

DAY ONE PROJECT

Unlocking Beneficial Capital by
Improving Investor Transparency

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Summary

Beneficial investment organizations (BIOs)—such as public pension funds, endowments, and the investment arms of charitable organizations—are a cornerstone of American welfare and the foundation of our modern capitalist system. American BIOs manage tens of trillions of dollars in pursuit of their goals, and this financial capital serves to power the American economy. But hundreds of billions of dollars are wasted by BIOs every year due to insufficient portfolio transparency, which contributes to BIOs paying excessive fees, assuming unnecessary and uncompensated risks, and chronically underperforming. Insufficient BIO transparency thus harms not only their direct beneficiaries (e.g., retirees, universities and charities), but it also harms America. Due to this opacity, billions of investment dollars are artificially diverted away from long-term projects that could have widespread social and economic benefits. In short, poor transparency on portfolio attributes, such as costs and sustainability, prevents beneficial investment organizations from actually benefiting their stakeholders and America.

Increasing BIO transparency through enhanced reporting and disclosure could unlock hundreds of billions of dollars in beneficial capital for long-term projects that would aid large segments of American society. Improved transparency would allow stakeholders to better understand BIOs' investment decisions and their long-term consequences, which could then underpin design changes (e.g., better governance and regulatory structures). Transparency is thus a catalyst to make BIOs more willing to change and improve how they invest, which will unlock capital for long-term, large-scale projects that America desperately needs and drive high risk-adjusted returns. Launching a Presidential Advisory Commission is the best first step for the Biden-Harris Administration to take to improve transparency among BIOs and unlock substantial volumes of long-term beneficial capital.

Challenge and Opportunity

BIOs owe a fiduciary duty to their beneficiaries: to maximize the investment returns on long-term capital entrusted to them by prudently managing portfolios of investments. BIOs are granted favorable tax status because increasing beneficiaries' long-term capital is desirable for American society. It provides higher, more stable income for retirees; expanded support for research, education, and the arts; and more resources for charitable causes. The foregone revenue from this favorable tax treatment amounts to hundreds of billions of dollars annually. Hence, whenever BIOs operate poorly and waste beneficiaries' capital, they also implicitly harm Americans in general by making this loss of tax revenue less justified.

There is significant evidence that such waste occurs and is both widespread and large in scale. It takes three main forms among BIOs:

1. Payment of excessive costs and fees to third-party asset managers and consultants¹
2. Exposure to unknown investment risks²
3. Chronic underperformance of investment portfolios³

The persistence of these harmful forms of waste is largely attributable to insufficient transparency. BIOs do not have to compete for their beneficiaries' capital—they are monopolies—and generally are not encouraged, by their design or governance, to innovate. As such, transparency is the primary mechanism by which BIOs' behavior is modulated. Beneficiaries and those acting on their behalf, such as state legislatures, must rely on the information that BIOs report and disclose to monitor their operations, as well as to make decisions about potential corrective actions. Without transparent measurement and reporting, there is very little incentive for BIOs to change or innovate in their investment management practices.

However, the extent and quality of reporting and disclosure among BIOs is inadequate. For example, a recent study by CEM Benchmarking finds that half of a typical BIO's investment expenses go unreported.⁴ Similarly, detailed reporting and disclosure on the sustainability of assets in BIOs' investment portfolios (e.g., in terms of environmental and social impacts) is uncommon in the United States—although it is the norm in many other developed countries—and is usually far from comprehensive when it does appear.

