Institutional Investors Go Green

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When most people think about campaigns for social causes they think of organizations like Greenpeace and Amnesty International. But in the post-Enron, post-Tyco world, the most effective campaigners may well prove to be big institutional investors – mutual funds and pension funds.

Not only do they have the money, but a reach and influence that traditional do-gooders can only dream about. When they talk, governments and corporations must listen. And, thanks in no small measure to the market scandals of the past two years, a number of these institutions – notably the managers of public pension funds and managers of indexed mutual funds, which now hold a substantial portion of traded securities – are broadening their interests to encompass social and environmental issues.

Last year, shareholder resolutions that were not directly aimed at the bottom line received unprecedented levels of support – particularly from large institutional investors and pension funds. “The 2002 season was quite remarkable,” says Meg Voorhes, director of the social issues service at the Investor Responsibility Research Center (IRRC), which monitors shareholder voting.

Social and environmental shareholder proposals got more than twice as much support as they have in the past. Before this year, Voorhes explains, it was rare for such proposals to garner as much as 15 percent of the vote. This year, 15 percent was a very modest showing.

Consider a resolution before Idacorp, the holding company for Idaho Power, asking management to review the re-licensing process for one of its hydroelectric plants. The proposal, which was sponsored by Trillium Asset Management, cited environmental factors as a major reason for the review – hardly the traditional stuff of shareholder concern. Yet the ballot question got 34 percent of the vote.

Likewise, a resolution asking oil-giant Unocal to support the core conventions of the International Labor Organization (ILO) did surprisingly well, with 33 percent of the vote. The proposal was put forward by the Long-View Fund, a union-backed investment fund, and was motivated by Unocal’s extensive operations in Myanmar – a country where human rights abuses are rife.
But “the real story of the season,” says Michelle Chan-Fishell, director of the green investments program at Friends of the Earth, is the popularity of shareholder resolutions targeting the climate-change issue.

In 2002, shareholders filed 19 significant resolutions dealing with greenhouse gases. Of these, only seven made it to a vote because management preferred to negotiate compromises outside the public eye. And of the seven, five got more than 15 percent of the vote, with resolutions at Eastman Chemical and American Standard getting a remarkable 30 percent and 27 percent, respectively. Compare that to 2001, when only six proposals on climate change were filed and these got an average of just 7 percent of the vote.

Some of the credit for the gain should probably go to the drafters of the proposals. The language “used to be quite broad and speculative,” explains Voorhes, “but they are becoming better focused. This year they were mostly asking for reports on emissions.”

Just as important, says Chan-Fishell, is the fact that Institutional Shareholder Services (ISS), a leading provider of proxy voting recommendations to the investment world, has changed its views on some of these issues. “Of course,” she reminds, “it could just be that this year, as a result of Enron, shareholders are actually reading their proxies and no longer voting blindly with management.”

**Shareholders as Social Activists**

Though Enron woke up a lot of individual investors, the real muscle is coming from large institutional investors that count shares by the millions – in particular, the state employee pension funds. This year, for example, Connecticut’s retirement plan (with some $20 billion in assets) became the first to file resolutions asking companies to report on their emissions of greenhouse gases.

Donald Kirshbaum, investment policy officer in the Connecticut state treasurer’s office and the person responsible for making proxy decisions for the state’s pension funds, is all in favor. “It makes perfect sense,” he notes. “Pension funds are long-term investors, and these complex issues tend to impact a company’s financial performance in the long-term.” Besides, he adds, Connecticut law requires the state treasurer to weigh the social, economic and environmental implications of investments. With so clear a mandate, Kirshbaum says, his state will continue to push companies on the issue of climate change.

In addition to the Connecticut retirement plan, a number of other large public pension funds played a role in driving the 2002 social and environmental resolutions. For example, the pension funds of New York City (with some $80 billion in assets) last year filed and/or supported resolutions on ILO standards, renewable energy and climate change.

Ken Sylvester, director of pension policy for the New York City Comptroller, echoes the
view that corporate social virtue serves his clients’ long term interests. “We see it as our fiduciary duty to get companies to behave more responsibly,” he emphasizes. In the years to come, Sylvester says, his office is going to focus on ensuring that the companies in its investment portfolio publish strong social and environmental reports—preferable using the guidelines prepared by the Global Reporting Initiative (GRI), a nonprofit group based in the Netherlands.

Although it did not sponsor any social resolutions in 2002, New York State’s Common Retirement Fund (with a whopping $112 billion in assets) did keep a hand in. State Comptroller Carl McCall supported some of the most successful social resolutions, including a request for the financial services company, Household International, to link executive pay to measures that prevent predatory lending.

