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Re-assessing the role of financial professionals in pension fund investment strategies

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Abstract

Funded pensions are now established components of most mature retirement income systems. The value of global pension fund assets is higher than ever before, and the way these assets are invested affects both the welfare of future retirees, and the performance of national economies. Recent research has identified systematic cross-national variation in the investment behavior of pension funds, explaining it through the preferences and influence of employer-sponsors and plan members. Yet the ongoing 'de-risking' of UK pension funds remains puzzling. Informed by the UK case, this article develops the argument that variation in pension fund asset allocation reflects the independent influence of networks of investment professionals who construct and institutionalize norms of liability driven investment.

Keywords:

Financialization; pensions; asset allocation; employers; crisis; regulation

I. Introduction

Funded pensions, where retirement income is paid out of accumulated financial assets rather than current income, are now firmly established components of most mature retirement income systems (OECD, 2016). The public policy importance of funded pensions has been cemented by strained Pay-As-You-Go (PAYG) arrangements, contributing to a 'financialization of the everyday' (van der Zwan, 2014) in which a range of social risks are increasingly insured on financial markets.

Despite being hard hit by two financial crises in the 2000s, the value of global pension fund assets is higher than ever (OECD, 2018). The way these sizable assets are invested is of consequence not only for the welfare of future retirees (Wiss, 2015; Yermo & Pino, 2010: 18), but also for the structure and performance of national economies (Clark, 2000, 2017; A.D. Dixon, 2008; Shiller, 2000).

Recent comparative research has identified systematic cross-national variation in the investment behavior of pension funds (OECD, 2016: 19; Yermo & Pino, 2010). To explain this variation, emphasis has been placed on understanding the investment preferences of employer-sponsors and plan members (Ebbinghaus, 2012; McCarthy, Sorsa, & van der Zwan, 2016; Wiss, 2015), as well as on understanding how pension fund governance structures the investment influence of these actors (Ebbinghaus & Wiss, 2011: 355-371).

Patterns of United Kingdom (UK) pension fund investment are puzzling by such accounts however. A Liberal Market Economy (LME) where pension fund governance is 'employer led' (Ebbinghaus & Wiss, 2011: 355-358), the UK is a context in which pension fund investment should be strongly geared towards equities. Yet, despite stability in the investment preferences and influence of employer-sponsors and plan members, the past fifteen years have seen UK pension funds 'de-risk' their investment portfolios and shift their asset allocation away from equities towards bonds.

In this article I examine the UK case and develop the argument that pension fund

asset allocation is not a straightforward reflection of the investment preferences and influence of employer-sponsors and plan members. Rather, it is in large part shaped by the independent influence of their agents - networks of investment professionals who have constructed and institutionalized norms of liability driven investment.

In the next section, I review existing explanations of variation in pension fund asset allocation. Section III presents the puzzle of the UK case, and section IV develops the expectations that inform my analysis. In section V, I present a narrative of the UK case, drawing on interview and documentary evidence to trace the process of change in pension fund investment decision-making since the 1990s. The final section is a discussion of this case in relation to the expectations that inform it. I set out the theoretical implications of my argument, with reference to recent developments in the strikingly different German context.

II. Employer-sponsors and plan members in pension fund investment strategies

Among institutional investors, pension funds stand out for the long-term nature of their liabilities. As a result, a first wave of political economy scholarship saw pension funds as a homogenous class of investor, expected to bolster equity markets by investing long-term in risky assets such as corporate stocks (Goyer, 2006: 400; Jackson & Vitols, : 6). By linking the investment strategies of pension funds to the nature of their liabilities, this strand of scholarship saw pension fund capitalism as a key feature of LMEs, as well as a potentially transformative force in Coordinated Market Economies (CMEs) (A.D. Dixon & Sorsa, 2009; Hall & Sockice, 2001).

More recently, a second wave of scholarship has drawn attention to heterogeneity in the investment behavior of pension funds. It has identified cross-national differences in pension fund asset allocation, challenging the idea that pension

fund capitalism is a force for convergence to the Liberal model. Far from adopting homogenous investment behavior, pension funds in LMEs tend to adopt 'risky' investment strategies based on relatively equity-heavy portfolios, while pension funds in Coordinated and Mixed Market Economies (MMEs) tend to adopt 'conservative' investment strategies based on investment portfolios that are relatively bond-heavy, (Wiss, 2015: 139).

Underlying this stylized pattern of cross-national differences in asset allocation are corresponding differences in pension fund governance. In CMEs and MMEs, the governing boards of pension funds are composed of members typically chosen by both sponsoring employers and employees (Stewart & Yermo, 2008: 6). The resulting strong plan member representation on pension fund governing boards is expected to ensure close alignment of the fund's investment strategy with the preferences of the fund's beneficiaries (Stewart & Yermo, 2008). In particular, member representatives are expected to skew the portfolio towards investments that are typically considered to be more conservative, such as government and corporate bonds (Ebbinghaus & Wiss, 2011: 367-371; Stewart & Yermo, 2008; Useem & Mitchell, 2000).