The problems that stem from weak transparency can and should be solved. Improved transparency—by means of enhanced reporting and disclosure by BIOs on fees and costs, sustainability impacts, and other operating performance criteria (e.g., racial diversity of portfolio)—would not only reduce harm to BIOs' direct beneficiaries by revealing unintended biases or operational inefficiencies, but it could also catalyze a new era of innovation among BIOs that would unlock beneficial capital for long-term projects that better the lives of millions of Americans. That is, improved transparency could be paired with better governance practices to motivate and sustain innovative behavior by BIOs. A likely outcome of such innovation would be BIOs more effectively utilizing their innate advantages as long-term capital allocators, which would result in a sizable expansion of funding for projects that benefit America at large. This is exemplified by the increase in long-term, direct investing projects undertaken by various BIOs

¹ See Blake, D. 2014. "On the Disclosure of the Costs of Investment Management." The Pensions Institute, Discussion Paper PI-1407.; Phalippou, L. 2009. "Beware of Venturing into Private Equity." *Journal of Economic Perspectives*, 23(1): 147-166. Phalippou, L., Rauch, C., and Umler, M. 2018. "Private Equity Portfolio Company Fees." *Journal of Financial Economics*. 129(3): 559-585.

² Lack of understanding of investment risk in the GFC led to the growth of factor investing. See, e.g., Ang, A. 2014. *Asset Management – A systematic approach to factor investing*. Oxford University Press.

³ See Robinson, D. and Sensoy, B.A. 2011. "Do Private Equity Fund Managers Earn their Fees? Compensation, Ownership, and Cash Flow Performance." *Review of Financial Studies*, 26: 2760-2797.; Phalippou, L. 2020. "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory." University of Oxford, Saïd Business School, Working Paper. Available at SSRN: <https://ssrn.com/abstract=3623820> or <http://dx.doi.org/10.2139/ssrn.3623820>.

⁴ See Halim, S. and Reid, M. 2020. "Asset owners report half of all costs", available at: <https://www.top1000funds.com/2020/11/asset-owners-report-half-of-all-costs/>.

that have chosen to prioritize innovation (e.g.: TIAA’s multi-billion dollar investment program in sustainable agriculture; the University of California retirement system’s deployment of over one billion dollars into clean-energy technologies; and the Teacher Retirement System of Texas’s direct investment of hundreds of millions of dollars into new infrastructure projects). These direct allocations often result from attempts to reduce investment costs over the long-run for BIOs (e.g., by cutting fees to external managers), but they also result in larger capital availability and wider funding availability for transformative projects—such as in infrastructure and climate-change mitigation.⁵

Plan of Action

The best first step that the incoming Administration can take to improve transparency among America’s BIOs—and unlock long-term capital—is to issue an Executive Order that creates a Presidential Advisory Commission. The most effective and enduring changes to the BIO landscape in the United States were precipitated by the Presidential Commission on Pension Policy (EO120710) under President Carter in 1979. That earlier Commission led to a package of new legislation and regulation that transformed how pensions and other BIOs act. Yet in the intervening decades, there has been surprisingly little progress in modernizing how BIOs function, particularly on transparency, even though the complexity and opacity of financial products offered by the financial services industry has increased significantly.⁶ The current imperative to create a new Commission is supported by findings from a 2017 study by the Government Accountability Office.⁷ The proposed new Commission could serve as a basis for coalition-building and bipartisan buy-in for subsequent reform, which would be supplemented by the Commission gathering official testimony and evidence. Priorities for this Commission are discussed in an Appendix to this document.

A Presidential Advisory Commission on BIO transparency will also be advantageous in creating momentum for other policy tools to improve transparency among BIOs. These tools could include: empowering an existing government agency with greater oversight powers to facilitate BIO transparency; creating new federal legislation or upgrading existing legislation; updating definitions of fiduciary duty within the Department of Labor; selecting commissioners for the Securities and Exchange Commission that prioritize better investment transparency; and creation of a new independent oversight entity. A Presidential Advisory Commission is a responsible precursor to all of those subsequent policy possibilities, and potentially others.

⁵ The Institutional Investors Roundtable (IIR) is a useful example of how BIOs can innovate when given the motivation and reason. It currently comprises 45 global pension plans and sovereign wealth funds with collective assets exceeding U.S. \$13 trillion to foster peer collaboration and innovation in areas of critical importance.

