

Pension Funds as Institutional Investors: Investment Performance before Ownership

Anna Tilba* and Terry McNulty

Anna Tilba obtained her PhD in corporate governance from the University of Liverpool, Management School, UK in 2011. Her main research interest includes corporate governance, institutional investors and corporate engagement. She reviews papers for such scholarly journals as *Corporate Governance: An International Review* and *Organization Studies* and her papers appear at various international conferences.

Terry McNulty is Professor of Management and Corporate Governance at the University of Liverpool Management School, UK. Previously he has worked at Warwick Business School and Leeds University Business School. Scholarly, practitioner and policy communities recognize his work about corporate governance and board effectiveness, as evidenced by research for the Higgs Review that informed the UK Code of Corporate Governance and studies published in leading scholarly journals since 1995.

*Address for correspondence: Dr. Anna Tilba, University of Liverpool Management School, Chatham Street, Liverpool, L69 7ZH, United Kingdom. Tel: +44(0) 151 795 3717. E-mail: a.tilba@liverpool.ac.uk

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ABSTRACT

Manuscript Type: Empirical

Research Question/Issue: This study examines how the practice of pension fund investment management informs the ownership behaviour of pension funds vis-à-vis investee corporations.

Research Findings/Insights: Using data from: 35 in-depth semi-structured interviews with pension fund trustees, executives, investment officers and financial intermediaries; documentary analysis; and observations of 4 fund investment meetings, we find a variation in pension fund behaviour, where a very small number of well-resourced and internally managed pension funds exhibit engaged ownership behaviour. By contrast, the vast majority of pension funds operate at a considerable distance from their investee corporations having delegated pension fund investment management to a chain of external relationships involving actuaries, investment consultants and fund managers. These relationships are laced with interests and influence dynamics, which explain why these pension funds give primary emphasis to fund investment performance and display little concern for matters of ownership and corporate governance.

Theoretical/Academic Implications: The “New Financial Capitalism” is characterized by ownership concentration, yet at the same time liquidity and a lack of institutional investor engagement with corporations. Findings suggest that the principal-agent view of the relationship between institutional investors and corporate managers is more assumed than demonstrated. This widely assumed theory of investor ownership and control is shown to be contingent upon the meanings and practices that underpin investment fund management by institutions.

Practitioner/Policy Implications: Shareowner engagement is proposed as a solution to problems of corporate governance. Findings about the relationships within the investment chain undermine the notions of pension funds behaving as owners and upholding corporate governance and accountability. This raises scepticism about realising aspirations for engaged ownership and shareowner stewardship contained in institutional investors’ engagement codes such as the Stewardship Code (2010) and contemporary policy debate in the UK and beyond.

Keywords: Institutional Shareholder, Pension Fund, Corporate Governance, Ownership, Qualitative Data, Stewardship.

INTRODUCTION

Agency theory provides a rationale for why investors, as owners of corporate equity, should engage with firms (Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1986; Leech and Leahy, 1991; Maug, 1998). The underlying assumption is that the need to align the interests of managers (the agents) with those of investors (the principals) provides investors with an incentive to participate in the company's strategic direction (Gillian and Starks, 2000; Anabtawi, 2006), in short to act as engaged owners.

However, pointing to the present era of Financial Capitalism, Davis (2008; 2009) and Jackson (2008) observe an ownership paradox related to institutional investors. The paradox is that while institutional investors seem to be increasing in size and also the concentration of their stakes, which gives them potential influence over managers, their use of equity is generally liquid and without commitment. This ownership paradox motivates us to examine whether institutional investors are actually able and/or willing to engage as owners.

An apparent lack of investor engagement in corporate governance is of major concern to not only scholars of corporate governance but also to practitioners and policy-makers seeking to effect better corporate governance. Investor disengagement is a subject of wide debate and significance beyond the realm of academe. In the US such concerns are evidenced by Conference Board reports (e.g. Tonello, 2006), whilst in the UK the financial crisis has served to heighten expectations of policy-makers on institutional investors to act as stewards and engaged owners of shares (Ownership Commission, 2012; The Stewardship Code, 2010). A UK government sponsored study in 2011-12T (Kay Review, 2012) aspires to longer-term investment behaviour and equity markets that better serve fund beneficiaries and corporations. The Report of The Ownership Commission (2012) promotes the culture of 'engaged ownership' with better links between the interests of the ultimate owners and the firms they own.

Pension funds are a type of institutional investor often associated with a potential to adopt a long-term perspective on equity holding and management and therefore seen as potential model investors for stewardship (Davis, et al., 2006). Against this theoretical and practical backdrop, this study examines how pension funds' investment management practice informs the ownership behaviour of pension funds vis-à-vis investee corporations. Consequently, through qualitative inquiry of actors and institutions involved on the capital side of the ownership and control debate, study reports a marked difference in behaviour of pension funds. On the one hand, a very small number of well-resourced and internally managed pension funds exhibit behaviour of engaged owners. However these funds are an exception rather than the norm. By contrast, the vast majority of pension funds operate at a considerable distance from their investee corporations having delegated pension fund investment management to a chain of external relationships involving financial intermediaries such as actuaries, investment consultants and fund managers. Furthermore, these relations of dependence along the investment chain are laced with interests and influence which predispose pension funds to give primary emphasis to fund investment performance rather than an engaged approach to ownership.

Our study contributes to existing governance research in several respects. Our analysis goes beyond a dyadic focus on institutional investors and investee corporations as principals and agents respectively, to attend to a broader examination of a wider system of diverse actors and relationships involved in the investment chain that links capital providers to corporations. Attention to the detailed practice of fund investment reflects theoretical and methodological turns within the fields of organisation studies and corporate governance research that are inclined to the detailed study of behaviour and processes (Ahrens et al, 2011; Pettigrew, 1992). Using this approach allows us to account for heterogeneity among pension funds which is something that has been observed but not explained in the literature (Monks and Minow, 1995;

Del Guercio and Hawkins, 1999; Ryan and Schneider, 2003; Cox, et. al., 2007). By puncturing the image of homogeneity that often characterises debates about institutional investors, this study finds that pension funds are not a monolithic category of investor but vary according to fund type, size of assets, maturity, internal investment management capabilities and liquidity requirements. These differences are critical to explaining their investment practice and behaviour vis-a-vis corporate management and why there are marked differences in engagement between pension funds.

Theoretically, the analysis serves not to over-turn or rebut agency theory and its view of institutional investors' behaviour, (indeed, there is some evidence to support this – scenario A later in the paper), but it is a significant jolt to a widely held theory and set of assumptions about relations of ownership and control. In keeping with qualitative inquiry being a means to reconsider established theoretical ideas, this research suggests that the principal-agent relationship as applied to institutional investor and corporate relations is more assumed than demonstrated in practice. Rather, the applicability of the theory is much more contingent on the features of investment funds as well as meanings and practices employed by those managing funds, including financial intermediaries. The contingent nature of the practice of investment management offers alternative explanations of institutional investor behaviour rooted in 'trading' and 'exit' behaviour rather than 'owner' and 'voice' behaviour.

The structure of this paper is as follows. We first review the literature on corporate ownership and control, highlighting an apparent paradox of institutional share-ownership concentration, which lacks the corresponding or desirable investor engagement, vis-à-vis investee corporations implied by agency theory. We then introduce UK pension funds as the research context. Following a discussion of the research design and methods, we draw on multi-method qualitative inquiry involving: interviews with pension fund trustees, executives, investment officers and financial intermediaries; observation of pension fund investment

meetings; and documentary analysis to explain the practices at work along the investment chain between pension funds and investee corporations, to reveal whether pension funds behave as owners. We conclude by considering the significance of our findings with respect to academic and current policy debates, and offer some implications for further corporate governance research.

CORPORATE OWNERSHIP AND CONTROL: INSTITUTIONAL OWNERSHIP AS A MECHANISM OF GOVERNANCE

Since Berle and Means (1932) examined the implications of dispersed ownership using the separation of ownership and control thesis, ownership behaviour by institutional investors has been considered an important governance mechanism of control to help align the interests of shareowners (principals) and managers (agents) (Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1986; Leech and Leahy, 1991; Maug, 1998). Jensen and Meckling (1976) refer to agency theory as ‘a theory of ownership’ (p. 309) where equity holding institutional investors are seen as significant monitors of managerial decisions (Mallin, 1994; Gillian and Starks, 2000; David, et. al., 2001; Hoskisson, et. al., 2002; Anabtawi, 2006; Johnson, et. al. 2010).

