

Rethinking Investing from the Ground Up: How PFZW and PGGM Are Meeting This Challenge

Jaap van Dam

Jaap van Dam is Director of Investment Strategy at the pension service organization PGGM (Netherlands). PGGM's major client is Pensioenfonds voor Zorg en Welzijn (PFZW), the pension plan for the Dutch health care sector; Jaap was responsible for the content of the PFZW-PGGM project described in this article.

In 2013, Pensioenfonds voor Zorg en Welzijn (PFZW), the second-largest pension fund in the Netherlands, adopted an ambitious set of investment principles – formally titled the Investment Framework – following an 18-month process that began by asking, “What if we could start investing from scratch?” and during which PFZW’s Board members interviewed more than 30 industry experts from around the world. The project produced three important results. First, the PFZW Board has taken full ownership of the resulting investment principles. Second, the project created a powerful common language, both inside PFZW and with the investment organization PGGM. Third, it produced a fresh set of investment principles that combines lessons from the global financial crisis with a desire for strong integration of sustainability factors in investment decisions.

Keywords: Investment Beliefs, Investment Strategy, Pension Fund, Social Responsibility, Sustainable Investing

The Project and the Players

In 2013, Pensioenfonds voor Zorg en Welzijn (PFZW), the second-largest pension fund in the Netherlands, adopted an ambitious set of investment principles, formally titled the Investment Framework. These principles were the outcome of an 18-month process that started with one fundamental question: “What if we could start investing from scratch?” The project was named (in somewhat awkward English) the White Sheet of Paper Project. As part of the process, PFZW’s Board members interviewed more than 30 industry experts from all over the world.

The Investment Framework is structured to find investment solutions that consider the financial ambitions and aspirations of PFZW pension plan members and also allow PFZW to use what the organization calls “the steering power of money” to achieve its sustainability objectives. This required a conscious decision to deviate from the efficient markets thinking that formerly prevailed at PFZW. The new framework both accepts dynamic changes in asset allocation over time and emphasizes bottom-up investing rather than the strong benchmark orientation that remains common practice in the institutional investment world. The new framework will be implemented as soon as is practical before 2020.

PFZW is the compulsory defined benefit (DB) plan for the workers in the Dutch health care industry, with more than 2.4 million predominantly female participants. Fund assets amounted

to US\$190 billion at the end of 2013. The PFZW Board consists of employer and employee representatives, with an independent Chair. PGGM is PFZW’s pension service organization; it is responsible for, among other things, risk management, fiduciary advice on investment policy, and the actual management of all investments, both internal and external to PGGM.

PFZW and PGGM were one organization (called PGGM) until 2008, when – for several reasons, including regulatory ones – they became separate entities. PFZW has a very lean structure, consisting of the Board and several committees, including an Investment Committee; the Board is supported by a staff of 20. In contrast, PGGM has more than 1,000 employees, of whom approximately 400 have some involvement in formulating investment policy or managing assets.

Project Origins

The global financial crisis (GFC) and its aftermath led PFZW’s Board to reflect on the following:

- Is the “efficient markets” paradigm relevant for us? Although PFZW invested largely in line with efficient markets principles, it again sustained significant losses, in terms of returns and solvency ratio, less than a decade after the dot-com crisis of 2000–2002.
- Looking ahead, it appears that both the long-term risk

capital we provide and the returns we need to earn on it have become scarcer. How do we cope with this problem?

- The implied license to operate traditional defined benefit (DB) pension plans can no longer be taken for granted. Societal trust in pension arrangements is at a very low level. How do we cope with this?
- Although we are recognized as one of the most sustainable pension plans in the world, movement toward sustainability in the real economy seems to be much more pronounced and salient.

