Have the public markets been manipulated (for example by false rumours of poor trading or imminent rights issues or sub-prime write-downs) for private gain and to what extent are hedge funds still contributing to short-term volatility in global markets, and how should they be regulated (if at all)?

* With six times the Parisian trade in over-the-counter derivatives, were London's bankers and regulators entitled to any schadenfreude at the recent plight of Société Générale?

* Where were the share owners, their auditors and the expensive professional advisers to HBOS, RBS, Northern Rock and Bradford & Bingley when they were following strategies (widely admired in the City) that are now seen to be unsustainable? And where, incidentally, are all those advisers who, less than a year ago, were urging the Boards of well-managed companies to "gear up" in the interests of having a more efficient balance sheet?

It would be most unwise to rely on the institutions that have presided over this mess - even if they have not caused it - to now take effective corrective action. Even hedge fund investors seem to have forgotten the lesson from the demise of Long-Term Capital Management ("When Genius Failed: The Rise and Fall of Long-Term Capital Management"). In early 2008, the flagship ABF fund managed by Peloton Partners failed with the loss of over $2 billion of investors' funds, notwithstanding an 87 per cent gain for investors in 2007 and the accolade early in 2008 of "best new fixed income hedge fund". Peloton was set up by two former Goldman Sachs' partners.

Chart 1: TRENDS IN UK ASSET PRICES, 1983-2008
FTSE 100 vs. House Price Index
January 1983 = 100



Questions are understandably and increasingly being asked about the role and rewards of managers of private equity funds. Indeed, venture capital seems to have morphed into private equity, generating serious political heat in the process. Some commentators have suggested that little venturing seems to be involved, beyond imaginative financial engineering and exploitation of the myopia of the public markets, which often ended up buying back the very companies sold too cheaply to private equity in the first place. According to the Boston Consulting Group (BCG), potential losses from defaults on buy-out debt could reach $300 billion.

In a Financial Times (FT) interview in early 2007, Wall Street legend Joseph Perella predicted that a massive shake-out of the world's asset management industry was on its way. Even he could not have anticipated how soon his predictions would come true. Yet the dismal performance of the UK fund management industry as a whole must be one of the main reasons why the outlook for pensions and pensioners is distinctly cloudy: why we are all being told to spend less, save a lot more (or pay more tax) and work longer.

What has gone wrong?

The underlying cause of the problem seems to be a typically British insistence on seeking to avoid risk, rather than a determination to manage it effectively. This has produced yet another case study in the laws of unintended consequences. These are being compounded by a 'little Englander' attitude to the way investment funds are allocated to different classes of assets, ineffective regulation of Britain's major financial institutions, a yawning gap between the ultimate owners of UK public companies and their managements, and perverse incentives for those managing other people's money.

The Laws of Unintended Consequences

As they considered ways to prevent another Mirror Group scandal, it seems unlikely that Britain's financial regulators and Parliament would regard today's situation as satisfactory, a case study in successful remedial action to make sure that 'never again will pensioners' assets be stolen from them by their company's directors.

Over half of FTSE 250 defined benefit pension plans (and two-thirds of all private company plans) are now closed to new entrants; more are in imminent danger. Not surprisingly, when the real costs to UK employers of honouring their pension promises was put at £440 billion more than their pension assets as at March 2006 (since when the FTSE 100 Index has fallen by over 40 per cent). This is a gap of an extraordinary £20,000 for every single household in Britain. For companies in the FTSE 100 Index, the recorded aggregate pension fund deficit in July 2008 was £41 billion compared with a surplus of some £10 billion a year earlier today. The deficit for all final salary scheme today is estimated at almost £230 billion (The Times, March 10,2009).

At the same time over half of UK corporate pension plans have been moving out of equities into lower yielding bonds. To make good the gap in returns, they turned to higher risk alternatives: hedge funds, property and private equity. There are now around 1,300 hedge funds in Europe, with some $400 billion of assets under management; and even in normal times as many as 300 could close in any one year for one reason or another.

It is not surprising that in these circumstances, shares in UK quoted companies have tended to under-perform their international competitors. The total return to investors in both BP and Shell over the last five years lags well behind that for Exxon or Total. This in turn means that more and more UK companies are either taken over (for example, BAA and BOC) or go private (for example, Boots) because they are relatively cheap.

Faced with takeover threats, corporate managements have preferred to shrink their equity base, buying back shares rather than investing in the future. Since 2003, UK companies have returned over £120 billion to shareholders in share buy-backs and special dividends.