A relationship between institutional investor equity ownership and corporate control has provided a theoretical platform for a substantial body of research aimed at addressing the fundamental agency problem involved in the separation of corporate ownership and control. In his seminal work, Hirschman (1970) has identified investor/company relationship within the ‘exit’ or ‘voice’ framework where investors sell the shares or ‘exit’ if they are dissatisfied or express concerns to management through ‘voice’. Indeed, the empirical evidence investigating this relationship is decidedly mixed (Bainbridge, 2003; Dalton, et. al., 2007) and there is research both in the US and the UK, which casts doubts on the claims that institutional investors

can and/or do act as an effective corporate governance mechanism (Gillian and Starks (1998), Edwards and Hubbard (2000), Karpoff (2001), Song and Szewczyk (2003), Renneboog and Trojanovski (2003), Kahan and Rock (2007) and Conyon and Sadler (2010)).

Inconclusive evidence as to the institutional investor role in corporate governance, provides added impetus to research a paradox observed by Davis (2008), and Jackson (2008), in what they describe as a transition from ‘Managerial Capitalism’ to an era of ‘New Financial Capitalism’. For these writers an era of ‘New Financial Capitalism’ is characterised by a re-concentration of corporate ownership in the hands of large investment fund managers and pension funds, yet those same institutional investors are not engaged in ownership behaviour and lack voice (Davis, 2008; Jackson, 2008).

Institutional Ownership Paradox: Concentration without Commitment

Davis (2008; 2009) and Jackson (2008), observe that although institutional investors seem to be increasing, in size, and the concentration of their stakes, which gives them potential influence over managers, this concentrated ownership is generally liquid and without commitment. This is reflected in the trend towards increased turnover and shorter average stock holding periods (Tomorrow’s Owners, 2008). In the US, Societe Generale Cross Asset Research (2008) shows that the average period of holding stock on the New York Stock Exchange (NYSE) was just 7 months. Similarly, in the UK, the institutional investors’ portfolio turnover reached 56% (Jackson, 2008), while the average duration of equity holding has fallen from five years in the 1960s to just over 7 months in 2009 (Haldane, 2010).

The change in duration of shareholding and the apparent lack of investor involvement with the investee companies provides an interesting context in which to consider the question as to the investor’s desire and/or ability to act as an owner. An impression of the distant and disengaged institutional investor runs counter to the principal/agent logic of shareholder

incentives to monitor and hold management to account. Davis (2008) observes this ‘New Finance Capitalism’ to be theoretically puzzling since, historically, large block holders are generally associated with influence, if not direct control and generally building long-term relationships with the investee companies. For this reason, Davis (2009) suggests that there is a need to develop new conceptual tools to reflect the current changes in institutional investor ownership behaviour. This necessitates an examination of the governance role and practices of other actors, such as financial institutions and their intermediaries, within the market.

Previously regarded as ‘the dominant conceptual foundation for corporate governance research’, (Dalton, et. al., 2007: 34), agency theory is now challenged on the grounds of doubtful assumptions, uncertain predictions and unintended effects. A number of scholars articulate concern about ability and inclination of investors to monitor and control the investee companies. Webb, et. al. (2003) argue that it is not the role of the institutional investors to act like banks, developing a long-term relationship with investee companies, because institutional investors have different time horizons and abilities. Similarly, Hellman (2005) suggests that even large institutional investors cannot assume active ownership because these organisations do not have the organisational capacity or design to acquire adequate knowledge about specific investee companies, so as to make any genuine or worthwhile contribution to discussions on corporate strategy.

Significantly, Hendry, et. al. (2006) find that in the case of investment fund managers, the traditional conceptualisations of fund managers as ‘principals’ are not reflected in the day-to-day practice of these actors, who primarily behave as traders. Hendry, et. al. (2007) emphasize that the meetings between the fund managers and the corporate executives are primarily used to inform trading decisions, rather than overseeing management as ‘owners’ or ‘principals’, concerning themselves with corporate governance issues such as executive pay, board structure and independence, and other governance concerns. In terms of the fund

manager's governance practices, they go on to conclude that any desire to maximise shareholder value, and any political/moral motivations related to ideas of responsible ownership, act primarily as rationalisations rather than as genuine motivators, and identify the main driving force for the 'new shareholder activism' of the institutional investor as the institutions' own profit maximisation and the need to position themselves competitively in the lucrative investment market.

Together, the above studies provide a fair amount of scepticism about the link between concentration of ownership and active ownership on the part of institutional investors. This also causes us to question whether viewing investor/company relationship through the agency lens offers only a partial, idealised and simplified view of this relationship . Furthermore, there are also studies that identify weaknesses and flaws in the investor's own governance and accountability mechanisms, as a contributory factor in the investor's failure to exercise the desired shareowner stewardship (Davis, et. al., 2009). Interestingly and significantly for this study, Hendry, et. al. (2006) suggest that viewing the investor/company relationship through a simple lens of principal/agent does not provide an accurate reflection of current investment practices. Hendry, et. al. (2006) also note there to be a separation of the lines of accountability and responsibility between shareholding and share ownership. For example, the relationship between pension funds and their investment managers involves two further intermediaries: the trustees of the pension fund and the small group of investment consultants who advise them, and that the 'the agency problems of such layered relationships are palpable' (p. 1124). Pye (2001) and Roberts, et. al. (2006) also indicate that the multi-layered relationships that the fund managers have both with the owners who supply capital, such as pension funds, and the pension fund trustees, require further examination.

Theoretically, this line of argument stimulates attention to the practices and complex relationships between a variety of actors, whose identity as principals or agents is not clear.

Implied here is a more complex view of corporate governance, and specifically, the relational dynamics associated with the governance notion of institutional investors acting as ‘owners’ holding managers to account. Rather, emphasis is given to attending to what is happening within the processes and relationships that encompass this array of actors and institutions. Herein lays a conceptual platform from which we build this study. In the next section, we introduce this research context by using a selection of UK pension funds as a case scenario, to examine institutional ownership as a mechanism of corporate governance.

RESEARCH CONTEXT: PENSION FUNDS IN THE UK

Pension funds are a good case to explore, as they may be considered to be the archetypal long-term investor. Pension funds are one of the largest asset-owning types of investor in the UK. Although pension fund ownership of total UK equity market has been declining since 1992 from 32.4% to 5.1% in 2010, in the period that preceded this study they held nearly 13% of total UK equity, exceeded only by insurance companies, who owned nearly 15% (ONS, 2010). Pension funds invested 43.1% of their assets in UK equities, a figure that amounts to nearly £400 billion (The Purple Book, 2010). By owning a considerable share of UK equities, pension funds continue to play a major role in the evolution of UK ownership (Franks, Mayer and Rossi, 2005). Furthermore, pension fund ownership of overseas equity has been steadily increasing from 24% in 2006 (The Purple Book, 2006) to 57.2% in 2011 (The Purple Book, 2011). This suggests that the significance of pension fund ownership behaviour stretches beyond the UK.

The pension fund industry is remarkably concentrated, with a relatively small proportion of big pension funds dominating the flow of capital. The current conditions within the industry are characterized by economic recession, unstable financial markets, and increasing pension fund liabilities and deficits. Since the financial crisis of 2008, and falls in

equity markets, UK pension fund funding levels have dramatically worsened, decreasing from the highest of 111.4% of pension fund funding in March 2007 to only 79.5% in March 2009 (The Purple Book, 2009). Furthermore, operating in a world where people live longer, also means that pension funds' liabilities have substantially increased. Assuming the s179 valuation¹, the total assets of 6,885 pension funds in 2009 stood at £780.4 billion, while total liabilities were £981 billion. In effect, industry conditions signify a profound change within the industry, which is now characterised by most pension funds moving away from being largely in surplus, to being in massive deficit. These deficits have perhaps fuelled the trend towards the Liability Driven Investment (LDI) strategies that also focus on short-term investment performance.

When it comes to pension fund governance and investment management, pension fund trustees are given a central role by virtue of their common law heritage. They have been entrusted with general investment powers and their fiduciary responsibilities include making decisions about the choice of investment products, the level of investment in particular assets, and the choice of investment managers (Trustee Act, 2000). Clark (2000) observes that the dominant arrangement of pension fund investment management is extensive delegation through investment experts, mostly due to the lack of expertise inside the fund. A lack of trustee investment expertise, opens-up a vital role for other financial intermediaries and experts in the investment process (Clark, 2000). However, one of the principal concerns of the Myners Report² (2001) and subsequent reviews of its progress, is that of trustees' excessive reliance on investment consultants. Notwithstanding the apparent significance of consultants in pension fund investment, they have received little attention within the research literature. Furthermore, it is unclear how the relationship between pension funds and their investment fund managers informs share-ownership behaviour.