While the GFC was the catalyst, there were four other reasons for initiating the project. First, after becoming a separate entity, PFZW began to develop an identity at a certain distance from its service provider. Being the asset owner, PFZW believed that it should formulate and own the principles for investing. Second, the GFC prompted questions about PFZW's role in the real economy that encompassed a broader scope than traditional investment questions. For example, does our asset portfolio include investments or investment categories that are harmful to the economy in general, or to parts of the financial sector in particular? Being a large asset owner with a long horizon, should PFZW not contribute to the economic and sustainable well-being of society instead of being agnostic to them? Third, there were questions about pension board control and competence. Are Boards in control of investment policy and its implementation? Who is really at the helm of the fund? Is the Board fully able to cope with the complexity of the investments? Finally, the separation between pension plan and service organization substantially lengthened the investment chain and brought in many new faces. The PFZW Board felt that having a strong set of principles would get everybody in the chain moving in the same direction and speaking the same language. These factors together brought the White Sheet of Paper Project into being in late 2011.

Project Design

The project had broad support within the PFZW Board; Board members were willing to devote considerable time to the project over the course of its several phases, which lasted 18 months in total. Six Board members, predominantly members of the Investment Committee, were willing and able to spend one day per week or more on the project. They proved to be its driving force, both inspiring the PFZW Board and directing the PGGM organization.

To provoke fresh thinking, the project adopted an “outside in” approach, meaning that the committed Board members took upon themselves to gain access to the best investment thinking in the world. The central question to be answered was stated as follows: “How can we invest in a way (1) suited to the financial ambitions of our plan participants, (2) in which sustainability is

fully integrated, and (3) that is intelligible and controllable?” These three larger questions were in turn broken down into a “pyramid” of 27 (3 × 3 × 3) more detailed questions.

This 3 × 3 × 3 pyramid was the central beacon in the design of the project. Based on the top three questions, the project was divided into three pillars, each of which took four to five months to complete. The whole process, which culminated in the Investment Framework, was geared toward answering these three primary questions.

Project Implementation

The specific challenge was this: How can PFZW find investment solutions that, as much as possible, realize the *financial ambitions* of its plan participants while integrating *sustainability* into investing, with investment processes that are *well understood and controllable* by the Board?

We decided that within each pillar, the “rhythm” of the process would be the same. Phase 1 was the “divergent phase,” geared toward opening minds and internalizing fresh thinking. Phase 2 was the “convergent phase,” in which Board members would decide how the information from the outside world would transform into the Investment Framework. Within each pillar, Phases 1 and 2 each ended with a large, interactive Board session lasting three to four hours; a few PGGM staff members were in the room during these sessions, mostly in the background, to ensure that PGGM understood the Board's thinking.

Preparation for these full Board meetings consisted of the following steps:

- **Collecting and discussing relevant, accessible literature on the key topics in the pyramid.** PGGM staff collected and summarized this literature.
- **Interviewing experts.** For each of the three pillars, 10 external experts on the topic at hand were invited to participate. For example, the six involved Board members interviewed peer investors such as Angeliem Kemna, strategic advisors such as Keith Ambachtsheer, and original investment thinkers such as Antti Ilmanen; PGGM staff then wrote up these interviews for the Board.
- **Asking Board members to fill out workbooks containing statements on the topics at hand.** Their ratings of these statements, which ranged from “like” to “dislike,” were gathered and processed to produce very clear input as a starting point for discussion.
- **Inviting a number of “contrarian thinkers” to address the full PFZW Board.** These speakers were asked to be very explicit about what PFZW should keep doing, what it should change, and what it should stop doing on the topic under review, which led to very intense and thought-provoking discussions.

During these exchanges, the project team took great care to document all the outcomes. The outcomes of interviews were written up, and each exchange led to a document summarizing the discussions. Three separate “pillar documents” were created out of these exchanges, which formed the basis for the final document that created the Investment Framework.