Meanwhile, within financial services, the more talented and ambitious people moved to areas which were expected to generate massive wealth for the few rather than enhanced quality of life for the many: proprietary trading, hedge funds, mergers and acquisitions and private equity.

Most galling of all to many observers, those managing other people's money poorly were still being paid massive bonuses. This had the effect of widening salary differentials to levels not seen outside Russia and the former Soviet Union in recent years. It also fuelled house price inflation, not just in London but across southern England as a whole as bonuses were used to buy second homes at prices local people could not match. This at a time when the outlook for the ultimate clients of Britain's financial services sector – Britain's pension holders – 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 around £4,000 a year, compared with £20,500 a decade ago.

This is a remarkable catalogue of consequences which is set to impact on every household in Britain. Quite apart from the cost to taxpayers of bailing out the banks and the consequences of the credit crunch for the real economy. How did this happen?

The Indexation Fallacy

Most UK pension funds allocate a significant portion of their portfolios of assets to investments in an index that tracks the share price performance of the generality of UK public companies. This is a convenient (and low-cost) way of giving investors exposure to the long-term prospects for British business.

However, the prospects for the next few years appear to be - at best - 'more of the same'. Even before the recent turmoil, most economists believed that equity returns were likely to be no more than half those that investors had come to expect during the decade of 'irrational exuberance'. It seems most unlikely that a rising tide will lift all the boats, as almost every UK fund manager and investment consultant is implicitly assuming with their closet indexation approach to equity investment.

The futility of seeking to win this particular race by backing every competitor was cruelly exposed when Shell announced in July 2005 that the merged Royal Dutch/Shell Group would be listed solely in London. Overnight, Shell alone accounted for over 8 per cent of the FTSE 100 Index, more than double its previous level. This forced the UK financial institutions tracking the Index to sell over £60 billion of other FTSE 100 equities to re-balance their portfolios, even though the medium-term prospects for Shell (and particularly its ability to build its reserves) were unaffected by the move.

No British pensioner has benefited from owning a share in every British high street bank. As stated earlier, in the period from mid-February 2007 (before the problems with US sub-prime mortgages surfaced) to early March 2009, the aggregate market value of the UK high street banks declined by some £250 billion, or some £10,300 for every UK household. Indeed, as they have recently discovered to their considerable cost, investors in any bank which has a proprietary trading operation, fails to insist on all its traders taking at least two weeks' continuous holiday every year and/or pays out multiples of annual salaries in cash bonuses (rather than in shares vesting over a minimum of five years) have been taking a huge risk. Such banks have no place in the public markets; like most hedge funds or private equity groups, they should remain in private hands, controlled directly by their owners.

Reckless Caution

Perversely, over the past several years, there has been a sustained move by pension fund trustees from active management to passive index tracking, to the general perplexity (not to say dismay) of many qualified observers. This should not come as any surprise. No one has ever been fired as a consultant or fund manager for average performance. The risks of under-performing the FTSE 100 benchmark far outweigh the benefits (to the manager) of superior performance; so they have adopted some variant of the indexation approach referred to above.

In this, they are encouraged by research analysts among whom hope seems to spring eternal. It is hard to see any other explanation for the apparently illogical fact that a company's past performance in terms of earnings growth is not reflected in current market ratings; while companies destroying economic value (because they do not earn returns in excess of their cost of capital) are often rated more highly than those with good prospects for creating significant value.

At the other end of the risk spectrum, pension fund trustees supported by the pension regulator are increasingly adopting an Oliver Twist-like approach to the companies sponsoring their pension funds: asking for more while they reduce their equity allocations by switching into bonds and other lower-yielding fixed interest securities. This has prompted the former Chief Executive of the London Stock Exchange (LSE), to question the 'reckless caution' that led UK pension funds to opt for low risk (and low return) bonds over equities. This simultaneously depressed valuations of UK-quoted companies, worsened pension fund deficits and forced quoted companies to fill the funding gap by reduced investment: mortgaging their futures in a competitive world, and opening them up to the risk of acquisition by overseas' predators or private equity houses looking for a bargain.

The result? Notwithstanding higher pension contributions, companies can confidently anticipate more demands from their pension fund trustees, at the behest of the pension fund consultants who largely caused the problem in the first place. Since the trustees are personally liable to ensure that their scheme's liabilities can be met when they fall due, they have every personal incentive – imperative even – to eliminate every pension risk, which in turn means yet further reductions in exposure to equities and increasing bond portfolios.