By contrast in LMEs, pension funds tend to take the legal form of a trust, in which trustees must administer the plan's assets in the sole interests of the plan participants (Stewart & Yermo, 2008). There are few or no legal requirements for member representation and occupational pensions tend to be 'employer led', with plan members exerting more limited investment influence (Ebbinghaus & Wiss, 2011: 355-358; Stewart & Yermo, 2008). Since employers are expected to prioritize lower contributions over stable and sustainable future benefits, such governance arrangements are seen to favor investment in equities (Ebbinghaus & Wiss, 2011; Harper, 2008; Stewart & Yermo, 2008; Useem & Mitchell, 2000).

Qualifying this stylized picture, McCarthy et al. show that plan members do not

always prefer lower yield, lower risk investments, and employer sponsors do not always prefer to invest in riskier assets (McCarthy et al., 2016). Rather, the investment preferences of business and labour are dynamic, influenced by pension fund financing needs, governance arrangements and regulatory context. In this way, McCarthy et al. explain changes in investment patterns that have occurred in the absence of change in the relative investment influence of business and labour (McCarthy et al., 2016: 760-762).

In sum, as political economists have increasingly sought to explain variation in pension fund investment behavior, they have shifted their attention away from the long-term nature of pension fund liabilities (Goyer, 2006; Hall & Sockice, 2001; Jackson & Vitols), towards the investment preferences and influence of employer-sponsors and plan members (Ebbinghaus, 2012; McCarthy et al., 2016; Wiss, 2015). Overwhelmingly, the underlying premise of second wave accounts of pension fund investment is that whether as ‘principals’ who delegate and monitor the investment decisions of appointed ‘agents’, or through direct representation on the pension fund boards, it is employers and employees who are ultimately responsible for making decisions about broad asset allocation.

III. A puzzling case of ‘de-risking’

The UK case stands out as puzzle when viewed in light of such explanations. While known for being heavily invested in equities in line with its ‘employer led’ pension fund governance arrangements (Ebbinghaus, 2011; OECD, 2013; Wiss, 2015; Yermo & Pino, 2010), the UK has seen a substantial and long-term shift away from equity exposure and towards bonds since 1994 (Myners, 2001: 54). Equity exposure more than halved after 2003, while bond exposure has increased by over 50 per cent in the same time period (see figure 2). As figure 3 shows, this shift is particularly notable in comparative context.

***** Figure 1 *****

***** Figure 2 *****

The trend is all the more striking because it precedes the immediate post-crash years when OECD countries retreated from equities (Antolin & Stewart, 2009; Ebbinghaus, 2012; Wiss, 2015; Yermo & Pino, 2010), and has carried on strong throughout an OECD-wide 'search for yield' in the protracted low interest rate environment (OECD, 2015). Although there has also been a simultaneous trend towards increased investment in 'other' assets, the overall trend has been towards assets typically seen as 'conservative' - even if 'other' investments are all classed as risky.

It is difficult to understand this shift in broad asset allocation with reference to the investment preferences and influence of employers and employees. The shift takes place without a corresponding increase in employee influence in pension fund governance. Moreover, two broad trends in workplace pension provision are likely to have shifted the investment preferences of employers further towards 'risky' asset allocation. The first is the well-documented trend from Defined Benefit (DB) to Defined Contribution (DC) arrangements (Munnell, 2006). The second is a less commonly analysed trend within DC arrangements from trust-based to contract-based provision (Ashcroft, 2009; UK Parliament, 2013).

In DB arrangements, which are almost always trust-based in the UK (UK Parliament, 2013), trustees acting as agents of the employer-sponsor have the duty to meet a pre-defined level of benefits. Since they face a considerable downside to failing to meet this target but derive limited benefit from exceeding it, they are usually incentivised to invest in a risk averse way (Bank of England, 2014: 20). In DC schemes, the employee/employer pay an agreed amount into the pension fund, but the income

received by the employee in retirement is dependent on investment returns, scheme charges, and annuity rates at retirement. In trust-based DC schemes, plan trustees have no duty to meet a defined level of benefits but they do have a duty to act in the interests of scheme members (Ashcroft, 2009: 5).

In contract-based DC schemes, which make up over half of UK DC schemes and are the main growth area in the UK pensions market (Ashcroft, 2009), pension funds are managed by a third party, such as an insurance provider, and operate on the basis of a contract between the scheme member and the provider. Since the provider responsible for making decisions on asset allocation is not bound by a duty of trust to plan members (UK Parliament, 2013), contract-based schemes have an incentive to maximize returns, and are expected to be less conservative in their asset allocation than trust-based schemes (Ashcroft, 2009; Bank of England, 2014: 20).

In sum, the strong trend away from DB and towards contract-based DC pension provision should have shifted the investment preferences of UK employers further towards 'risky' asset allocation. In the absence of a simultaneous increase in employee influence in UK pension fund governance, it is therefore difficult to understand the ongoing aggregate de-risking of UK pension funds with reference to the investment preferences and influence of employers and employees.