⁶ Monk, Ashby H. B. and Sharma, R. 2016. “‘Organic Finance’: The Incentives in Our Investment Products” Stanford University, Global Projects Center, Working Paper. Available at SSRN: <https://ssrn.com/abstract=2696448>.

⁷ The Nation’s Retirement System: A Comprehensive Re-Evaluation is Needed to Better Promote Future Retirement Security” GAO 18-111-SP: <https://www.gao.gov/products/GAO-18-111SP>; S.1435 ‘Commission on Retirement Security Act of 2019’. There have also been recent efforts to launch a similar review in the Senate: <https://www.congress.gov/bill/116th-congress/senate-bill/1435>.

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The objectives from this exercise are summarized in the following Policy Logic Diagram:

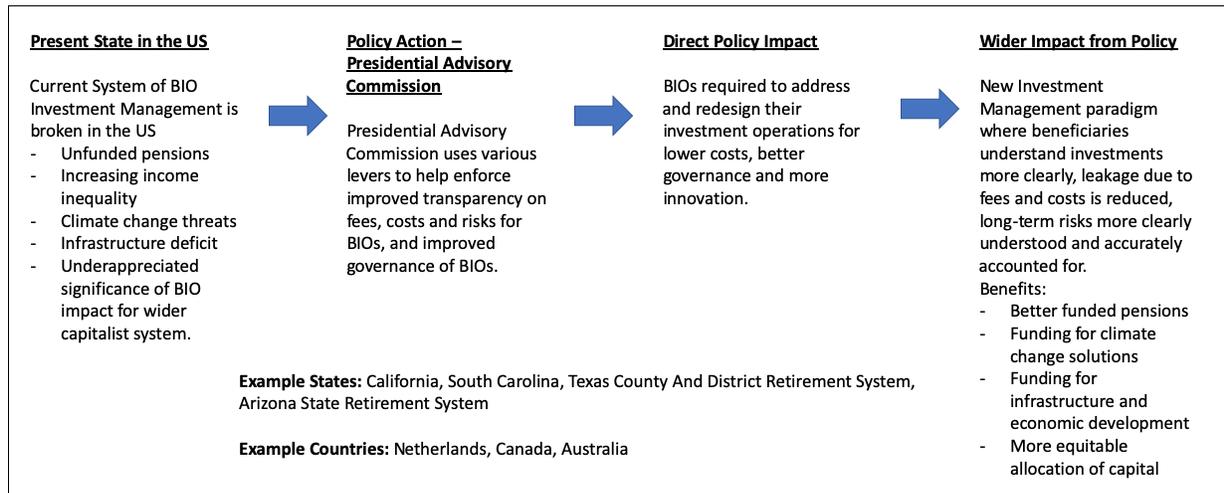


Figure 1. A Policy Logic Diagram showing the objectives of a Presidential Advisory Commission.

Appendix

The primary objective of a Presidential Advisory Commission on BIO transparency should be assessing the ‘transparency gap’ among these organizations and analyzing pathways for closing it. This gap can be thought of as the difference between what is actually being disclosed and reported by BIOs and what should ideally be disclosed and reported. As such, the core mission of a Presidential Commission would involve:

- Identifying what information is being reported by a wide spectrum of BIOs in the U.S., how it is reported (e.g., format, frequency), and where this information is sourced (e.g., from internal records, from external asset managers, or from third-party consultants); and
- Identifying what information should be reported to achieve the “ideal state” of transparency for American BIOs, as well as how such information should be reported and from where it should be sourced.⁸

Alongside studying where and how deficiencies in reporting occur, it will be vital for a Commission to undertake impact-sizing of any deficiencies it uncovers; that is, it should attempt to quantify the total cost of each deficiency to affected parties—chiefly, beneficiaries and U.S. tax-payers. Impact-sizing will help inform the debate about which policy instruments may be justified in closing the transparency gap.