The Rush into "Alternatives"

Given the poor returns from indexation strategies and increased exposure to bonds, it is small wonder that the smart money fled to alternatives: currency trading, private equity, hedge funds, commodities and derivatives of one form or another, as well as property. With catastrophic consequences, as is now apparent.

Speculation in currencies by the banks has trebled since the introduction of the euro reduced the number of trading currencies. Stock lending (a proxy for short selling) in the London market has doubled in the last two years. There has been a surge in the use of derivatives - "financial weapons of mass destruction", in the words of Warren Buffett. The total value of outstanding derivatives' contracts world-wide is now estimated to be over 100 times the GDP of the UK.

London has in fact now overtaken New York in terms of foreign exchange and over-the-counter derivatives. The value of hedge fund assets managed out of London is reported to have more than tripled in the last few years; and the London market manages over 75 per cent of total European investments in hedge funds. On any one day, hedge fund trades can account for 40 per cent of the transactions on the LSE.

Thus, in the interests of eliminating risks for pension fund trustees, the London financial markets appear to have taken increased risks in the search for enhanced returns outside the normal equity and bond markets. Secure in the knowledge that if they fail (as worst will) their performance bonuses will be secure and sponsoring companies' shareholders will ultimately pay the bills as they fall due. Indeed, the average hedge fund produced a return of just 4 per cent in the year to March 2008; but since then the HFRX Index has fallen sharply and many funds are facing crippling demands from their investors for redemptions.

This vicious circle can only be broken if pension fund trustees and their advisers are motivated to do more than simply to avoid risk. In this, they are aided and abetted by the way pension funds are regulated and accounted for. As a result of the credit crunch, interest rates on corporate bonds have increased, with the perverse result that pension fund deficits are lower. At July 2007 corporate bond rates, the current aggregate pension fund deficit for FTSE 100 constituent companies was about £100 billion: more than double the reported figure. (Some experts believe the current deficit could be as high as £200 billion).

Investment risk, like any other business risk, needs to be managed.

Solution: Word Class Asset Management:

The laws of unintended consequences cannot, of course, be repealed. But that does not mean that Britain's pensioners are necessarily condemned to continue to suffer more years of unacceptable equity returns and continuing uncertainty for pension holders and shareholders alike. With the right fund management approach, attractive investment returns remain possible even in today's volatile market conditions.

A pension invested 70 per cent in equities and 30 per cent in money market funds seven years ago would have seen its total value more than double if the manager had confined equity investments to the top quartile of FTSE 100 companies in terms of total shareholder return over the period. While the manager who simply matched the Index – an exceptional performer within the UK fund management industry – would have seen the value of the fund decline by well over 25% after all fees and costs were taken into account.

The problem, of course, is that very few fund managers seem able to perform this apparent miracle (only around one in three US mutual funds out-performed the S & P 500 Index over the last decade). So rather than risk the appointment of an expensive failure, the trustees and their advisers take refuge in the indexation approach. The roulette wheel of pensioner prospects is given yet another spin.

But the author's experience over the last dozen years in venture capital and as Chairman of five large UK public companies suggests that it is possible to out-perform the Index consistently by a massive margin over a decade or more. However, managing investment risks for pension holders more effectively will require a radically new approach.

A noted US educationalist once said, "If I want to know what to do about the education of poor kids, I simply look at the education of rich kids". Tomorrow's pension holders need access to the world class financial advice currently available only to the superrich.

First, pension fund trustees should insist on asset allocations that take advantage of today's globalized economy. They should avoid the pitfalls of the indexation fallacy, by making use of instruments like Exchange Traded Funds which effectively allow for 'smart indexation'. They should appoint managers of their equity portfolios who will act as owners of companies rather than speculators in shares, bridging the ownership gap that has proved so debilitating for Britain's economy. Finally, fund managers and consultants' interests should be much more closely aligned with those of their clients: they should be rewarded for creating wealth for pensioners (and avoiding costs to shareholders) rather than simply for retaining an investment account.