IV. Bringing financial professionals back in

In explaining the puzzle of the UK case, I embrace the institutionalism of existing accounts of variation in asset allocation. My analysis is guided by the assumption that asset allocation decisions are made by political actors whose influence and preferences are shaped by - and also shape - the institutional context. In existing accounts of pension fund investment behavior, employer-sponsors and plan members are the key political actors, and corporate governance arrangements constitute the relevant institutional

context. But in the analysis of the UK case that follows, I draw on recent research which points to the importance of financial professionals, and the broader institutional context of financial regulation.

According to this research, financial professionals involved in pension fund capitalism such as asset managers, actuaries, and pension consultants exert an independent influence over pension fund investment strategies. Pension fund trustees increasingly take asset allocation decisions on the basis of advice from investment consultants (Jenkinson, Jones, & Martinez, 2016; Tonks, 2005), and there has been an increase in ‘outsourced’ asset management in which pension fund trustees or governing boards delegate not only the implementation of asset management, but also key aspects of investment strategy including high-level asset allocation decisions (Clark & Unwin, 2017; Tonks, 2005). Labour trustees in particular are increasingly likely to delegate investment decisions to financial professionals (Verma & Weststar, 2011).

Financial professionals have their own distinct investment preferences. In particular, the literature paints a picture of international networks of financial professionals who construct and disseminate the investment norms guiding pension fund asset allocation. These norms are informed by investment beliefs – lenses through which financial markets are analyzed (Franzen, 2013; Koedijk & Slager, 2010). They constitute a ‘paradigm of pension investment’ (Ambachtsheer, 2005) or ‘standard of investment knowledge’ formulated and adopted on a global scale (Franzen, 2013: 15). Of particular importance here is a shared educational background among investment professionals schooled in modern investment theory by universities, business schools, and international accreditation bodies like the Chartered Financial Analyst Institute (Franzen, 2013).

Accounts of financial professionals enacting a global paradigm of pension investment tend to homogenize the investment behavior of pension funds, and cannot in

isolation explain observable variation in asset allocation. One way to account for such variation may be to combine these insights with those of research about how regulation constrains and shapes pension fund investment behavior. In particular, recent work has pointed to the role of quantitative investment limits (Ebbinghaus & Wiss, 2011) and accounting standards (Amir, Guan, & Oswald, 2010; Adam D. Dixon & Monk, 2009) in pension fund decision making, highlighting the tendency of such regulation to foster more conservative investment behaviour.

In the analysis that follows, I proceed inductively to develop an explanation for the de-risking of UK pension funds. I draw on documentary and interview evidence (see appendix for interview list) to trace the process of change in investment decision-making across the UK occupational pensions landscape. Looking beyond the investment preferences and influence of plan members and employer-sponsors, and informed by the research outlined above, I pay particular attention to the investment preferences and influence of financial professionals and the regulatory context in which they operate.

V. The UK ‘de-risks’

I start the analysis at the publication of the Myners Review of Institutional Investment (Myners, 2001). This review was commissioned in 2000 by the first Blair government, to examine possible investment distortions within UK financial institutions. As the first authoritative exposition of financial industry influence in UK pension fund investment, the report forms the starting point for the case. I then step back two decades, to trace the process of ‘de-risking’ back to the changing investment norms of financial professionals since the late 1980s.

Financial industry influence in DC and DB investment before 2000: the Myners Review

The influence of investment professionals over asset allocation is clearest in contract-based schemes. In its discussion of DC pensions, the Myners Review concluded that while in theory members of contract-based DC schemes could shape investment behavior by voting with their feet, in practice this occurred 'only in a minority of cases' (Myners, 2001: 54). A group of twenty-five life insurers were defining asset allocationⁱ, within a small market of passive consumers that offered few incentives for financial innovation (Myners, 2001; Interview 4). Investment practices were overwhelmingly characterized by 'lifestyling' – asset allocation would mechanically shift from equities to bonds as plan members neared retirement (Myners, 2001; Ashcroft, 2009).

Although the influence of investment professionals was most obvious in contract-based schemes, it was not confined to them. In trust-based schemes, whether DB or DC, it was the responsibility of the trustees to make investment decisions on behalf of the plan members. Yet, according to the Myners Review, trustees were 'heavily dependent on advisers' for investment decision-making - including for strategic asset allocation decisions (Myners, 2001: 8). The advisers in question were investment consultants, operating primarily within branches of actuarial firms (Myners, 2001: 64).

Investment consulting for pension funds had emerged as a business in the UK in the early 1980s, and grew fast in the 1990s. Trustees were not required to have expertise in investment - only to 'obtain proper advice' about it (Pensions Act, 1995). They therefore usually lacked professional qualifications in finance and were increasingly seen to possess neither the resources nor the expertise to make investment decisions (Myners, 2001: 4). Overall, the review concluded: 'although in law trustees are making the strategic asset allocation, in practice, there must be considerable doubt over the extent to which they are exercising genuine decision-making power' (Myners, 2001: 9).