Coincidentally, there are heightened expectations on pension funds to become engaged owners. Following governance scandals, from Enron in 2001, to the collapse of Lehman Brothers in 2008, a number of regulatory ‘soft-law’ codes in the UK such as the Myners Report (2001) and its subsequent reviews (HM Treasury, 2004; 2008); ISC’s Responsibilities of Institutional Shareholders and Agents: Statements of Principles (Institutional Shareholders’ Committee, 2007); NAPF (2007); The Walker’s Review (2009); and the most recent UK Stewardship Code (2010), have encouraged pension funds to be more engaged corporate owners. Yet UK studies that examine pension funds in relation to corporate governance are few, and yield conflicting results. Solomon, et. al. (2000), Clark and Hebb (2004), Mallin (1994; 2001; 2010) and Becht, et. al. (2009), suggest behaviour of pension funds akin to that of the engaged and active owner. However, Faccio and Lasfer (2000), Cox, et. al. (2007), Crespi and Renneboog (2010) and FairPensions (2008; 2009), create an impression of pension funds operating very much as distant holders of shares.

All in all, the nature of the interaction between pension funds and corporations is subject to much theoretical and normative prescription, but the empirical picture is ambiguous. It is crucial to examine how pension funds are connected to their investee companies, what practices and relationships are at work along the investment chain, and how do these inform pension funds’ ‘ownership’ behaviour.

RESEARCH DESIGN AND METHODS

In the interest of research rigor and transparency this section explains the research methods used; the sampling of pension funds; the process of gaining access; how the data were collected and analyzed.

Data Sources

Qualitative data allow the researcher to build and develop theory by get close to actors and settings in order to examine relationships and understanding complex practices (Shah and Corley, 2006). To understand pension funds ownership behavior, we used data collected from actors involved in pension funds' investment via an extensive semi-structured interview program (35 interviews), documentary analysis and observations of four pension fund investment meetings.

Sample of Funds and Interviewees

We used theoretical sampling (Shah and Corley, 2006) to identify the funds to study, and whom to interview. The literature on pension fund governance suggests that pension fund context, size of assets, maturity, internal investment management capabilities, liquidity requirements as well as pension fund type (e.g., occupational or local authority fund), may be relevant when determining the approach to investment management and ultimately the fund's relationship with investee corporations. Accordingly, these pension fund characteristics served as sample criteria which informed the identification of the pension funds in two phases of the research process.

As a first step, the Pension Funds Online Database³ was searched. Using the sorting tools in the database, 2,866 UK pension funds were sorted by their share of UK ownership. The population range was generated according to fund size in terms of capital value, the highest being over £37 billion and the lowest being just over £2 million. From the sorted list, the largest top 100 occupational and local authority pension funds were then selected for the second screening phase.

In the next phase, the Top 100 pension funds were analyzed and cross-compared, to establish the characteristics such as pension fund type, amount of assets under management,

allocation to equity, mode of investment management, and maturity. After examining these characteristics within the database listings, it was decided that there was enough diversity within these funds to reflect the different characteristics and ensure a representative sample. The sample represents both local authority and occupational pension funds, with assets under management ranging from £30 billion to just under £1 billion, and total membership ranging from 239,144 to just over 10,000.

All interviewees were selected with careful consideration of their professional role and the expected contribution to this research project. Thus, the interview program covered the roles of trustees, pension fund officers, executives and chief investment officers. In recognition that pension fund investment decision-making and management also involves external experts, actuaries, investment consultants and investment fund managers were also interviewed. The names and interviewee contact information were obtained from the Pension Funds Online UK Top 100 pension funds listings; Actuaries & Pension Fund Consultants League Table 2007; and Investment Managers and Advisers League Table 2007.

Observations

As the fieldwork gained momentum, access to observe four pension fund investment committee meetings was successfully negotiated. The lead author observed an investment committee meeting of a local authority pension fund with assets under management exceeding £ 3 billion; the Annual General Meeting of a Local Authority Pension Fund Forum, which brings together 48 local authority pension funds with a combined assets under management exceeding £ 95 billion; and two investment outlook meetings in occupational pension funds, with assets under management exceeding £ 22 and £ 13 billion respectively. Observing investment meetings enabled us to contextualize interviewee's accounts and shed more light on the kind of processes and interactions that take place within pension fund investment.

The combination of interviews with observations signifies an important strength of this study. Formal and systematic method of data collection from multiple sources helped to ensure trustworthiness of our work (Shah and Corley, 2006). The two methods have also complemented one another by illuminating and ‘validating’ themes and issues of interest (Bluhm, et. al. 2011).

Documentary Analysis

Written documents were also an important source of information about pension funds, their organisation, and investment management. In order to minimise the time spent asking general questions during the interviews about matters for which information was available publicly, pension fund organisational charts, official role descriptions, investment policy statements, investment performance evaluations, funding strategy statements, annual reports and accounts, valuation reports and similar type information were collected and studied prior to each interview.

Data Collection

Overall, data collection took place between August 2008 and May 2009. As the fieldwork progressed, the research benefitted from a ‘snowball’ effect in getting access to the interviewees and to observe meetings. Creswell (2007) suggests that twenty to thirty interviews are sufficient for building grounded theory, and this figure served as an approximate indicator of the extent of the interviewing component of the fieldwork. Subsequently, we found that we were reaching data saturation point after conducting around twenty-five interviews, as it became apparent that further distinct themes were no longer emerging from the interviews. After a short break and further data analysis, the remaining ten participants were interviewed as a useful way to ‘validate’ the existing accounts. In total, 35 semi-structured discussions occurred, with each respondent, lasting between sixty and ninety minutes. All interviews were digitally recorded and transcribed, resulting in approximately 42 hours of recordings and 548

pages of transcriptions. Appendix A provides the list of respondents. Appendix B contains the interview protocol.

Data Analysis

Data collection and analysis occurred concurrently. The process of initial data analysis began during the data collection, and therefore, lasted between August 2008 and September 2010. The data analysis was inductive and interpretative and aimed at obtaining deeper understanding of the processes and relationships between the key actors involved in pension fund investment. The process of analysing the interview data, comparing it with observational and documentary data, recoding the initial findings and going back to the literature resulted in a more systematic development of the research themes.

Content analysis was used to analyse the interview transcripts. To warrant the robustness of this data analysis, we used the techniques similar to those used by Eisenhardt, (1989), Dacin, et. al. (2010) and Creed, et. al. (2010), which consisted of four steps. NVivo 8.0, a qualitative research software was used to assist and facilitate the analysis of our qualitative data. Figure 1 demonstrates the data analysis showing the categories and themes from which we developed the findings and the relationship between them.

FIGURE 1 DATA ANALYSIS STRUCTURE

Insert Figure 1 about here

In the *first step* of the analysis, interview transcripts, entered in NVivo as text files, were coded on the basis of ‘in vivo’ words. These comprised of descriptions offered by interviewees, all revolving around pension fund investment and the associated practices of

actuaries, investment consultants and investment fund managers. These formed the first-order codes.

In the *second step* of the analysis, second-order codes were identified. For example, comments on the first order code such as pension fund investment management, were further grouped into codes or ‘tree nodes’ labelled ‘context’, ‘roles’, ‘investment aims’. Following Lincoln and Guba’s (1985) recommendations, the second-order codes were then refined through triangulation of interviews, with the notes taken during the observations of meetings and documentary analysis, to produce a set of higher-level nodes. This process resulted in 1185 coded passages.

In the *third step* of the analysis, links between second-order codes and higher-level nodes were collapsed to produce theoretically distinct themes, for example, the wider context was further grouped into nodes labelled ‘interests’ and ‘accountability’. This was a recursive rather than a linear process; with analysis moving iteratively between the first and second-order codes, with patterns in the data emerging into conceptual themes (Eisenhardt, 1989; Dacin, et. al., 2010).

In the *fourth step* of the analysis, the emerging conceptual themes were organized into the overarching themes that inform our main findings and theoretical reflections. Three themes strongly emerged here: reliance on external expertise; dependencies along the investment chain; and influence and focus on investment performance.

To ensure credibility of our analysis (Shah and Corley, 2006), throughout the process, the authors discussed coding, cross-referencing and emerging themes. Also NVivo allowed the interview content to be analysed systematically using codes, keywords, word frequencies, reference counts, quantifying theme coverage and theme cross-comparisons. To ensure coding consistency, a random selection of ten interview transcripts were re-coded by an independent third-party investigator, albeit a person not directly involved in the study. The degree of

agreement was measured using the Kappa value through NVivo Code Comparison Queries. There was a substantial agreement above chance with Kappa value found to be 0.71.

We also aimed to ensure that during the interpretation, the data was linked with the research questions and concepts, and there was a close fit between the data and the research claims (Easterby-Smith, et. al., 2008). We also kept a record of our data collection, management and analysis process, to ensure objectivity. To help improve accuracy, respondents' feedback was also sought where possible (Lincoln and Guba, 1985). Usually this was done during the interview process, by reiterating the respondent's statements, to make sure the intended message was understood correctly.