Global Asset Allocation

The sponsors of Britain's final salary pension plans must take back control of the management of their pension funds' assets. Annual general meetings should take a greater interest in the management of their company's pension fund as they must in the Board's remuneration report and in the appointment of auditors. The combination of independent trustees concerned to avoid investment risk and problems with their regulator, fund managers programmed to take a UK index tracking investment approach so that they do not under-perform their competitors, and consulting actuaries required to apply accounting standards that assume that fund managers will not add value for their clients, constitutes a toxic mix.

It is also dangerously myopic. London is a global financial centre. Yet, notwithstanding the idiosyncrasies of the UK financial markets, referred to earlier, most UK pension funds are invested solely in UK equities and fixed income securities. This is an unnecessarily constrained investment approach in today's globalized economy: a "Little Englander" attitude in the global village era. At minimum, pension fund trustees should have a legal 'duty of care' to insist on asset allocations which reflect the realities of today's globalized economy, and to appoint world-class managers for each asset class.

It is possible to compare the performance of a typical UK equity-focused pension fund (65 per cent UK equity, 32.5 per cent fixed income and 2.5 per cent in cash) over a seven years period with that of a more diversified global asset allocation as follows: international equities (40 per cent), real estate (15 per cent), commodities (7 per cent), private equity (8 per cent), fixed income/bonds (30 per cent). The results are striking. Over a seven-year period, the diversified international portfolio dramatically out-performed the typical UK equity focused portfolio in terms of investment returns, volatility and cost. The international portfolio delivered over three times the net returns, with lower annual volatility.

Put very simply, if every UK pension fund had been managed in a way that recognized the realities of today's global economy, despite the current turmoil, significant pension fund deficits would not be hobbling the strategic freedom of many major UK companies. Nor would many would-be pensioners be facing an uncertain financial future; defined benefit pension plans would not be on the way to becoming endangered species outside the public service.

Put very simply, if every UK pension fund had been managed in a way that recognized the realities of today's global economy, despite the current turmoil, significant pension fund deficits would not be hobbling the strategic freedom of many major UK companies. Nor would many would-be pensioners be facing an uncertain financial future; defined benefit pension plans would not be on the way to becoming endangered species outside the public service.

Smart Indexation

For many funds, the lowest cost way to purchase exposure to a particular asset class will be through some form of index tracking product. However, rather than simply tracking an existing index, thus falling prey to the dangers of the indexation fallacy discussed earlier, investors can now purchase shares in a wide range of so-called intelligent or smart indices in the form of exchange traded funds (ETF).

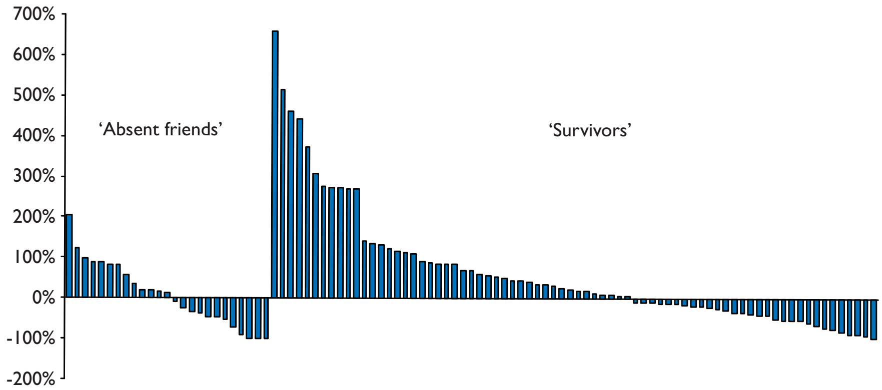
There are currently some 730 of these funds with $575 billion of assets, allowing the expression of almost any allocation model – by market size, geography and industrial sector, as well as fixed income. It seems likely that before long ETFs will also be able to provide access to commodities, hedge funds, property and private equity for smaller investors: asset classes that have been difficult for investors to access in the past, because they were too illiquid or expensive.

In addition, pension fund trustees must insist that managers of their equity funds act as responsible owners, managing investment risk rather than seeking to avoid it by tracking indices either overtly or covertly. This will become ever more important in a world where credit is scarce. Investors will not be able to reply on being "taken out" of a poor investment for an attractive cash premium; and banks will not be prepared to continue to prop up companies that seem set to destroy shareholder value because they are failing to cover their cost of capital.

Seven years ago, the ideal manager of equities would have recommended shares in every company that was about to be a top performer over the intervening period in terms of total shareholder return; and they would have urged their clients to sell every company that was about to produce a negative return. Such a manager would have delivered huge value to his or her clients over a period which saw a fall of around 30% in the FTSE 100 Index: the top 25 FTSE 100 performers in the last seven years delivered a median total return of over 100 per cent, despite the turmoil in the worlds financial markets.