In seeking investment advice, trustees had little choice between distinct investment allocation options. The investment consulting industry was 'small and highly concentrated' (Myners, 2001: 9), with 70 percent of the market split among four firms: Watson Wyatt, William Mercer, Bacon and Woodrow, and Hymans Robertson (Myners, 2001: 64). The reliance of both DC and DB schemes on investment advice that was so concentrated reinforced the development of dominant industry-wide investment norms, and the adoption of similar investment strategies across pension funds. Concentration had led to 'a commonality of investment policy among pension funds' and trustees were aware the advice offered by investment consultants did not vary greatly from practice to practice (Myners, 2001: 70).

Changing investment norms

While homogenous, investment norms have not remained static over time. In the 1980s 'asset only' investment approaches were dominant (Aon Hewitt, 2014; Chambers et al., 2005). Assets were invested in an 'off the shelf' (Aon Hewitt, 2014: 4) or 'one size fits all' (Myners, 2001) way, and asset allocation was not tailored to specific schemes. In particular, trustees ignored the liability profiles of their schemes, and 'mature and young schemes were invested side by side' (Aon Hewitt, 2014: 4). Assets were chosen for their growth potential, and pension funds were seen as long-term investors ideally placed to benefit from asset classes that were subject to higher volatility in the short term, but higher returns in the long run (Blake, 2003: 6).

Pension funds were encouraged to maintain a static and 'balanced' split across asset classes, typically consisting of 70 percent equities and 30 percent bonds and other assets. Since balanced funds targeted a performance benchmark consisting of the average return on a peer group of funds with a similar strategy (Chambers et al., 2005: 3), there were powerful herding incentives for asset allocation (Myners, 2001: 56). Over

time, this meant that even greater weight was given to equities as a result of their high historical returns (Chambers et al., 2005: 3). Under ‘asset only’ investing, UK pension schemes led the ‘cult of equity’ (Sutcliffe, 2005), and equities peaked at 79 percent of the aggregate DB portfolio in 1994 (Bank of England, 2014; Pension Protection Fund, 2016).

Already by the late 1980s and early 1990s however, actuaries and investment consultants had begun to construct an alternative investment paradigm, in which liabilities rather than assets were central. In response to growing dissatisfaction with the investment performance of leading balanced fund managers, analysis by investment consultants cast doubt on the ability of fund managers to consistently add value by tinkering with investments within prescribed asset allocation boundaries (Myners, 2001: 54). Instead, drawing on academic studies (e.g. Ambachtsheer, 1987; Leibowitz, 1987; Winklewoss, 1982), pensions consultants began to stress the importance of making investment decisions with liabilities in mind.

Consultants trained in actuarial science began to recommend the use of Asset Liability Management (ALM) to assist trustees in setting their asset allocation strategy (Myners, 2001: 54). This involved the use of quantitative techniques to structure the asset portfolios of pension schemes by paying ‘due regard to the structure of their liabilities’ (Blake, 2003). The practice began to take hold among large pension schemes, and by 1990 an estimated 30 percent of UK DB pension funds were applying ALM (Blake, 2003).

Liability-driven investment becomes institutionalized

The increased attention that trustees were advised to pay to liabilities was encouraged by the Minimum Funding Requirement (MFR), introduced in 1997. A response to public concerns about the security of occupational pensions following the Maxwell scandal, the MFR introduced for the first time the requirement that pension

schemes hold a minimum level of assets to meet their liabilities (Thurley, 2008). As a result, it highlighted the need for trustees to consider their fund's potential asset-liability mismatch (Thurley, 2008). Crucially, the MFR was designed and drafted by the Faculty and Institute of Actuaries. Actuarial and consulting firms, who benefited from the corresponding requirement that pension trustees obtain professional actuarial valuations for their funds (Thurley & McInnes, 2017), were key in introducing this regulatory development that encouraged liability sensitive investing (Blair, 1995; Blake, 2001).

As pensions consultants promoted liability sensitive investment within the new regulatory framework, the use of peer benchmarked balanced funds declined steadily (Aon Hewitt, 2014; Chambers et al., 2005; Franzen, 2013). By the end of the 1990s, it was barely half as prevalent as it had been at the beginning of the decade (Myners, 2001: 54). ALM became increasingly common practice, and sophisticated asset-liability models were developed by North American and British researchers in close co-operation with practitioners (e.g. Mulvey and Towers-Perrin, 1996). Initially confined to the biggest pension funds, ALM was 'implemented in cascades starting at the largest market player' and gradually became the industry standard (Franzen, 2013: 120).