RESEARCH FINDINGS

Empirically, the research findings enable a distinction to be drawn between engaged and disengaged pension funds, the latter which are much more prevalent (as indicated by the larger circle on Figure 2) and rely on external financial experts for investment strategy formulation and implementation. Within Figure 2, the horizontal axis indicates the engaged and disengaged behaviour vis-à-vis investee corporations, the associated management style and the specific actions vis-à-vis investee corporations. The vertical axis illustrates the distinction between engaged and disengaged funds by outlining the respective features of pension fund investment management practice.

FIGURE 2 ENGAGED AND DISENGAGED PENSION FUNDS

Insert Figure 2 about here

Overall, Figure 2 is intended to show that large pension funds with sufficient internal resources and in-house investment management (Scenario A, below) are linked more directly with their investee corporations, being able to exhibit a more engaged ownership stance. The size of pension fund ownership stake in a corporation and the ethos of the fund also inform engagement. By contrast, the majority of pension funds delegate their investment management to external experts (Scenario B, below) and operate at a considerable distance from the investee corporations. In exercising a fiduciary responsibility, to act in the best interests of the pension scheme's beneficiaries, by deciding on pension fund investment strategy - pension fund trustees and executives rely upon external expertise, for example, actuaries, investment consultants, investment managers and corporations. Accordingly, for this vast majority of pension funds the investment management process is laced with dynamics of dependence and influence and the primary focus is on fund investment performance, rather than corporate governance considerations. These findings are elaborated upon below, beginning with Scenario A on the engaged pension funds where we explain this behaviour through the operating structure of the in-house investment management.

Scenario A. Engaged Pension Funds

When it comes to the investment of pension funds, trustees have the ultimate responsibility for first, establishing the extent of fund liabilities, then considering the suitability of different asset classes for meeting the scheme's funding requirements, and finally selecting investment fund managers to manage fund investments. Although pension funds within our interview sample can be characterized as 'large' pension funds – of all those within the UK top 100 pension funds, only two pension funds exhibited engaged ownership behavior: namely, conducting company research and monitoring, voting and proxy voting, writing letters, and

holding face-to-face meetings with senior management and boards of directors about structural and strategic corporate governance issues. Even then those pension funds respondents gave preference to discussions and routine negotiations *'behind the scenes'* and cast their behavior in terms of *'sophisticated engagement debate'* and *'trying to create and maintain long-term relationships with the companies'*. These pension funds were also investing in specialist corporate governance teams to work in-house and working with external industry bodies such as PIRC, RImetrics or National Association of Pension Funds (NAPF).

We found that such ownership behavior is explained by pension fund internal resources which underpin in-house investment management; relatively large ownership stakes in corporations; and a pension fund ethos and organizational values pursued by trustees and fund executives. Engaged pension funds with in-house investment management are untypical in the UK pension fund landscape as the following quotations actors involved in the pension fund industry suggest:

'We are different in that we do have a little bit more in-house resources and...we probably do have more hands on involvement. Because of our size we take a more direct approach...we do see that it is the job of the trustees to influence the companies.' (CEO of an occupational pension fund with over £5 billion of assets under management)

'...We are probably two of the most active pension funds in terms of resources for corporate governance within the pension fund itself...we are a large pension fund and we have the luxury of being able to employ two full-time people to look at these sorts of issues – some pension funds wouldn't have the resource and I think that generally resource within corporate governance is a huge issue –Hermes has a team of 25 people looking at corporate governance around the word, they can obviously have a much bigger impact than our team of two could have, so resource is a huge issue.' (Corporate governance counselor of a UK top 10 occupational pension fund)

These few pension funds with in-house the investment expertise have more control over shaping pension fund investment strategy and investment management. Unlike most pension

schemes that would externalize their investment management from a cost perspective, funds like the Universities Superannuation Scheme (USS) are able to either manage the investments internally and/or have specialist corporate governance teams in-house who engage directly with the investee companies. Beyond these funds, the only other examples of pension fund ‘voice’ we could find was by collective bodies such as the National Association of Pension Funds (NAPF) and the Local Authority Pension Fund Forum (LAPFF) on behalf of a multitude of local authority funds.

We found that relatively large share ownership stakes in companies to be another factor that facilitates ownership behavior in pension funds. For example, even a stake of 0.3% in a company was considered to be quite substantial, providing access into the board arena and enabling these funds to directly voice corporate governance concerns, as a Head of Responsible Investment at the UK top 5 occupational pension fund explains:

‘...we are relatively large UK pension fund so our influence in the UK is roughly between 0.3 – 0.5% of anything that is listed– which doesn’t sound much but actually that puts us at the top in most companies, so our level of influence is the strongest in the UK.’ (Head of Responsible Investment /Occupational Pension Fund/over £30 billion).

Another pension fund CEO notes that owning large stakes at companies allows gaining the access to the corporate management where *‘the management would take corporate governance concerns more seriously and pull in more senior company representatives to those meetings’*.

This study finds that pension fund ethos and trustees’ and managers’ understandings of their own roles and duties in relation to the trust seem to be crucial in the form of engagement adopted. This study finds that actors within more involved pension funds are not only *able* but also *willing* to be more engaging. The respondents within this group of funds argue that involved engagement *‘makes sense’* for two distinct reasons. One underlying motivation behind engagement relates to trustees considering that engagement adds value and produces better financial returns for the pension fund. Since better investment performance is in the best

interests of the pension fund members, engagement becomes part of pension fund ethos and trustees' fiduciary duty. In other words, trustees see engagement as part of their fiduciary duty.

A CIO of the UK top 5 occupational pension fund with assets under management exceeding £30 billion explains:

'We actually follow our corporate governance approach because we believe that it would lead to better performance and we do the same with our sustainability and responsible investment. We actually believe that over the longer term the companies which are better governed are likely to outperform those companies that are not' (CIO/ Pension Fund/Industry: Education).

'I spent many years meeting UK companies, chairmen of the board, promoting better governance because I firmly believe that well-governed companies do actually improve long-term performance of investment funds' (Corporate Governance Counsellor/Pension Fund/over £15 billion).

The other reason relates to trustees' personal values and sense of altruism and responsibility that resonate with pension fund ethos of being a responsible owner of shares, providing not only capital but also concerned with environmental, social and governance issues for a greater good of society. According to a CEO of one occupational pension fund with nearly £14 billion in assets the pension fund's mission is:

'Not just about the money but what the money would buy - the quality of life, which is where the social responsibility is. That is the mission, if I am evangelical about anything it is about what the responsibility could lead to – it is that kind of influence, rather than the short-termism, that self-individualistic, hedge funds – that kind of philosophy' (CEO/Pension Fund).

'I am a firm believer that there are other things that need to be taken into account other than just profit when it comes to investing money and the pension fund has the biggest pot of money in the region' (Trustee/ Pension Fund/£ 4 billion).

Discussions with trustees about their values and motivations behind engagement suggest that the actions associated with engagement are not 'alien' or externally imposed by the codes such as the Myners (2001) or the Stewardship Code (2010). Rather engagement is embedded in the

investment management philosophy and connected to the overall in-house investment decision making.

In sum, we observe clear and significant connections between pension fund in-house investment management, i.e. the pension fund size, the presence of internal resources, the level of expertise, pension fund share ownership, ethos and trustees' values and the level of pension fund involvement with their investee companies. A small minority of extremely large pension funds have sufficient internal resources and willingness to engage in a direct way with corporations, while the majority of pension funds delegate investment management to external specialists and are singularly concerned with investment performance rather than considerations of ownership and governance. We explain this alternative Scenario (scenario B) in more detail below.

Scenario B. Disengagement and Delegated Fund Investment Management

For the majority of pension funds studied this research found that in making strategic investment decisions, trustees employ the expertise of actuaries, investment consultants and the investment fund managers, typically drawn from outside the fund. Indeed, all pension funds employed actuaries and investment advisers from external retirement consultancy firms and delegated pension fund asset management to professional investment fund managers. Using Figure 2 and the concept of an investment chain, the following sections show how disengaged pension fund ownership behaviour plays out, starting first with an analytical description of how delegation to fund managers occurs and then moving on to explain how dependencies and influences along the investment chain, ensure that pension funds focus on investment performance rather than matters of corporate governance.

Strategic Investment: Reliance on External Expertise

During the actuarial valuation of pension fund liabilities, which occurs at least once every three years, an actuary establishes the funding needs of the scheme based on variables

such as human longevity, future salary levels, rates of inflation and pension fund investment portfolio performance. Through interviews with actuaries and observation of four pension fund investment committee meetings, during which pension fund investment strategy was discussed, we found there to be considerable ambiguity associated with actuarial valuation. The ambiguity comes from the approximate nature of the variables that the actuaries are working with, since it is difficult to predict future human longevity or the rates of return on pension fund investments. For example, assumptions about the total pension fund liabilities covered by the Pension Protection Fund, range from £834.2 billion to £981.0 billion (The Purple Book, 2009). In reality therefore, rather than providing the trustees with one precise liability calculation, an actuary produces several assumptions, and then highlights the advantages and disadvantages of each, leaving trustees to decide which figures to use as a basis for fund funding needs. Accordingly, adopting higher or lower liability projections has implications for pension fund asset allocation, exposure to equity investments, and the terms of the mandate issued to fund managers. The higher the liability the greater demand for more funding. It is here that funds' may look to the investment 'market' to produce required investment returns. The actuary then, plays an important role in setting the foundation for the subsequent investment choices of asset allocation and fund manager selection by trustees. In respect of the latter, trustees typically call on the advice of another financial expert: the investment consultant.

