The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

April 2025

RETHINKING PENSION FUND INVESTING:

THE JOURNEY CONTINUES

"A central thesis of this book is that business has evolved, but that the language that is widely used to describe it, has not."

"The modern business environment is characterized by 'radical uncertainty'. It can be navigated only by assembling the collective knowledge of many individuals and by developing collective intelligence…a problem-solving capability which distinguishes firms that get this, from their competitors that do not."

"What we call 'profit' is no longer primarily a return on capital, but is 'economic rent'. It describes the earnings that arise because some people, places, and institutions have commercially valuable talents and attributes which others struggle to emulate. It arises from many sources, including from the ability to do things better than other organizations."

"The success of modern business does not depend on transactional skills, but on strong social relationships between and among stakeholders. A modern business is more a community than a collection of offices and factories."

John Kay

The Key Message of John Kay's New Book

Our *Letter*s have been referencing Sir John Kay's research and writings for decades. He is an influential British economist, Founding Dean of Oxford University's *Said Business School*, and winner of many excellence awards for his research and writings on economics and business topics. The quotes above come from his 2024 book "*The Corporation in the 21st Century"*, with the subtitle "*Why (almost) everything we are told about business is wrong*."

The four Kay quotes above all point to the key message of his book. We must shelve the 'old' academic business models based on physical capital, contracts, principals, agents, earnings calls, share price maximization, and move to a new, more integrated stakeholder theory of the firm based on co-operation, win-win outcomes, and long horizon value creation.

Kay points to economist Edith Penrose as being among the first to write about this business model transition. In a 1959 paper she noted a shift to firms "*not defined by the assets and contracts they owned, but by their capabilities and their ability to deploy those capabilities in producing innovative goods and services. Evidence suggests that the growth of these firms is connected with attempts of particular groups of people to do something."* Kay goes on to observe that Penrose recognized these attempts as reflecting the increasingly cooperative nature of business activity and its focus on solving visible problems. The evolution of the *APPLE* organization offers a good example of this 'to do something' dynamic in action over multiple decades involving a particular group of people with names like Jobs, Wozniak, Wayne, Markkula, Scott, Sculley, Ive, and Cook.

Kay's message of rethinking the purpose and design of the firm aligns well with the key message of the March 2025 *Letter* titled "**Making Investment Theory More Pragmatic: How Context Clarity Can Help**". That *Letter* recounted the evolution of our own thinking towards a new, more integrated stakeholder theory of the firm based on innovation, co-operation, win-win outcomes, and long horizon value creation. This *Letter* continues the exploration of the practical implications of this evolving theory of the firm for institutional investors charged with the task of turning good theory into good practice. A useful theory of the firm should offer a strong basis for rethinking the structure of sound investment management practices.

Madden's 'Pragmatic Theory of the Firm' and TenHaken's Confirmation

To that end, prior *Letter*s have referenced Bartley Madden's "Pragmatic Theory of the Firm" (PTF) as a viable candidate for such a theory. PTF postulates that a firm's purpose defensible to all its stakeholders is four-fold:

1. Provide a vision that inspires employees to commit to behaving ethically and making the world a better place through the products and services the firm provides.
2. Survive and prosper through continual gains in efficiency and sustained innovation, which depends on the firm's knowledge-building proficiency. Systems thinking is an important part of knowledge-building. Earning at least the firm's cost of capital is a financial requirement.
3. Work continuously to sustain win-win relationships with all of the firm's stakeholders (e.g., customers, suppliers, employees, and shareholders).
4. Take care of future generations through products and services that are designed to minimize waste and environmental harm.

The January 2025 *Letter* offered confirmation of the validity of the PTF. The Letter's title was "**Understanding Corporate Longevity: What Secret Sauce Do Firms Over 100 Years Old Have In Common?**" It reviewed Vicki TenHaken's 2016 book on the lessons we can learn from companies that have survived and prospered continuously for over 100 years. What has been the secret sauce that has enabled these firms to accomplish this for such a long time?

According to TenHaken, corporate longevity is related to four factors:

1. Strong corporate vision and culture,
2. Unique core competencies and change management,
3. Close relationships with employees and business partners,
4. Active members in the local community.

The January *Letter* noted…. "*comparing Madden's Pragmatic Theory of the Firm with TenHaken's longevity findings, it is hard not to observe that the two mirror each other closely. Thus the conclusions of Madden's deductive approach to setting out the conditions for sustainable corporate value-creation are confirmed by TenHaken's historical approach to understanding the drivers of historical corporate longevity*". Here we further note the convergence of John Kay's "The Corporation in the 21st Century" findings and conclusions with those of Madden and TenHaken.

What are the implications of this ex ante/ex post investment theory/practice evolution being fostered by people like Ambachtsheer, Kay, Penrose, Madden, and TenHaken? Specifically, what should it motivate the professionals responsible for the oversight and management of $trillions of retirement savings to do? At a very high level, it should surely lead to decisions to emphasize ownership-focused long-term value-creation strategies over short-term 'beauty contest' trading gains.

A more challenging question is how to effectively implement such a long-term strategy, when short-term beauty contest games continue to play day in, day out in the media?