As the use of ALM spread, it further reinforced the influence of investment consultants in strategic asset allocation decisions. The investment alternatives produced by ALM depended heavily on the underlying assumptions of the asset-liability model. Yet trustees lacked the technical expertise to challenge complex models or their underlying qualitative judgments. Among schemes using an asset-liability model at the time of the Myners Review, trustees were involved in the setting of underlying assumptions in only 30 per cent of cases. Myners concluded that consultants were 'the sole source of serious qualitative input' to asset-liability models (Myners, 2001: 59).

Gradually, the UK started to shift away from the 'cult of equity' towards asset allocation that was more closely shaped by the liability structure of UK DB pension schemes. In particular, asset allocation began to reflect the demographic differences between funds, as well as a number of what investment professionals call 'technicals' such as inflation and interest rates (Interview 1). As an increasing number of corporate DB pension funds began to close to new entrants, DB scheme membership came to consist of a greater, and increasing, proportion of retirees and a smaller, and decreasing, proportion of members in the accumulation phase. From 1994, this maturing of pension plan liabilities within the new context of liability-sensitive investment drove a decrease in aggregate DB allocation to equities and an increase in allocation to index-linked bonds (Mercer, 2014; Pension Protection Fund, 2016).

This trend was further strengthened by the publication of the Myners Review. Drawing heavily on consultation responses from the financial community, the Review sought to institutionalize a scheme-specific funding standard reflecting the maturity structure of the liabilities of each pension scheme. This recommendation, which was immediately accepted by the government (HM Treasury and the Department for Work and Pensions, 2001), further incentivized the selection of asset classes on the basis of their volatility match with scheme liabilities. In addition, the review had the effect of further strengthening the investment advisor relative to both the actuary and the fund manager (Blake, 2003), encouraging pension funds to 'spend more on asset allocation' to improve investment decision making and investment returns (Myners, 2001: 60).

The Myners Review was closely followed by the implementation of FRS17 in 2003. This accounting standard faced criticism from both unions and employer sponsors, but was accepted by the investment industry. It became policy in a depoliticised way, on the basis of the professional judgment of the Accounting Standards Board (Bridgen & Meyer, 2009; Veron, 2007). FRS17 replaced the MFR, but continued to reinforce the shift of pension fund assets into bonds (Blake, 2003).

Crises reinforce the trend towards liability-driven investment

The final chapter of the UK's de-risking story begins with the 'perfect pension storm' of falling equity markets and simultaneously falling interest rates between 2000 and 2003. This toxic combination eroded assets while sending liabilities soaring. It signaled the end of the traditional balanced mandate of a fixed portfolio mix of equities and bonds, as it became apparent that this approach exposed pension schemes to considerable funding gaps (Franzen, 2013). Moreover, the regulatory response, which took the form of the Pensions Act of 2004 and the creation of the Pensions Regulator (tPR), strengthened the imperative for trustees to avoid funding gaps (Franzen, 2010; Interview 4).

The global financial crisis of 2007-08 inspired no further regulation relevant to strategic asset allocation. However, interview evidence suggests a perception among trustees of a hardening of the stance of tPR towards funding gaps (Interview 4, Interview 5). This perception has further discouraged trustees from questioning investment advice (Interview 4).

As a result, almost two decades since the Myners Review first identified the heavy dependence of trustees on investment consultants, the influence of the consulting industry is at an all time high (CMA/IFF Research, 2018; IFF, 2018; OMB Research, 2016) and the overwhelming majority of clients purchase advice on strategic asset allocation (Bank of England, 2014: 19, 36). Trustees continue to have little choice in asset allocation since the provision of investment advice remains highly concentrated – now in the hands of the 'big three' investment consultancies, Mercer, Aon Hewitt, and Willis Towers Watsonⁱⁱ. ALM is standard in the market, with nearly 90 percent of schemes basing their investment decisions at least in part on an asset-liability study (Bank of England, 2014: 19, 36; Franzen, 2013: 244). Moreover, within the practice of

ALM, the link between assets and liabilities has been successively tightened (Franzen, 2013: 243).

Changing patterns of asset allocation in DB and DC investment

The industry's emphasis on liability driven investment has resulted in similar asset allocation for a given set of liabilities across firms (Bank for International Settlements, 2007; Bank of England, 2014: 20). Differences in scheme maturity correspond closely with differences in the relative proportion of the fund's portfolio invested in equities and bonds (Pension Protection Fund, 2016), and go a long way towards explaining the much greater degree of 'de-risking' by corporate pension funds as compared to the local authority pension funds (Bank of England, 2014: 39). Over time, maturing liabilities have driven the continued aggregate decrease in DB allocation to equities. By 2016, equity allocation had fallen to just 30 per cent of the aggregate DB portfolio (Mercer, 2014; Pension Protection Fund, 2016), while total bond allocation had risen to 51 per cent (Bank of England, 2014; Pension Protection Fund, 2016).

The de-risking of UK pensions has overwhelmingly been driven by the asset allocation patterns among DB schemes (Mercer, 2014; Pension Protection Fund, 2016). While there has been some de-risking among DC schemes, most continue to rely primarily on equities (Schroders, 2016). In 2016, the average default DC fund of a FTSE 350 firm invested just under 67 per cent of its total assets in developed equities, only 16 per cent in bonds, and 13 per cent in alternatives (Schroders, 2016).