The chart below shows total shareholder returns for the seven years to end 2007. Each bar represents the return achieved by a different company in the class of January 2001. The so-called 'absent friends' are those members of the FTSE 100 class of January 2001 who were no longer publicly quoted in London at the end of 2007 for one reason or another: mostly because they have been taken over by overseas' companies or taken private.

Chart 2: TOTAL SHAREHOLDER RETURNS, %
FTSE 100 Class of Jan. 2001
Seven years to Dec. 2007



Source: Invesco Perpetual, February 2008

Selecting the winners of the future and avoiding the losers will only be possible if investors (and particularly pension fund trustees) take a far more robust approach to the institutions and organisations that have effectively caused today's pension problems. They should insist that their fund managers only invest their pension fund assets in companies where they are fully satisfied about the longer-term potential for the business. In short, they will need to behave like responsible owners, rather than speculators in shares. Recent estimates suggest that only about 20 per cent of the equity of US and UK public companies is held by investors who have a long-term stake in the health and success of the business.

Such an approach seems likely to require a fundamental change of thinking: a "back-to-basics" approach to managing investment portfolios which bridges the ownership gap, like the best venture capitalists who are very selective and only invest in a business after the most exhaustive enquiries. A typical successful venture house will see around 300 possible investments every year, take around 30 seriously and end up making perhaps five investments for their clients. The best fund managers are also very selective, turning over less than 25 per cent of the stocks in their portfolios every year.

However, avoiding the unacceptable returns from equities of the past will involve investors, as well as their fund managers, asking some penetrating questions before investing in (or retaining an investment in) any quoted company. Specifically, pension fund trustees and those managing their assets should spend most of their time worrying about investment: how to protect and grow their members' assets. No investment should be approved unless the company reflects the following eight qualities required to deliver superior returns to investors. These are what investor engagement with companies should be all about.

First, the underlying forces at work in the market favour the company. It is always much easier to row with the tide rather than against it; good managers are adept at spotting when the tide is about to turn and positioning their company to 'catch the flood'. For example, some will stand to benefit from increasing environmental concerns; others will be penalized. In the UK retail sector, some companies are more exposed than others to the uncertain future of the UK high street as house prices fall and debt-fuelled demand is reined back. Some companies are particularly well placed to exploit the lifestyle changes now under way in British society: more concern for health and exercise, more concern for the environment , more leisure travel. And so on.

Second, the company is the right owner of all the businesses within its portfolio, adding value as "a responsible parent". Managements very rarely suggest that parts of their empire should be de-merged or spun off. Yet experience (for example Carillion and Kesa) suggests that this can often generate significant shareholder value as the de-merged company gets the top management attention it deserves. Carillion, which was de-merged with Tarmac in mid-1999, today has a market capitalization almost double that of the entire Tarmac Group when the author joined the Tarmac Board in mid 1992; While Kesa now has a market 55 percent higher capitalization than Dixons, which one mounted a takeover bid for its former parent.

Third, the sales revenue is growing in real terms, without the need for mergers and acquisitions to mask management's failure to offer products and services that customers are ready and able to pay for. Recent analysis suggests that only a very small minority (perhaps one in six) of major UK companies are able to grow their top line organically at more than 5 per cent a year, even in good times

Fourth, the assets crucial to the company's competitive position are in good repair. The Chief Executive of Tesco once stated that the most important influence on his business is the balanced business score card which, amongst other things, takes account of the health of the most important aspects of the business: the people and property, as well as the financial returns and market share. In manufacturing companies, the intellectual property and the quality of the production equipment will be critical: world-class manufacturing performance is simply unattainable without world-class technology and asstes.

Fifth, management understands the importance of partnerships, with all the groups with a stake in the company's future – suppliers, customers, local communities and their people. Partnerships are much easier to talk about than they are to deliver in practice. However, partnership sourcing can transform the economics of producers in superficially unattractive markets. One London hedge fund stated that they were closing down because they had ill-advisedly shorted Geest shares; they were apparently unable to distinguish this company from its peers in the food industry.