Six Critical Management Tasks

A logical place to start addressing the 'investment management implications' question systematically is to pose yet another question: What are the critical managerial tasks that can facilitate a firm achieving its four-part purpose over the long term? Madden proposes six:

- Task #1 Nurture and sustain a high-proficiency knowledge-building culture
- Task #2 Strategic thinking
- Task #3 Organizational structure
- Task #4 Efficiency of existing businesses
- Task #5 Innovation for existing and future businesses
- Task #6 Performance measurement

Madden notes that Task #1 is the single most critical determinant of long-term performance. Knowledge-building proficiency is the key to successfully addressing Tasks #2, #3, #4, #5, and #6. All this suggests a six-point check list for institutional investors as they evaluate the firms they have already invested in, and as they evaluate the prospects of firms that might become investment candidates.

The idea of a six-point checklist raises another question. Is it possible to devise metrics that would provide an indication of how well a specific firm is performing in addressing each of the six tasks? Posing this question to Madden, he made a number of interesting suggestions:

<u>Task #1 High Proficiency in Knowledge-Building</u>: produces a sustainable return-on-capital above the firm's cost of capital. The Cash Flow Return On Investment (CFROI) is a possible return-on-capital metric. Portfolio managers that use the life-cycle framework (part of the Pragmatic Theory of the Firm) refer to this CFROI sustainability result as favorable "fade." Other high proficiency knowledge-building metrics include the R&D/Sales ratio versus competitors, and the proportion of Selling, General & Administrative Expenses for intangible expenditures versus competitors.

<u>Task #2 Strategic Thinking</u>: assessments of management's strategic thinking is occasionally analyzed in security analysts' reports and highlighted in CEO shareholder letters. Conference call transcripts may provide insights as to a firm's culture that can identify doable challenges and accept failures as part of developing options to facilitate adapting to change. For an excellent analysis see Richard Rumelt, *The Crux: How Leaders Become Strategists*. Jeff Bezos rightfully emphasizes that strategic thinking needs to get beyond existing capabilities in a recent *Bloomberg Business Week* interview.

<u>Task #3 Organizational Structure</u>: the extent of bureaucratic command-and-control reflected in a firm's organizational structure is indicated by the number of managerial levels separating the CEO from front-line employees. The highly productive steel company *Nucor* has maintained four layers which is a fraction of the layers at *U.S. Steel*. In a recent *Observer* interview, CEO Brad Smith of high-performing firm *Intuit* noted "*a rapid experimentation culture cuts through hierarchy, creating an environment where everyone can innovate and debate turns into doing*." Also, data from the *Great Places to Work* survey indicates how employees experience the firm's culture.

<u>Task #4 Efficiency of Existing Businesses</u>: conventional accounting-based metrics such as operating margins are useful. However, current accounting practices are obsolete due to essentially ignoring intangible assets. For R&D intensive firms, earnings, return-on-capital, and organic growth rates need to reflect capitalization and amortization of intangibles.

Task #5 Innovation for existing and future businesses: the magnitude and success of new product introductions provide a quick guide as to innovation. So too do measures of the impact (citations by other patent holders) of a firm's patents. Discussions with management can provide insights about innovation in existing businesses versus future businesses. How does management orchestrate resources for both existing businesses and future businesses that are typically posting losses and may compete with existing businesses? For more on this, see *Humanocracy: Creating Organizations as Amazing as the People Inside Them* by Gary Hamel and Michele Zanini (2020).

Task #6 Performance Measurement: accounting-based performance metrics gain usefulness at higher levels in the organization. For example, long-term life-cycle track records reveal levels and trends in CFROIs (adjusted for inflation and intangibles) and in the firm's reinvestment rates (asset growth rates). For more, see Bartley J. Madden, *Value Creation Principles: The Pragmatic Theory of the Firm Begins with Purpose and Ends with Sustainable Capitalism*. At lower levels, the goal should be to provide information that not only is a useful measure of work productivity, but also provides information to help employees take actions to improve their work processes. For a comprehensive analysis on this topic, see Mike Rother, *Toyota Kata*: *Managing People for Improvement, Adaptiveness and Superior Results*.

Final Thoughts

This *Letter*'s title is "Rethinking Pension Fund Investing: The Journey Continues". For us, this rethinking journey started years ago, and the message of this *Letter* is that while we are making progress, the journey is by no means over. An earlier critical *Letter* journey marker was the concept of 'ownership investing' for pension funds and other long-horizon investors. Acting like owners prompts very different behavior than acting like traders. The journey marker in this *Letter* is the reality that the business sector itself is also evolving in both theory and practice. Peter Drucker's 'pension revolution' continues to unfold on both the investee and investor sides of the fence.[i]

Keith Ambachtsheer

Endnotes:

i. *One of those earlier 'rethinking pension investing' Letters was titled "**Improving Investment Models for Pension Funds: How Are We Doing?**" It made the important distinction between 'macro' investing (i.e., setting and implementing investment policy at the asset class/factor level), and 'micro' investing (i.e., selecting and owning individual firms as investments in part or in whole). In that context, this Letter has a clear 'micro' investing focus. In contrast, the recent Trumpian trade war eruption has all the makings of a major 'macro' investing event. It will likely trigger a multi-year period of global 'stagflation'. How long and deep will real economies stagnate? How high will the prices of good and services rise? How high an equity risk premium will investors demand? All questions to be addressed in future Letters.*

Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
416.925.7525. www.kpa-advisory.com