Yet, this risk-heavy profile does not reflect a starkly different underlying investment strategy on the part of the investors of DC pension scheme assets relative to those of DB schemes (Interview 4; Interview 5; Interview 1). While DC schemes do not have liabilities strictly speaking, the dominant investment practice of 'lifestyling' - recently super-ceded by conceptually similar individual 'glidepaths' - ensures that asset

allocation in DB and DC schemes is shaped by scheme demographics to a similar extent (Interview 4; Interview 5; Interview 1). Thus the high equity exposure of DC schemes primarily reflects the fact that they are still - on aggregate and relative to DB schemes - young and in the accumulation phase (Interview 1, Interview 3, Interview 5).

Moreover, asset allocation in DC schemes is increasingly structured 'as if' to match liabilities, taking into account the expected effect of changes in 'technicals' like interest and inflation rates on individual benefits (Interview 5; Interview 3). Two of the 'big three' investment consulting firms pioneered Liability Driven Investment (LDI) for DC schemes (Payne, 2006), and asset allocation started to become less equity-heavy, despite the youth of the sector (Ashcroft, 2009).

VI. Discussion and Conclusion

The starting point for the preceding narrative was that it is difficult to understand the ongoing de-risking of UK pension funds with reference only to the investment preferences and influence of plan members and employer-sponsors. Although employers continue to have more of a role in pension fund governance than employees, and the spread of DC arrangements means that employers bear less of the risk of pension fund investment decisions, the share of equities in pension fund portfolios has declined steadily over the past 25 years.

In analysing the UK case, I have been guided by recent research highlighting the independent influence of financial professionals in shaping pension fund investment behavior, and the regulatory context in which they operate. My findings lend support to these insights, but also allow us to go beyond them.

The UK case shows how pension fund asset allocation was shaped by the independent influence of networks of investment professionals - most notably, a concentrated industry of actuaries and investment consultants - who constructed and

institutionalized norms of investment that increasingly took into account the specific structure of pension fund liabilities.

In the context of liability driven investment practices, the de-risking of UK pension funds has been fueled mainly by the sharply maturing liability profiles of DB schemes. Pension scheme demographics, as well as other ‘technicals’ such as inflation and interest rates, emerge from the UK case as important economic values that shape asset allocation in the context of liability sensitive investing.

The implication of this is that the homogenous class of institutional investors, identified by first wave accounts of financialization, should not necessarily constitute pressures for institutional convergence. Rather, the liability-focused investment norms constructed by these investors bring about variation in asset allocation, according to the economic and demographic circumstances that structure pension fund liabilities. In this way, homogenous investment norms may be important in explaining variation in pension fund investment patterns, both across countries and over time.

As expected, regulation also had an important role to play in shaping asset allocation. The Minimum Funding Requirement, FRS17, and the Pensions Act of 2004 all contributed to the de-risking trend, by incentivizing pension funds to closely match their assets to their scheme’s liabilities. Yet, the analysis presented here gives causal primacy to the agency of investment professionals rather than to the regulatory context. The case study shows how the beginnings of the shift towards liability-sensitive investment preceded all relevant regulatory activity. Pensions consultants and actuaries initiated the underlying change in investment norms, and were also the key players in the introduction of the MFR.

My account of UK de-risking does not depart from the institutionalism of existing accounts of variation in asset allocation. Asset allocation decisions are still made by political actors, whose preferences and influence shape and are shaped by the

institutional context. Within the bounds of institutionalism however, my theoretical contribution is twofold.

First, I show that patterns of pension fund asset allocation are only partially shaped by employer sponsors, by plan members, and by the institutions of corporate governance. At least in some cases, they are defined by the independent influence and preferences of investment professionals, and the regulatory context which they help shape and in which they operate.

Second, ideas play a more central role in my argument than they do in existing explanations. While existing explanations depart from the premise that some assets are more risky than others, the explanation developed here shows how the concept of risk is itself socially constructed, with implications for investment preferences. Under asset-only norms of investment, demographic differences among pension schemes did not lead to differences in asset allocation. But where the risk of holding an asset is understood relative to the liabilities it must fund, pension fund demographics, as well as prices like interest rates and inflation rates, become central to strategic asset allocation decisions.

If the argument developed in this paper is correct, we should observe pension schemes with similar demographics, facing similar market prices, and operating within similar regulatory environments to display similar patterns of asset allocation - regardless of the system of corporate governance. Although beyond the scope of this article to offer a quantitative or in-depth qualitative test of whether this is the case, recent developments in Germany seem to offer preliminary support for the argument. A CME with diametrically different pension fund governance arrangements to the UK, and lacking an established and powerful pensions industry, Germany constitutes a tough test for the argument developed in this paper.