PFZW’s Investment Framework, 2013–2020

The resulting PFZW Investment Framework summarizes, in 12 pages, the identity and the ambition of PFZW, the new context in which the plan now operates, and the 16 beliefs and principles that will govern PFZW’s investments going forward:

1. Beliefs and Principles Regarding Investment Policy

- Investment is necessary to achieve our pension ambition with an acceptable level of contributions. This is possible with acceptable risks.
- We assume our social responsibility by contributing tangibly to a sustainable, viable world.
- A sustainable, viable world is necessary to generate sufficient returns over the long term.
- Only a limited number of fundamentally different sources of return reward the assumption of the associated risk over a longer horizon. This means investment solutions can comprise a limited number of elements.
- The world is fundamentally uncertain, and future developments are difficult to predict. A robust investment solution is one aimed at fulfilling the ambition in the long term while taking account of this uncertainty.
- Innovative investments are necessary to continue to achieve our ambition in the future.

2. Beliefs and Principles Regarding Policy Implementation

- To achieve our ambition, we must issue clear mandates. Good implementation requires asset managers to adopt a critical attitude with regard to their mandates.
- The policy implementation is fully geared to the efficient fulfillment of the pension ambition. This requires customized benchmarks that differ from those of the investable universe as a whole. We do not see “beating” benchmarks in the short term as an efficient means of achieving the ambition.
- A focused portfolio of investments of which we have a thorough knowledge and that fits in well with our identity can contribute effectively to achieving the ambition.
- Costs are an important component of the return and therefore need to be controlled.
- PFZW has its own views on a responsible remuneration policy.

3. Beliefs and Principles Regarding Governance and Control

- The Board is responsible for the policy and its implementation and reports on it to plan participants.
- Intensive cooperation between PFZW and its service provider, PGGM, gives PFZW greater control of the implementation of its investment policy.
- Critical countervailing power is required to make the right investment decisions and ensure adequate implementation.
- Focus increases controllability and reduces risk in the investment policy.
- Complexity is used only if it is appropriate for the achievement of PFZW’s pension ambition.

Some observations, explanations, and comments on these beliefs and principles follow.

Sustainability

The PFZW investment beliefs and principles on sustainability are based on the idea that PFZW assumes a responsibility for contributing tangibly to a sustainable world and that, at the same time, a sustainable world is a necessary condition for generating adequate returns over long investment horizons. In other words, taking the long view, PFZW cannot afford to see a sustainable world as an externality. This idea goes beyond the typical ESG framework: the health of the entire financial system is at stake. The large amount of capital entrusted to PFZW makes it a responsible party. Moreover, given its size, PFZW can make a serious impact – the phenomenon known as “the steering power of money.”

The Investment Framework document does not hesitate to make outspoken statements:

Contributing to a sustainable, viable world requires a decisive approach, with carefully considered, relevant and sometimes daring choices when it comes to making investment decisions. That means we deliberately make certain investments while avoiding others. By targeting the assets entrusted to us and the influence they give us, we can make a positive contribution and minimise the negative aspects of our footprint.

Moreover, the document notes that

In order to fulfil our pension ambition, both now and in the future, we must handle the ultimately scarce constituents of return, such as raw materials, capital and people, with the utmost care. Making sustainability an integral part of the investment policy therefore contributes to returns over the long term. That requires us to invest in ways that are not always in line with current thinking on investment.

We are largely dependent on the health of the financial system in order to generate returns. We believe a short-term focus poses a risk to the stability of the financial system. We occupy a position at the beginning of the financial chain, from where we can play a pioneering role in promoting a more sustainable financial system – on the one hand by demonstrating exemplary behaviour and on the other by exerting our influence to encourage parties within and outside the financial sector to conduct themselves with a view to the long term.

Parsimoniousness, Flexibility, and Uncertainty

The PFZW Investment Framework recognizes the value of parsimoniousness, given that the number of return sources is limited. By making the investment solution as parsimonious and simple as possible, the Board can expand its overview and understanding of the investment process. No sacrifice in terms of risk or return is implied; essentially, many “investment categories” are differently packaged forms of the same underlying ingredients.