Sixth, the company's financial position is sustainable, earning returns that exceed the weighted average cost of capital by a margin sufficient to compensate shareholders for the risks they are running. No investor should be backing companies that are effectively destroying economic value by earning returns below their cost of capital. Bain & Co. calculate that across the G-7 as a whole, in a test sample of 2,350 firms, some $2.4 trillion of value was destroyed over a recent 10-year period of strong global economic growth. This is comparable to the amounts lost due to the sub-prime crisis (or to corruption - on which governments and the corporate governance industry have tended to focus their attention).

Next, the company has sound leadership and an effective management team. It has been said that "there are no bad troops, just bad officers". The quality of any management is as important to any company's prospects as it is difficult to define. Public reputations are little better than a guide to the effectiveness of the corporate PR effort, as the demise of the 'hero-leader' concept illustrates: the people with the best track record of creating shareholder value are often virtually unknown to the investment community and to financial commentators. They succeed not by self advertisement but by building remarkably effective and cohesive teams, with shared values and a passion for winning. This was one of the secret ingredients in the relative success of the companies at the top of the total shareholder return chart shown above (see Chart 2); it seems to have been completely absent in many failed banks.

Finally, the Chairman and independent directors have the combination of competence, courage and commitment to call management effectively to account. In particular, they will be prepared to resign if they are not satisfied that the business is being run in the interests of all the stakeholders rather than the management. The best independent directors are those who can devote the necessary time, having reputations to lose and who can afford to resign when they do not like what they see. Quality is much more important than quantity.

Remarkably, very few investing institutions and even fewer analysts and commentators, pay any serious attention to these essential qualities to delivering superior returns. The results of their negligence are all too apparent in the collapse in the value of the UK's high street banks. However, there are (very few) exceptions, which investors would do well to search out. Such managers will probably conclude that fewer than one in five of the current FTSE 100 constituents qualify as attractive longer-term investments.

Positive Incentives

Finally, the interests of those managing pension holders' assets need to be much more closely aligned with those of their clients: just as public and private investors expect senior management to have a significant personal stake in the companies they are managing. Consultants and fund managers should be rewarded for creating wealth for their ultimate clients (Britain's pensioners) and for avoiding further costs for shareholders.

A duty of care on trustees to pension holders and the sponsoring company should replace the personal liability that simultaneously deters competent people from serving as pension fund trustees and gives consultants a marvellous excuse for the approaches to shareholders that are so prevalent today. In the US, a 'duty of care' requires directors to exercise an objective and reasonably prudent standard of skill and care in the discharge of their functions; it imposes an oversight responsibility to see that the company functions within the law to achieve its purposes.

Fees should also reflect both the costs of running any share portfolio (basically fees charged by an exchange traded fund) and an agreed proportion of the absolute net return achieved by the fund after all costs: 'no gain, minimum fee' should be the fund management equivalent of the 'no win, no fee' in the law courts, on both sides of the Atlantic.

Finally, clients are entitled to expect that their advisers follow their own advice by investing some of their personal resources in the funds that they manage: co-investment in the argot of the world of private equity. Any successful private equity investment will attest to the importance of senior management having significant 'skin in the game'. The author's own experience suggests that in public and private companies alike, extensive (but voluntary) employee share ownership is a powerful motivational force, contributing importantly to the success of the business in generating outstanding returns for investors. Westcountry Television - where employees collectively accounted for some 20 per cent of the equity in what turned out to be one of the most successful venture-backed investments of the 1990s - is an excellent example.

The next five years need not mean more of the same, only worse. However, this will be the result unless boards of directors become much more assertive: managing pension funds with the care and concern they devote to managing the business. They should be satisfied that they are not continuing to make the same mistakes; "if you do what you have always done, you will get what you have always got", as the saying goes. At minimum, pension fund trustees and boards should be asking their fund managers why they have held any of the stocks which have accounted for so much destruction of value for pensioners. They should be seeking assurance that their funds are being managed by people with a global perspective, avoiding the indexation fallacy, engaging with their main investments and with interests that are aligned with their beneficiaries.

Recent analysis of US experience of recessions since 1890 suggests that the stock market bottoms 9-12 months after the economy goes into recession and that the market rises over 40% in the next 12 months (all the rise is during just 20 trading days). Once the current crisis is over, the benefits from seizing the opportunities outlined above would be very substantial. Institutional investors behaving like responsible owners of businesses rather than short-term speculators in shares; successful companies rewarded with share prices that enable them to expand at home and abroad, using their shares as currency; and pensioners facing a much more secure future than now seem possible.