In the early 2000s, two new occupational pension vehicles – Pensionsfonds and

Contractual Trust Arrangements (CTAs) - were introduced to the German pension system. These vehicles were subject to very few investment restrictions. They were to operate in a regulatory context similar to that of UK pension funds, and much more liberal than that of existing retirement savings vehicles (Ottawa, 2008; Rössler, 2000).

This investment freedom attracted financial professionals to a country where pensions consultants and asset managers had previously had little investment influence (Wagner, 2006). The industry brought with it a 'more holistic asset-liability approach' to making strategic investment decisions than the asset-driven approach that dominated investment decision-making in existing vehicles (Cresswell, 2017). The new pension funds adopted asset allocation practices similar to those of equivalent UK DB schemes (Interview 2), resulting, as figure 3 showsⁱⁱⁱ, in a higher aggregate equity exposure than (more mature) DB funds in the UK, and a much higher exposure than the regulated pension vehicles (Mercer, 2011, 2012, 2013, 2014, 2015, 2016).

Particularly striking is that this equity-heavy asset allocation occurred in the context of CTA and Pensionsfonds governance arrangements that have tended to reflect existing patterns of German corporate governance in terms of employee representation (Rössler, 2000). Indeed, unregulated vehicles have quickly become popular with unions, who expressed little concern about investment consequences of regulatory freedom, and have embraced the outsourcing of investment management to investment professionals (Ziegler, 2008).

The arrival of these newcomers to the German pension landscape may also produce pressure for change in investment practices in Pensionskasse, Direktversicherungen, and Unterstützungskasse, the traditional, regulated German occupational pension vehicles. Restricted by quantitative limits on investment in each asset class (ABA, 1999) and by BaFin's strict stress-test parameters (Franzen, 2010; Ottawa, 2014), these vehicles continue to have among the lowest equity exposures of all the European pension industries, investing only 13 per cent of their portfolios in

equities on average between 2011 and 2016 (Mercer, 2011, 2012, 2013, 2014, 2015, 2016).

Yet, industry commentators have noted a ‘quiet revolution’ among regulated vehicles in terms of an increased influence of consultants and fund managers (Ottawa, 2013; Röhrbein, 2012a, 2012b), and most regulated pension funds now express a desire for higher exposure to equity depending on individual fund demographics (Franzen, 2010; Ottawa, 2014).

A CME without a long-established pensions industry, Germany constitutes an unlikely case for this paper’s argument. Yet even here, there are signs that asset allocation is being similarly shaped by the liability-driven investment norms of financial professionals, within the confines of a bipartite regulatory framework.

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Acknowledgements

This paper has benefited from the expertise of seven generous interviewees, three excellent reviewers, and each one of the STARS workshop participants. I am particularly grateful to Waltraud Schelkle, Anke Hassel, Tobias Wiss and Pieter Tuytens.

Figure 1. Broad asset allocation in UK pension funds. Source: Mercer (2016).

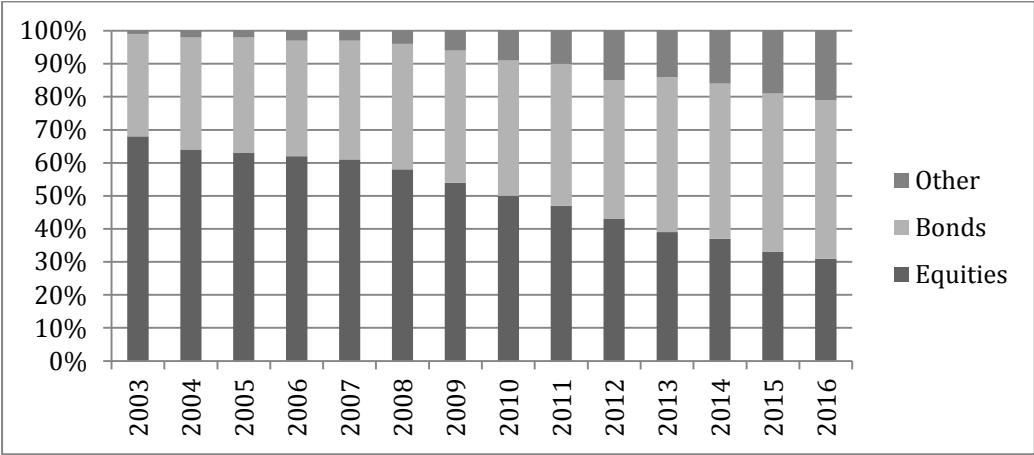


Figure 2. Variation of investments in equities, bills and bonds, 2004-2014 (OECD, 2015).