Following actuarial advice, the investment consultant then plays a crucial role in the next phase of the investment process by advising trustees about the appropriate asset allocation mix and by recommending investment fund managers. This research found that similar to the actuary, investment consultants consider their role as identifying different investment alternatives, rather than suggesting specific investment solutions. Consultants will indicate the advantages and disadvantages of the alternatives, and let the trustees decide the most appropriate course of action. However, significantly, all interviews with pension fund trustees

and investment experts, indicate that while consultants perceive their role purely as advisory, the trustees for the most part regard the consultant's advice to be '*telling*' or directing the trustee as to what investment strategy to pursue. A pension fund trustee illustrated this difference in perception and the significant implications in terms of responsibility as follows:

'the problem [is]... I am a trustee, you are a consultant and you say "I recommend that you do this.", I hear you saying, "I advise you that the best option for you is this"...but ultimately, the buck stops with the trustees, and the Regulator will be asking them questions. If the scheme meets problems further down the line, it is the trustees who will be held to account.'

Another trustee observed about investment recommendations:

'Recommendation to me has this ring of endorsement about it.'

We find that trustees' lack of investment expertise, their reliance on investment consultants and their perception of consultants' recommendations as '*endorsing*' in this way, have huge implications for pension fund investment strategy, such as investing equity allocations via active investment fund managers, and focusing fund mandates on producing short-term investment returns.

When it comes to relationships between pension funds and their investment fund managers, the picture that emerges from the study, is that trustees delegate the running of pension fund investments, and more specifically, equity investments, to fund managers. However, fund managers are only responsible for the obligations set within the mandates provided by pension fund trustees. Our interviews indicate that this agenda is overwhelmingly oriented towards generating investment performance, rather than attending to matters of corporate governance.

A clear finding from this study, is that trustees perceive that their '*primary fiduciary responsibility is to maximize the return to be able to pay the pensions to the members*', which

in turn means that trustees *'leave it to the fund manager to go and talk to the companies they invest in'*. We did find that there is an expectation that the fund managers will do *'something'* about the corporate governance of the investee companies, but there is no clear prescription within the mandate as to how to behave in relation to shares and shareholdings, other than selling if the investment performance is poor.

A CEO of an occupational pension fund with assets under management exceeding £11 billion illustrated this point as follows:

'What we delegate to our fund managers is "make us money, provide good returns" and what we select our fund managers on... are people who can pick the right stocks. We ask them to vote and they vote, and that means they can tick the corporate governance box. But it is box ticking. And if they don't like the way the company is being run, they will do what we all can do, which is sell it.'

Making a similar point albeit from a different role and organization, a Head of a Client Accounts Team for a global investment manager with assets under management exceeding £300 billion, said:

'What is surprising on corporate governance is that more clients aren't asking more questions. Often corporate governance takes a back seat and [our clients] seem quite comfortable devolving responsibility to us. I am not sure if they ever read what we do on their behalf. I go to trustee meetings and I never get asked about corporate governance. Trustees are focused on the delivery of performance, not the drivers of that performance at the company level. What they employ us to do is to implement the strategy that they have decided on, that they take the responsibility for.'

Furthermore, we found that pension fund trustees reinforce the short-term investment performance focus by quarterly fund manager performance appraisals and giving incentives and rewards to fund managers *'for outperforming'* their target benchmarks. Unsurprisingly, fund managers focus on producing short-term investment returns which they pursue through active stock trading.

Dependence along the Investment Chain

Within a chain of investment management relationships we found dependence between actors. Of particular note here is the interdependence between actuaries and investment consultants; investment consultants and the fund managers; and between fund managers and the investee corporations. We explain these dependencies and how they play out in pension fund investment process next.

Within the relationship between an actuary and an investment consultant we found that although an actuary and an investment consultant provide different expertise and services, their tasks often go *'hand in hand'* and the advice they provide to trustees is overlapping. All the interviews with actuaries and investment consultants indicated that it is a common practice for both experts to work together on the same pension fund client and discuss particular issues from different angles. Hence the actuary and the investment consultant can develop similar views on how to advise the trustees on a particular investment issue. This is especially so when both experts work for the same firm, use the same pool of research resources and have the same *'house view'* on investment managers. As an actuary explained:

'[Name of the firm] is one of the biggest consultancies and we have a central pool of expertise, so we share it with our colleagues in the firm. But the dynamic is sometimes difficult. There is a risk of people becoming a bit lazy about finding what's involved and they rely too much on each other'.

A pension fund CEO also intimated that experts may have a tendency to support each other's recommendations:

'Consultants have a house view on whether it is appropriate for pension funds to be in certain asset classes. If the consultants have cornered the market and have 70% of pension fund clients, and if they don't like hedge funds, they don't tend to get many clients investing in hedge funds... we are very conscious that they have a house view behind them...but what the actuary and the consultants say-goes'.

By way of further explanation about how this interdependence plays out within pension fund investment, we found that if a consultancy house is specialising in researching (and

recommending) particular active or ‘trading’ equity managers, an actuary can support these recommendations, by producing actuarial valuations of the effects of these asset managers on pension scheme’s funding. In so doing, an actuary would be endorsing the consultant’s advice and inadvertently ‘*channelling*’ pension fund equity allocations via these fund managers.

Supporting this interview data, examination of actuarial and investment consultants appointments within the UK top 100 schemes (Pension Funds Online, 2008⁴) revealed that 45% of schemes appoint actuaries and investment consultants from the same firms. The fact that 45 pension funds within the UK top 100, and over half of pension funds within this study, are employing consultants and actuaries from the same firm, suggests that the phenomenon of dual appointments is widespread. Coincidentally, we also document relatively high equity asset allocations within these funds. The average asset allocation to both domestic and overseas equities at the time of data collection exceeded 50%. Thirty seven percent of pension funds that employed an actuary and the investment consultant from the same consultancy house, invested roughly over 55% of their assets in equities. One pension fund invested almost 100% of their assets in equity. These findings indicate that there may be a link between the relationships between an actuary and investment consultant and trustee focus on investment performance within the fund manager mandate.

Within relationships between investment consultants and the fund managers, we also found mutual dependence, which reinforces the short-term investment performance focus among equity fund managers. Investment consultants rely on investment fund managers and their investment strategies, to provide a ‘*value-added*’ service to their pension fund clients. Significantly, and at the same time, the fund managers depend on consultants for their recommendations and access to prospective pension fund clients. A CEO of a local authority pension fund with over 2 billion of assets under management explained consultants’ dependency on the fund managers in this way:

'Consultants have to keep a good relationship with the fund managers because they need the intelligence about all of them to be able to do their job and advise us'.

A fund manager from a global asset management house confirmed a dependence on consultants:

'The dynamics are interesting because most of our business is brought to us, or introduced to us, by those consultants. They are crucial to the way our business operates and runs...consultants are closer to the clients sometimes than we are' (Head of Client Account Team/Global Financial Services Provider).

A pension fund Chief Executive also confirmed that investment consultants are *'the gatekeepers'* between the pension fund trustees and the investment fund managers, whilst, an Investment Manager highlighted that *'investment performance becomes a key in trying to keep investment consultants happy and staying on their buy lists'*.

Within the third set of relationships between the investment fund managers and corporations, we also observe dependence (on the fund manager side) and find little evidence of engaged ownership behaviour on behalf of pension funds. Among five well-known and reputable asset-managing houses investigated for this study, only one showed evidence of engaging with the investee companies on corporate governance matters, ranging from executive remuneration, board structure and independence, combined roles of CEO and Chairman and the overall strategic direction of the company - and even that engagement was said to have *'had very little influence'* on corporate practices. We found that even those investment fund managers who may be in a position to monitor and discipline the corporate executives, because of their vast internal resources and the size of the stakes they hold in these companies, tend to keep their distance, for a number of reasons. Firstly, a lot of significance is given to maintaining *'good relationships'* with the company executives. The fund managers are dependent on these very executives for information that help develop their stock trading

models and make buy and sell decisions. A Head of Client Accounts Team for a fund manager explained:

‘A lot of managers go along with the executives...they want to have good relationships with these senior execs because that is the source of information to help them with making buy/sell decisions. And so they don’t push... they are not incentivised to do it at the moment.’