While the ideal standards for information reporting and disclosure proposed by a Commission may not be immediately adopted by the relevant organizations (e.g., the Federal Accounting Standards Board, the Governmental Accounting Standards Board, or the Securities and Exchange Commission), it seems advisable that a Commission should draft an ideal standard that is detailed and feasible, and that provides justifications for each component of the draft standards. Below is a list of some component categories that a Commission might consider in drafting a reporting standard. This list is by no means exhaustive—other components can and should be considered—but it does address some key problems in current transparency standards. A draft standard for enhanced reporting and disclosure might include more detailed:

- **Fee and cost disclosure**: A top priority for improving transparency must be a more granular, decomposed presentation of the fees and costs associated with hiring external asset managers (e.g., reporting fees for specific managers rather than an aggregate across all external managers). Relatedly, an enhanced standard might compel BIOs to go farther in helping beneficiaries and regulators understand the extent to which such fees and costs are justified, by reporting more information connected with benchmarking and attribution. Reporting net returns, disaggregated fees and costs, and manager-specific benchmarks for each manager would substantially improve transparency, as well as help

⁸ This latter element could serve as a foundation for a new set of standards for information reporting by BIOs, and a key responsibility of a Commission could be to codify such standards (if only in draft form).

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clarify whether each external manager is really an efficient and effective provider of performance for a given BIO. Even deeper disclosure might involve comparing each manager's fees and costs with an annualized/amortized estimated expense of 'insourcing' that manager's function (i.e., making internal hires and building internal infrastructure to replace that manager's contribution to expected risks and returns for the BIO's portfolio). Similarly, reporting of external managers' fees and costs might include a comparison with average fees and costs among peer managers; this information might not currently be readily available, and a useful task for the Commission may be to explore ways in which this information may be made more visible for potential users.

There is also a need to improve reporting on costs that arise from inside a BIO's own organization. Although the reporting of internal costs (e.g., for personnel, legal counsel, office supplies) may be more transparent for some BIOs than it is for reporting on their managers, these internal figures often lack context. Pushing BIOs to report the costs of their own operations alongside benchmark figures for relevant peers—as is voluntarily done by some Canadian public pension funds—could provide such context. Another helpful task for a Commission would be to explore how to compile and disseminate such benchmarked information, as it is scarce and difficult to assemble at present.

- **Risk disclosure:** Nearly equal in importance to greater transparency on fees and costs is improved visibility on the risks to which BIOs are exposed—both in terms of the portfolios they hold and the organizations that they operate, including people, technology, infrastructure and formalized processes. Presently, the vast majority of risk reporting conducted by BIOs fixates on expected short-term statistical properties of the portfolio (e.g., anticipated volatility, or value-at-risk), rather than illuminating how the portfolio and organization might be vulnerable to 'named' sources of risk over time. For example, practically no U.S.-based BIO reported on its likely exposure to pandemics prior to the onset of COVID-19, even though the general characteristics of a pandemic could be envisioned. Likewise, presentation of the expected risks that would materialize from imaginable events—e.g., international armed conflict, nationwide food shortages (from drought, disease, etc.), or major terrorist attacks—go unreported. Many of these risks fall under the umbrella of environmental, social, and governance (ESG) concerns, and more extensive and comprehensive standards for reporting of ESG-related risk—beyond greenhouse gas contents of portfolios, and other narrow conceptions of sustainability—should be an essential ingredient of any draft standard delivered by a Commission.
- **Disclosure on technology and data:** Apart from fees paid to external managers, the costs of data and technology are the largest costs (along with compensation of personnel) that many BIOs face. As with other costs, more granular reporting on data and technology costs could be a beneficial requirement in a new draft standard. But perhaps more important is more comprehensive disclosure on the external data and technology solutions a given BIO leases or purchases. Reporting on this matter is in no way

DAY ONE PROJECT

standardized, and is not common among U.S. BIOs. More transparency about what major technologies they pay for could help ensure that BIOs are efficiently using beneficiaries' capital by reducing the likelihood that they purchase inferior technologies.

DAY ONE PROJECT

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