The beliefs and principles for coping with uncertainty and dynamically adjusting the investment solution through time have two core components: First, that strategic asset allocation decisions should be as robust as possible for a broad set of potential socio-economic regimes; and, second, there are limited opportunities to detect major dislocations in terms of valuation, the financial/economic state of the world, and other major risks that will predictably influence future returns on a 3- to 10-year horizon:

A long-term focus is key... To a certain extent we are able to identify in time those circumstances which, for example, could result from major economic imbalances or extreme valuations and lead to major risks or opportunities. If our view of the future changes so substantially that the current policy no longer fits in with the ambition or could produce undesirable outcomes, the investment policy may be adjusted.

This principle was absent in PFZW’s former thinking, and therefore no mechanisms or processes existed to change the policy when relevant circumstances changed. Note that such mechanisms are part of policy determination rather than policy implementation.

Investment Management

The PFZW Investment Framework addresses principal / agent issues between the fund and its investment managers. It favors long-term relationships and acknowledges the existence of leakage – in the form of agency costs, short-termism, and actual fees paid – that must be addressed in relationships with investment managers. It also requires investment managers to be aware that sustainability is deeply rooted in what PFZW wants:

Pensioenfonds Zorg en Welzijn is aware of agency issues and the sometimes invisible costs which can arise in outsourcing and takes measures in order to control and minimize these as far as possible. As part of these measures we expect asset managers to act, in terms of both letter and spirit, in accordance with PFZW’s interests. That applies to the contribution to our ambition and to the contribution to a sustainable and viable world.

The related issue of designing and implementing investment management mandates has several dimensions. An important one is the notion that “alpha is not the solution to the pension fund problem,” attributed to Lionel Martinelli of EDHEC. Another is the recognition that a benchmark is a means rather than an end: the benchmark should be geared toward the end, which is fulfilling both financial and sustainability goals. The resulting question – “Why is this benchmark an efficient means to solve our problem?” – should lead to better benchmarks, in both financial and sustainability senses: “Does this benchmark reflect our thinking?” In short, we are looking for direct links between ambition and investment management. Needless to say, this transition will not be achieved overnight.

All this leads to focused investing as a logical alternative to a benchmark orientation in which every deviation from the benchmark is classified as “risk.” Focused investing creates the opportunity for PFZW to play a more active role in capital markets, acting as owners rather than holders of financial titles and investing where we have the confidence that we are turning savings into wealth in a sustainable way:

In addition to the creation of broadly diversified “anonymous” mandates, Pensioenfonds Zorg en Welzijn also expects a favorable risk–return profile to be achieved through more focused portfolios of investments of which we have a thorough knowledge. We then look through the market to the company itself, focusing fully on the long-term risk–return profile. It is the underlying cash flows that are important in the investment decision, not the market index.

Moving Forward

The Investment Framework described here was adopted by the PFZW Board in June 2013. In June 2014, the Strategic Investment Plan 2014–2020 is expected to be completed. This plan translates the framework into several SMART objectives for 2020 and draws a roadmap for getting there. The plan distinguishes between incremental change – being more intense and effective in what we are doing already – and transformational change – fundamentally changing the way we operate. For example, the review of benchmarks following from the new investment beliefs and principles and the move toward focused investing are elements of transformational change.

The Strategic Investment Plan provides a clear framework to incorporate transformational changes in a controlled way, while at the same time providing opportunities for learning by doing in order to prevent analysis paralysis. The plan defines three stages. In 2014/15, all the groundwork for change will be laid, and implemented where possible, to keep the momentum of change as strong as possible. In 2016/17, big steps will be taken toward full-scale implementation. As plan implementation proceeds, there will be windows to take a critical look at how the Plan is unfolding, and to make adjustments if necessary.

After the Allied victory in the Second Battle of El Alamein in late 1942, Winston Churchill cautioned that this was not necessarily the beginning of the end of World War II, but was perhaps the end of the beginning. Similarly, it is too early to claim victory for our White Sheet of Paper Project, but we feel we have made a good beginning.

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105 St. George Street
Toronto, Ontario Canada M5S 3E6
Tel: 416.925.4153
icpm@rotman.utoronto.ca
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