When meetings between fund managers and corporate executives do happen, they are focused on obtaining (more subjective) information, which would indicate managerial ability to deliver what has been agreed in terms of corporate strategy rather than engaging with the executives on the issues of corporate governance, such as code compliance. An Investment Fund Manager managing over £4 billion in assets reflected on the nature of their meetings with company executives by saying that:

‘...it comes down to the relationship. What we are looking is to understand the change which we think is going to take place. It’s crucial that we believe that the management can deliver, so we’d go to a meeting and try to get that information. It’s a question of keeping a relationship going with the management. If we lose faith in the management, we just sell it.’

All our interviews with investment fund managers indicated that fund managers see themselves primarily as ‘*money managers*’, whose business model is to maximize a return against a given benchmark, which is achieved by trading shares. For example, when asked about the significance of monitoring and disciplining corporate executives, one Investment Director admitted that he would keep investing in a company with poor corporate governance compliance records, and not challenge the management, as long as it does not affect the performance of the fund. If and when it does, he would simply sell the shares. Equally, it was felt that the perceived value of the company with higher corporate governance standards was ‘*really negligible*’. These observations provide a platform to discuss our next finding about the relations of influence within the investment chain that further encourage a focus on investment performance.

Influence and Focus on Investment Performance

The preceding sections observed trustee reliance on external expertise within the process of strategic investment and relational inter-dependencies between actors along the investment chain that links pension funds to corporations. This section builds on of these findings by examining the influence dynamics between trustees and other actors within the pensions fund investment chain, which encourages trustees to focus on investment performance within fund manager mandates, in keeping with, and achieved through, the share trading activities of the fund managers. The effects of the external influence can be seen in several stages of the pension fund investment process.

During the actuarial valuation there are several opportunities when an actuary can influence the trustees to (over)rely on the market, and focus the investment fund manager mandates on investment performance. to help address pension fund deficits. The situation is most evident in the case of Occupational Funds wherein an actuary who represents both the employer and the pension fund faces employer pressure to recommend lower employer contributions to the fund. This may inadvertently influence the trustees to rely more on the market and investment performance of the active fund managers, for fund growth. An actuary from a leading UK retirement consultancy house explained the nature of actuarial influence:

‘Essentially, to provide the pension scheme benefits, the money has either got to come from the company, or from investment returns. The idea is that equities would strike a fair balance between the two. The employer may request that trustees invest more in equities...it’s very rare for the company not to have influence into actuarial valuation, because it directly affects how much money the company is going to pay into the scheme over the next 5 or 10 years’.

Accordingly, faced with balancing both the long-term needs of the fund and the short-term costs to the employer, an actuary may set the trustees on the course of investing more ‘*in the market*’ to compensate for lower employer contributions. Documentary analysis and the observations of actuarial presentations during the investment committee meetings, also

revealed that by presenting assumptions *with* equity investment returns, an actuary indicates to the trustees, that pension fund income and funding level can be higher than in the scenario where the actuarial assumptions are calculated *without* the investment returns. Contrasting funding scenarios send a powerful signal to the trustees to focus their investment strategy on asset allocation, and to pick fund managers who can outperform the market. In short, an actuary also implicitly encourages the trustees to link their investment aims with the stock-picking abilities of the equity fund managers. This also sets the tone for how the investment consultant approaches the task of advising the trustees.

In establishing the appropriate asset allocation mix, and selecting investment fund managers, we found that despite the concerns of the Myners Review (2001), investment consultants have significant influence over the formulation of pension fund investment strategy, and subsequently how the pension fund equity investments are being managed on behalf of pension funds. Although trustees have the legal power and responsibility to make strategic investment decisions, much of the influence within the investment strategy still lies with the expertise of a small number of investment consultants, like Mercer, Watson Wyatt (currently Tower Watson), Hewitt and Hymans, who dominate the industry. Interviewees' perceptions about investment consultants' influence and significance is mirrored almost identically in the same order of mention within the Actuaries, Pension Funds Consultants & Investment Advisers League Table 2010 (Pension Funds Online, 2010). The sources of consultants' power include vast specialised research and investment analysis capabilities, good connections within the investment community and the lack of investment expertise within pension funds.

Interviews with pension fund trustees and chief executives as well as investment advisers, indicated that it is the investment consultants who provide '*the leadership*', '*put things on the agenda*', '*choose the issues*' within pension funds' investment strategy, and

decide what the pension fund clients ‘want’ and what the fund managers ‘should sell’. A Trustee of an industry-wide pension fund with assets under management exceeding £ 3 billion and a Director of one of the UK’s civil society organisations, aimed at encouraging responsible investment among pension funds, explained how this happens:

‘...trustees aren’t sure what to do, they feel they need to trust somebody, and they trust their investment consultant. As a result, trustees end up being advised into investment strategies, which are complex, putting not enough emphasis on asset allocation, and far too much emphasis on stock picking by active fund managers’.

This in turn encourages a ‘trading’ mentality among the fund managers.

The interviews with pension fund trustees, chief executives and chief investment officers all suggest that consultants play a significant role in determining pension fund asset allocation and fund manager selection, biasing pension fund investment strategy towards the short-term return for the fund. By way of motives, interviewees suggest that this is because consultants are financially gaining from the provision of such advice. A Chief Investment Officer of one of the UK’s top 5 pension fund highlighted that:

‘Consultants’ advice is not objective, because they are after a fee income. There is not enough long-term thinking within the managers and trustees, and that is partly a fault of the consultants, because they are getting paid to do something, analyse the managers, make recommendations - and that tends to create short-term thinking and pressures - and that is the problem.’

Furthermore, the evidence from all pension fund interviewees, as well as the accounts of the investment fund managers, indicated that because consultants act at the interface between trustees and the investment industry, the fund managers are under pressure to produce short-term investment returns through ‘portfolio churning’, in order to be able to obtain and sustain a place on consultants’ recommendation lists and thus access the pension fund clients. Moreover, the rivalry between investment fund managers for pension fund business also encourages these managers to ‘trade’ in order to generate more investment income and be more competitive.

Guided by the pressing need to fill in the pension fund deficits, trustees, actuaries and consultants are all primarily focused on investment performance and delivery of benchmarks, and trustees actively intensify this focus on investment performance, through quarterly fund manager appraisals. What do our findings mean for the broader ownership and control debates? We discuss the theoretical and policy implications next.

DISCUSSION

Within the governance literature about ownership and control, the relationship between corporate management and institutional investors has been traditionally conceptualised in terms of a relationship between agents and principals. The underlying agency rationale being that there is an incentive for institutional investors to engage with firms and the incumbent management in order to ensure managerial accountability (Mallin, 1994; Gillian and Starks, 2000; David, et. al., 2001; Hoskisson, et. al., 2002; Anabtawi, 2006; Johnson, et. al. 2010).

Empirically, we found limited evidence to suggest that pension funds behave in a way that supports this theoretical argument. Although we document a variation in pension fund behaviour vis-à-vis investee corporations where a very small number of well-resourced and internally managed pension funds are willing and able to express ‘voice’ (Hirschman, 1970) and exhibit ownership behaviour, these funds are an exception rather than the norm. Rather, our findings support the view that despite theoretical ideals, the ownership behaviour of institutional investors is more assumed than demonstrated. Consistent with Davis (2008; 2009), and Jackson (2008), this study reveals that there is very little evidence to suggest that pension funds and their financial intermediaries, such as investment fund managers, see themselves as principals and act as engaged share owners. Rather the vast majority of pension funds operate at a distance from their investee corporations. These funds exhibit ‘exit’ ownership behaviour (Hirschman, 1970) and conduct their investment strategy through a chain of relationships

involving actuaries, investment consultants, investment managers and corporations. By examining pension fund investment practice and how it informs pension fund ownership behaviour, this study illuminates something of what Pye (2001), Hendry, et. al. (2006) and Roberts, et. al. (2006) identified as the little explored multi-layered agency relationships that link firms, their managers and suppliers of capital.

Operating with high dependence on external experts, pension funds' investment practices are shown to be laced with interests and influence which ensure that pension funds give primary emphasis to fund investment performance rather than matters of corporate governance. Furthermore, the lines of responsibility and accountability between the actors within the investment chain are loose, perhaps even confused. Although the trustees have the fiduciary responsibility to decide the investment strategy, hampered by personal liability concerns, trustees draw on the expertise of the actuaries and investment consultants and give the responsibility for the execution of the investment strategy, particularly equities management, to their investment fund managers. However, unlike trustees, the external experts have only limited accountability for their effects. For example, if the investment strategy does not yield the expected results due to an investment adviser's poor choice of asset allocation options, or if a pension fund loses a significant amount of money due to the fund manager's unsuccessful investment models, it is the trustees who are ultimately accountable. All trustees can do in this situation is to change their investment consultant or manager. It appears that investment experts are quite powerful, yet, they bear little responsibility for the outcomes of their services to the trustees. Furthermore, although the fund managers hold the shares on pension funds' behalf, they have neither the incentives nor direct obligation to act as owners, because they are left with no clear instructions within their mandate as to how to behave in relation to the shares, other than '*making money*'. Nor are they held accountable by pension fund trustees for their share-trading behaviour.