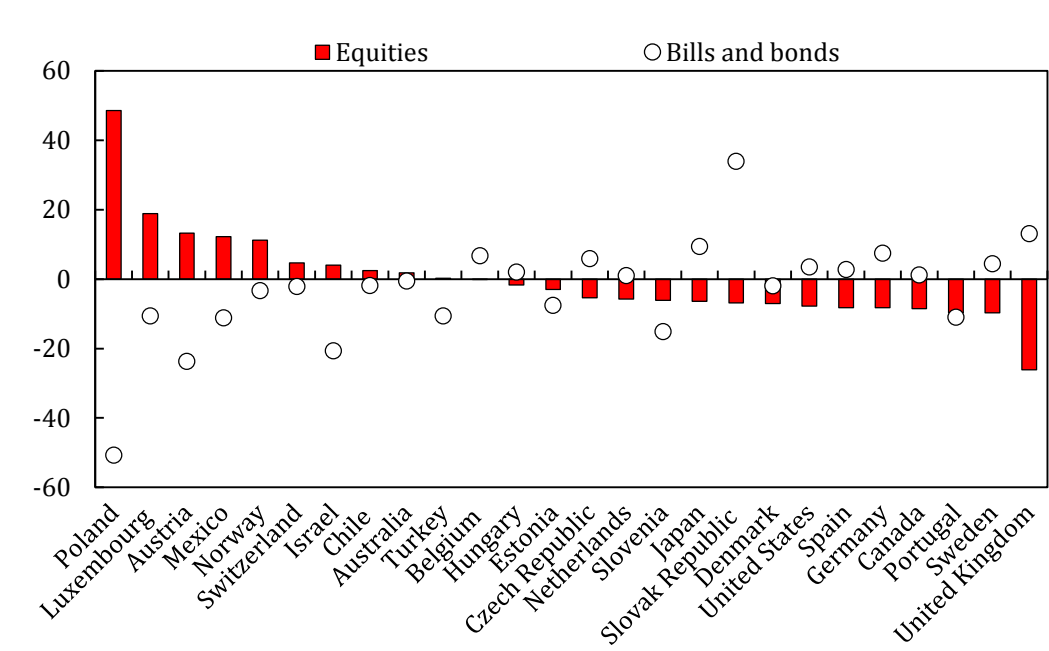
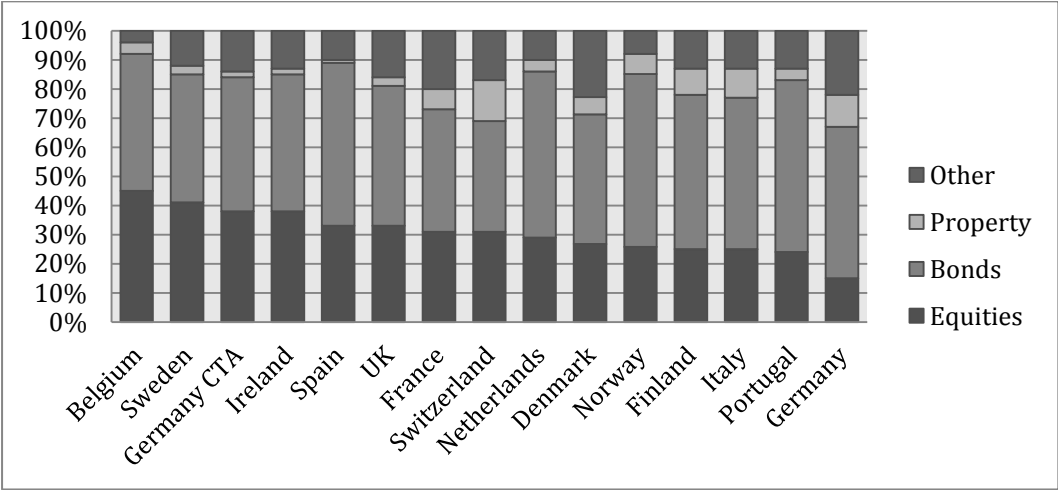


Figure 3. Broad strategic asset allocation by country. Source: (Mercer, 2015).



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Words: 7998

Appendix: Interview List

I include evidence from seven semi-structured elite interviews conducted between May and July 2018:

Interview 1, Asset manager: Senior Retirement Strategist, Vanguard Asset Management Ltd

Interview 2, Actuary: Head of Strategic Development at Pensions Insurance Corporation

Interview 3, Consultant: Head of UK DC Solutions, Aon

Interview 4, PLSA Policy Lead: Defined Benefit and Investment Policy Lead, Pensions and Lifetime Saving Association (PLSA)

Interview 5, In-house asset manager: Head of Strategy Coordination, Universities Superannuation Scheme (USS)

Interview 6, Union-appointed trustee: UCU-appointed Director of the USS Board of Trustees

Interview 7, Employer-appointed trustee: UUK-appointed Director of the USS Board of Trustees

ⁱ See Myners (2001: 128) for full list of insurers and their respective market shares.

ⁱⁱ The big three account for over 50% of the market, while the top six firms account for an estimated 70% of DB schemes (NAPF, 2014).

ⁱⁱⁱ The graph focuses on CTAs for reasons of data availability. These make up over 80% of the assets of unregulated vehicles (Franzen, 2010; Schmid & Menne, 2014).