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Relative performance evaluation and pension investment management: A challenge for ESG investing

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ABSTRACT

The fund management industry is the primary investment arm of the pension funds that control a significant portion of global capital market assets. Pension assets are frequently cited as vehicles for the use of "environmental, social and governance" (ESG) factors in investing for broader, extra-financial aims. Yet, compensation practices in the pension investment management industry remain focused on relative performance. This study examines the use of relative performance evaluation (RPE) as a form of compensation and control, including its historical emergence, using a genealogical history that attempts to provide some critique of its current day usage. In doing so, it follows the call by Norman Macintosh to both examine the social embeddedness of accounting, and to engage in reflexive accounting histories. The study argues that continued focus on relative results may pose challenges to incorporating ESG factors, and that further study of the RPE technique is needed, particularly with the increased focus on ESG at the policy level.

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1. Introduction

With total assets under management standing at $90 trillion (compared with $48 trillion for global publicly traded market capitalization), the fund management industry is clearly at the centre of the economy and capital markets (IFSL, 2009; WFE, 2010). $24 trillion of this is represented by pension funds (IFSL, 2009). Due to their high political profile, labour-influenced investment practices and long-term investment horizons, pension funds are under continual pressure from various sources to direct their portion of this global wealth towards "social ends" (Arnold and Hammond, 1994; Neu and Taylor, 1996). For example, the United Nations Principles for Responsible Investment, released in 2006, have paved the way for an international focus on incorporating environmental, social and governance (ESG) issues into investment decisions.

> As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. (United Nations, 2006)

Despite increased attention on ESG factors, the ability of institutional investors, and pension funds in particular, to focus on these extra-financial factors is a subject of ongoing debate. Part of that debate centres around the requirement for pension funds to discharge a fiduciary obligation to plan beneficiaries, which has typically meant a focus on investment returns.

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However, this study turns the focus onto another contributing factor, the compensation and evaluation process used widely in the pension and investment management industry.

Within this industry, RPE-based incentive schemes dominate compensation and evaluation. Since "managing money is not the true business of the money management industry . . . rather, it is gathering and retaining assets" (Lowenstein, 1995), industry practice is to reward managers on the level of assets under management. Assets normally flow into funds that perform better than their peers. Thus, positioning relative to others determines compensation, client-retention and hiring/firing decisions.

This incentive structure has been studied in many industries (Gehrig et al., 2009; Gibbons and Murphy, 1990), but less is known in the case of the fund management industry, and even less in the specific instance of pension fund investment. This is an important gap, since research has pointed to effects on behavior and fund performance, and these have been linked to broader economic impacts. Thus, at both the organizational and societal levels, there is a clear motivation to learn more about how fund managers react to RPE.

Norman B. Macintosh's model of control systems cites RPE as an example of a management control system that is able to take into account technological and organizational/social factors. In his book "The Social Software of Accounting and Information Systems", Macintosh urges practitioners, students and academics to consider the "organizational behavioural ramifications" of accounting and information systems. In it, Macintosh outlines a model of management control that combines both personal and impersonal forces. He identifies the work of fund managers as a Craft Technology utilizing a results-oriented control system:

> . . . since the desired results can be determined in advance the appropriate management controls are simple, involving instrumental tests which focus on results. For the investment fund the appropriate test is the annual percentage increase in the fund's value. This can be compared readily with other funds. (Macintosh, 1985, 252)

Macintosh also spent considerable effort emphasizing the need to place accounting within a social context. Using a variety of theoretical bases, he purposefully set out to challenge the notion that accounting is a mere technical practice situated solely in the domain of the firm, (Jonsson and Macintosh, 1997; Macintosh et al., 2000). Concurrent with this was the call by Hopwood and colleagues to consider the constitutive nature of accounting, including its social aspects. "Accounting in action" proposed by Hopwood in the 1980s was similarly directed towards bringing accounting out of its technical domain and more firmly into the organizational and social.

The current study will frame RPE within the push to consider non-technical aspects of accounting. It draws on the idea of "accounting in action" to trace the emergence of RPE within this industry by examining the conditions that made its adoption and popularity possible. It then examines the use of RPE in one empirical setting, Canadian pension funds, to determine its impact on the use of ESG-driven investment practices. It argues that relative evaluation against pre-determined benchmarks forces a portfolio into a narrowly constrained opportunity set; the opportunity set is based on the underlying market portfolio against which the fund is being measured, or the universe of investment opportunities that its peer group invests in. This makes it difficult for investment managers and pension funds to include investments falling outside this narrow range, including those that focus on ESG factors.

The study also builds on the work of Neu and Taylor (1996) who argued that taking calculative techniques at face value can mask the underlying issue: that a focus on the purely financial is deeply embedded in the institutional practices of pension fund management. In keeping with Macintosh's call for more critical work, it aims to critique the use of RPE and argue for reform in the compensation structure and monitoring framework for pension assets.

The paper proceeds as follows. Section 1 comprises this Introduction. Section 2 introduces the literature on RPE. Section 3 reviews the theoretical and methodological framework for the paper, that of accounting in action and the genealogical approach of Foucault. Section 4 analyses the RPE system's social embeddedness. Section 5 concludes and offers avenues for future research.

2. Literature—relative performance evaluation

Relative performance evaluation is part of compensation. Literature has examined its use primarily from an economic perspective which characterizes it as an agency based monitoring technique. Its behavioral impact has been examined at the portfolio level. However, literature has yet to address it through frameworks other than economic ones, and it also has failed to point out effects broader than at the portfolio level. The current study aims to extend the literature by doing both.

A review of the current literature begins with the observation that performance measures are based on both motivating incentives and penalties (Baiman and Demski, 1980; Merchant, 2006). Merchant (2006) has classified these into three broad categories, including market based measures, accounting based measures, and combinations of measures involving market, accounting and/or disaggregated financial and/or non-financial measures. Standard management accounting techniques such as variance analyses, flexible budgeting and relative performance evaluation procedures become part of the third category. Relative performance evaluation would involve, for example, holding managers accountable for generating market returns greater than the overall market, or greater than the average of a peer group (Merchant, 2006, 901).

It is this last category that this paper addresses. Relative performance evaluation has been identified in the agency literature as a method by which to increase the efficiency of a principal-agent contract. The efficiency gain arises because

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