This study shows that within this investment chain there are many agents but few active principals. Conversely, in practice, the roles, aims and context of the various actors and their host institutions (see figure 1), are not at all in line with the assumptions of ownership and stewardship. For example, organisational aims of active investment fund managers, to generate more clients and hence more commission income, incentivise portfolio churning. In the context of pension deficits, trustees are compelled to prioritise investment returns. This means that in reality the shares held by pension funds represent *'just a vehicle for delivering the revenues for paying the pensions to the members'*. It appears that the interests of the trustees are geared towards performance of the investment portfolio of their investment fund managers, irrespective of the performance of the individual stocks at the company level. This is also reflected in the fund manager mandates. The study is further evidence to support the findings of Hendry, et. al. (2006) that a trading mentality, rather an owner mentality prevails amongst pension funds and that (investment) performance override governance concerns. The findings of the study lend support to a developing scepticism surrounding the re-concentration of ownership, which will lead to increased ownership on the part of institutional investors (Webb, et. al. (2003), Hellmann (2005) and Hendry, et. al. (2006; 2007).

In the context of agency theory, we are able to offer explanations to the 'theoretically puzzling' ownership paradox (Davis, 2008) -an ownership alarmingly absent of any significant stewardship responsibility – this despite enthusiastic regulatory and other policy encouragements. The findings of this study suggest an empirical reality that is more complex than the dyadic principal/agent or owner/fiduciary conceptualisation of the investor/company relationship. This study identifies a disconnect between the beneficiaries of investment and the activities through which their money is invested. This disconnect is rooted in distinctions between the actual share owners (pension fund beneficiaries), the institutions that hold shares (pension funds), the institutions that provide investment expertise services (actuaries and

investment consultants), and those institutions that actually manage the stocks (investment fund managers). The complexity and the interdependencies between these actors provide a new focus on the content of corporate ownership and control, which should be taken into account. This study therefore has very significant implications for corporate governance research in that it identifies the need for new theory building, so as to develop more appropriate ways of understanding and analysing the current and emerging intricacies of the complexity of equity ownership in the UK – the patterns, behaviours and relationships, displayed by and between the legal and the beneficial owners of shares, and the companies in which they invest.

Policy Implications

The relationships within the investment chain have significant implications for both policy makers and practitioners. i.e. pension fund trustees and the fund executives who are responsible for investment decisions and complying with the best practice codes. Within policy debates, shareowner stewardship is put forward as one of the solutions to the governance problems identified as a contributor to financial market failure (The Stewardship Code, 2010; The Kay Review, 2012; The Report of the Ownership Commission, 2012). There are expectations on pension fund trustees and executives to have a clear policy on voting, and engage with investee companies individually or collectively with other investors. We find a large gap between the notion of stewardship, as configured by The Stewardship Code (2010) on the one hand, and what is happening in practice. Drawing on evidence from this study, it would seem that pension funds lack the in-house expertise, skills and resources to act as stewards. Operating at a distance from their investee corporations, the majority of pension funds build a working relationship with asset management companies, rather than the companies whose equity they hold. The overall findings of this study call into question the practicality of the aspiration of the language of ‘engaged ownership’ and ‘shareholder stewardship’ and cast doubt as to whether the majority of pension funds (and their investment

fund managers) will be willing and/or able to engage with corporations in the true spirit and manner suggested by The Stewardship Code 2010, which indicates that it may be of limited regulatory value.

Moreover, the relationships create increasingly favourable conditions for active trading. For example, the dependencies within consultant-fund manager relationship and the fund manager rivalry for pension fund clients, further encourages fund managers to trade, which suggests that the fund managers are likely to continue to focus on the short-term investment and outperformance, through active stock trading. At the same time, persisting and worrying pension fund deficits (The Purple Book, 2009; 2010; 2011) also give strong grounds to suggest that pension fund trustees are likely to continue to focus on the performance of their investment portfolios, and thus encourage the trading mentality within their investment fund managers. This has relevance to the interim Kay Review (2012), which looks at the causes of short-termism within the UK equity markets, and the latest Report of the Ownership Commission (2012), which attempts to enforce better investor stewardship and closer links between the share owners, and raises concerns that these regulatory efforts may prove limited, in action and effect. We suggest that in debating the desirability of increased pension fund involvement in corporate governance as significant holders of shares, policymakers ought to consider the extent of pension funds' reliance on other agents and indeed the complexity of interdependencies and influence dynamics within the investment chain.

CONCLUSIONS AND IMPLICATIONS FOR FURTHER RESEARCH

This study is offered as a timely contribution to academic and public concerns about the governance role of institutional investors. In keeping with the possibilities afforded by qualitative research to get closer to actors and settings, this study has researched barely studied relationships and practices associated with equity asset management by pension funds.

Focusing on relationships within an investment chain, the study offers an analytic description that challenges orthodox theoretical argument and related practical aspirations to do with institutional investors acting as owners. It does not deny the possibility that some pension funds may seek to fulfil this role, but it does suggest that the vast majority prioritise fund performance, and the associated economic considerations. Rather, the study offers insight about how aspirations and practices employed in investment management are geared to investment fund growth primarily rather than the governance of corporations. As a grounded analysis of an assumed mechanism of corporate governance, namely investors holding corporations to account, the results imply a need for further reflection both theoretically and practically about what is actually happening and attainable.

Hendry, et al. (2007), identify that the new shareholder activism pursued by the institutional investor is rationalised partly as a response to the duties of ‘responsible ownership’, and partly with a view to maximising shareholder value, but they conclude that the ‘driving forces’, the prime motivators for their governance activism, are concerns for their own profit maximisation and the need to maintain their competitive position in the investment market. This primary motivation has implications for their governance behaviour – their corporate governance monitoring and engagement.

This study has reported how through conduct and effect, accountability and liability considerations arise between actors in the investment chain – and within the complexities and intricacies of their relationships. These initial findings suggest that while pension fund trustees are ultimately responsible for the outcomes of the investment strategy, the external investment experts play a critical role in the design and implementation of that strategy. It is not clear as to what, and if at all or to what extent, these experts (actuaries, fund managers and investment analysts) are accountable to each other, or the fund. Keeping a focus on roles and relationship, it would, therefore, be interesting to explore these relationships further.

The position of the pension fund trustee, in its capacity as a fiduciary, vis-a-vis the fund beneficiaries, calls for further attention. Having sought, often through necessity, the advice and guidance of the various experts, their situation is unavoidably complicated in that they must be able to justify their selection, and defend their adoption or rejection of the advice given, in the event the fund fails to deliver and redress is sought. The actuary is the first expert called upon to establish the funding needs of the scheme, and thereby plays an important role in setting the foundation for choices of asset allocation, and, the correspondingly appropriate fund manager selection. There is significant potential for interdependence therefore, between the trustee, the actuary and the investment consultant, particularly where both experts work together for the same pension fund client, or work for the same firm. This, we suggest, has accountability and governance implications that call for further consideration.

Fund managers, driven by their own particular competitive motivators (Hendry, et al., 2007), and giving primary emphasis to fund investment performance, as our study suggests, could be seen to be operating at considerable distance from their investee corporations, this, we suggest compounded, by the complex and intricate nature of the relationships of interdependence we have identified in the investment chain. This also has significant governance implications.

In a social, political and economic context which variously identifies governance failures and pension fund deficits as matters of the central concern, the complicated nature of the investment process, the actors involved, and the complexities of their relationships set the direction and establish the necessity for further research.

ENDNOTES

¹Section 179 valuation (s179): to calculate the risk-based pension protection levy the Pension Protection Fund (PPF) Board must take account of scheme underfunding. To obtain a consistent basis for determining underfunding, schemes can complete a PPF valuation (section 179). This valuation will be based on the level of assets and liabilities for the scheme. The liabilities will be based on the scheme benefits taking into account key

features of the levels of compensation paid by the Board of the PPF as set out in Schedule 7 of the Pensions Act (The Purple Book, 2009).

²In 2001 Paul Myners published a review of institutional investment in the United Kingdom, where he pointed out several areas where change would result in better investment decision-making, codifying several principles for best practice for investment decision-making (HM Treasury, 2004).

³Pension Funds Online is a fully searchable online database containing information about the largest pension funds from both the UK and the rest of the world. It provides contact and financial information for major pension funds. The database also provides details of thousands of companies who supply advisory services to pension funds (<http://www.pensionfundsonline.co.uk/about/pfo.aspx>)

⁴This study uses the 2008 ranking to reflect the sample at the time of data collection.

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FIGURE 1 DATA ANALYSIS

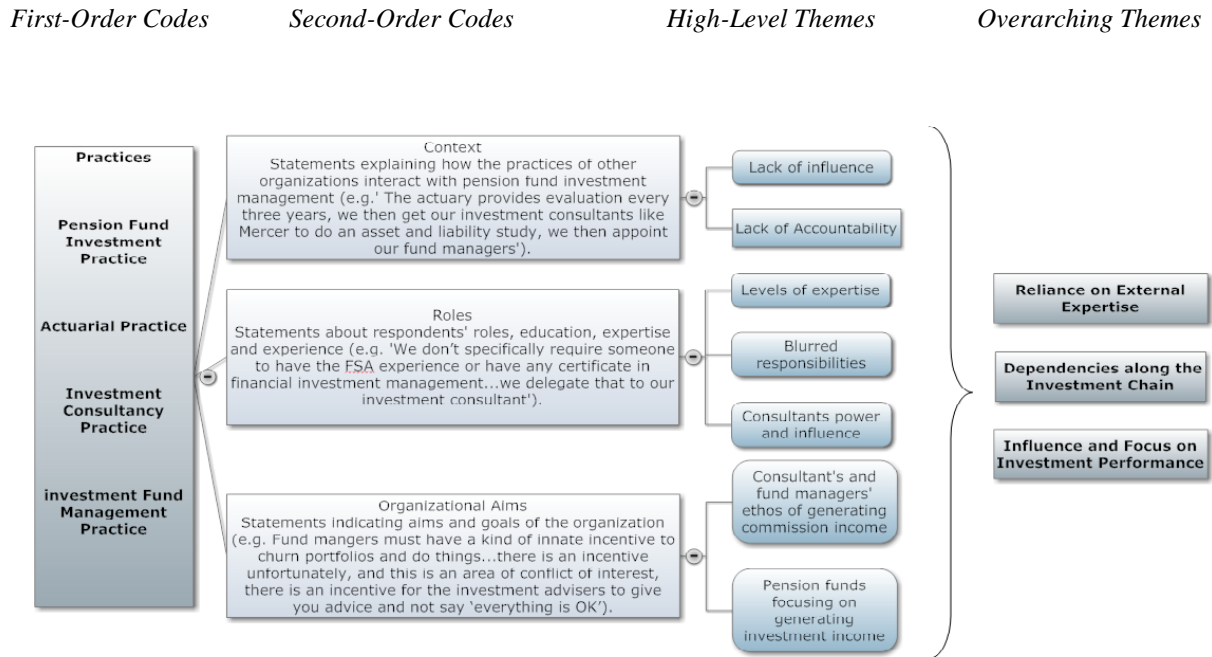

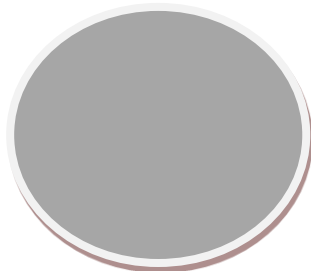


FIGURE 2 ENGAGED AND DISENGAGED PENSION FUNDS

Ability & Willingness →		Engaged Funds	Disengaged Funds	← Lack of Ability & Willingness	
		<i>In-house investment Management</i>	<i>Delegation</i>		
↑		<i>Company research & Monitoring</i> <i>Voting /Proxy voting Letters</i> <i>Face to face dialogue</i> <i>Hiring/Firing management</i> <i>Resolutions/Proposals</i> <i>Threats of EGMs</i> <i>Public Tactics</i>	<i>Fund manager mandate: Delegating voting and all to do with engagement to the fund manager and focus primarily on investment performance. Discipline is exercised through Exit (selling/trading)</i>	↑	
		Internal Resources			Reliance on external expertise
		Share Ownership			Dependencies along the investment chain
Pension fund Ethos		Influence and focus on investment performance			

APPENDIX A

List of Respondents

Position	Type of Organization	Assets under management (£bn)	Industry sector
Executive member of LAPFF/Trustee	Local authority fund LAPFF	£3.9 £95	Local Government
Chief Executive Officer	Occupational fund	£7.0	Chemicals and Allied Products
Trustee	Local authority fund	£3.9	Local Government
Chief Executive Officer	Occupational fund	£22.6	Energy and Utilities
Chief Executive Officer/Trustee	Occupational fund	£13.8	Energy and Utilities
Trustee	Occupational fund	£1	Energy and Utilities
Chief Executive Officer	Occupational	£5.1	Retail and Wholesale Trade
Treasurer	Local authority fund	£3.9	Local Government
Corporate Governance Counsel	Occupational fund	£15.9	Tourism and Travel
Trustee	Occupational fund	£1	Energy and Utilities
Chief Executive Officer	Occupational fund	£1	Telecommunications
Trustee/Executive Director	Occupational fund	£3.4	Industry-wide
Manager, Pensions Investment	Corporate	N/A	Energy and Utilities
Chief Executive Officer	Occupational fund	£2.4	Media
Chief Executive Officer	Occupational fund	£11.9	Energy and Utilities
Chief Investment Officer	Occupational fund	£30.1	Education
Pensions Policy Manager	Occupational fund	£30.1	Education
Chief Executive Officer	Occupational fund	£3.4	Industry-wide
Trustee	Local authority fund	£4.3	Local Government
Chairman of Trustees	Occupational fund	£12.7	Energy and Utilities
Pensions Secretary	Occupational fund	£2.3	Energy and Utilities
Co-Head of Responsible Investment	Occupational fund	£30.1	Education
Chief Investment Officer	Local authority fund	£7.9	Local Government
Chief Executive Officer	Local authority fund	£4.3	Local Government
Trustee	Occupational	N/A	Education
Pension Fund Manager	Local authority fund	£2.3	Local Government
Investment Director	Asset management	£12.1	Finance
Actuary/Retirement Consultant	Investment consulting	N/A	Investment Consulting
Chief Investment Manager/Former CIO of local authority fund	Asset management	£1.5	Finance
Investment Manager	Asset management	£37	Finance
Actuary	Investment Consulting	N/A	Investment Consulting
Client Relationship Executive	Asset management	£300	Finance
Senior Consultant/Chairman/Non-Executive Director	Investment Consulting NAPF BESTrustees The Pensions Regulator	N/A	
Fund Manager	Asset Management	£4	Finance
Partner	Law firm	N/A	Legal

APPENDIX B

Interview Protocol

- Brief introduction of the research project and participant's role in the project
- Ensure confidentiality and anonymity
- Ask permission to audio record the interview
- Ensure that the recording is for the academic use only. Let the respondent know that it is possible to stop the recording at any time.
- Discuss briefly the issues that will be covered during the interview
- Any questions?

START RECORDING

Introduction

- Perhaps we can start by you sharing a bit about your background, your role and responsibilities here.
- Whom are you working with?
- (if respondent is a trustee) What other duties, if any, do you have besides being a trustee?
- How does the trustee committee work?

Pension fund Characteristics and governance

- Can you describe the fund and how it operates
- Can you give a sense of key features of the fund eg, size of liabilities etc m differences among the pension funds?
- How do these features and characteristics of the fund inform the pension fund approach to investment and equity ownership?
- What are the issues of concern to you? Board turnover? Influence of the sponsor? Pension fund buyouts?

Rules/Regulation

- What are the key regulations you have to comply with?
- What do you think are the key issues there?
- What are the challenges? Where is the regulation going?

Expertise/External Experts

- What is the scope of your understanding of the investment issues?
- Tell me what expertise you draw upon, if any, in performing your role?
- To understand pension funds you need to understand other sources of expertise you are drawing on. Could you tell me what are they? Do they represent a source of influence? How?
- Does the level of trustee's expertise depend on pension fund characteristics? How?
- What is your perspective on the role of external experts in the world of pension funds? Are some more important than others? What is the investment chain?
- What are the important issues for you here?

Context

- Talking about the wider pension fund system, what are the challenges for you working within this system?
- Where do you see the biggest issues here? How does your fund fit within this context?
- Are there any tensions or potential conflicts of interests or different motivations within this chain?
- How does your experience help/hinder you overcoming these challenges?

Investments

- Tell me about your investment process?
- How do you allocate and manage your assets/equities?
- What are the key issues for you there?

Engagement

- How, if at all, do you have contact with your investee companies?
- How do the capabilities and resources of the fund come into play in your decisions to engage?
- What do you specify in your fund manager mandates? What is important there?
- In terms of corporate governance, within fund manager mandates, do you have any sense of what the fund managers are looking at when they hold stock on your behalf?
- Do you know or can you give an example where either you or the fund manager engaged with the investee corporation? How? Why?
- If not then why not?
- What is your sense of the relative power of institutions on corporations? How effective are you in holding corporations to account?

Conclusion

- Is there anything else you would like to add? Anything that hasn't been asked that is important?
- Do you have any questions?
- Thank you for your time.

SWITCH OFF RECORDING