According to IRRC, a well-publicized comment by McCall indicating that the state’s retirement funds might sell their 2.5 million shares in Household if the company didn’t address this problem helped the resolution achieve 27 percent of the vote. The Minnesota State Board of Investment is apparently also backing the initiative at Household.

But the fund to watch, the undisputed trendsetter on social and environmental issues, is the California Public Employees’ Retirement System (Calpers). Not only is Calpers one of the largest pension funds in the world (with close to $150 billion in assets), it has long been a leader on corporate governance issues as well as social issues.

Chan-Fishell speculates that social activism is getting a boost because other funds are watching the policy shifts at Calpers. She cites a recent decision by the pension fund giant to factor social and human rights criteria into investment decisions in emerging markets, as well as an earlier announcement indicating that Calpers would vote its shares in favor of solid social and environmental resolutions unless it could be shown that a resolution would impair the company’s financial performance. Previously, Calpers had placed the burden of proof on the filers of a resolution, asking them to show that it wouldn’t hurt the company’s bottom line.

Although the burden-of-proof reversal has fundamentally changed the way the pension fund votes its shares, Calpers’ emerging markets decision has received more publicity—and more criticism.

The emerging markets initiative operates on two tracks. At the country level, it requires Calpers to consider factors such as human rights violations, support for ILO standards, the existence of a free press, and the strength of a country’s democratic institutions in preparing its lists of “permissible” and “prohibited” countries for investment. As a result, Calpers has announced that it will divest from Indonesia, Malaysia and Thailand, and begin to invest in Hungary and Poland. At the company level, Calpers will move from being a passive investor to an active one, with its managers considering social issues when making investments.
A key person behind the emerging markets reforms (as well as many of the other significant social/environmental changes at Calpers) is Philip Angelides, California’s state treasurer. Angelides defends these decisions on economic grounds. “I wouldn’t characterize what we are doing as ‘socially responsible’ investing,” he says. “I would characterize it as ‘smart’ investing. We are trying to improve our long-term performance, period.”

Angelides says there is an extensive body of literature showing a strong correlation between openness, democracy, political stability, workplace protections, labor rights, freedom of the press and sustainable environmental practices on the one hand, and a country’s long-term economic growth on the other. “Besides,” he adds, “given the abysmal returns in foreign emerging markets, I just thought it was time for Calpers to look again at the standards and criteria used to judge investments in those markets.”

Angelides would also apply similar principles to corporations in the United States. He argues that socially responsible companies in the end do better financially. “Since pension funds are long-term investors,” he concludes, “we wouldn’t be living up to our fiduciary responsibilities if we didn’t look at some of these broader social and environmental issues.”

James Hawley and Andrew Williams, professors of business at St. Mary’s College in California and the authors of The Rise of Fiduciary Capitalism, predict this trend is likely to grow. “Most large institutional investors are now index investors, which means they own the whole economy,” explains Williams. “They will have a tendency to be more concerned with the overall health of the entire market than they are with how any one single investment is performing.”

“Institutional investors are going to increasingly have to monitor their portfolios for interactions and for what traditional economists call externalities,” adds Hawley. “They will have to worry about how one company’s actions on education, training, pollution or the environment benefit or damage all the other companies whose shares they own.”

If Hawley and Williams are right, why aren’t other large institutional investors behaving like Calpers? Why is it only the public pension funds taking the lead?

Michael Flaherman, chair of the investment committee of the Calpers Board, thinks this omission is driven by conflicts of interest. “Corporate pension funds and university endowments,” he explains, “shy away from public criticism of companies because they have to manage a series of relationships: with their peers, customers, suppliers, donors and others. Mutual funds, on the other hand, gather assets by managing 401(k) plans, so they, too, have some huge, ingrained conflicts of interest.”

Nell Minow, the editor of the Corporate Library, an online repository of research on corporate governance, puts it more succinctly: “Private and corporate pension funds think
like corporations, whereas public pension funds think like politicians.”

The one exception to this rule is TIAA-CREF. Ever since the big college teachers pension fund was created, it has been active on social, environmental and governance issues. Ken Bertsch, TIAA-CREF’s director of corporate governance, thinks it has to do with the company’s original constituency, which largely consisted of progressive academics. “Additionally,” he says, “we became large early on, and mostly indexed in the early ’80s, so we were forced to care. It also helps that in the past we haven’t had to compete heavily for 401(k) money, so we have fewer conflicts of interest than many other money managers.”

This issue of conflicts of interest among money managers is itself becoming a subject of activism. In July 2002, New York’s McCall and California’s Angelides joined forces with North Carolina Treasurer Richard Moore (sole trustee of the state’s public pension fund with some $60 billion in assets) and New York Attorney General Eliot Spitzer to call on investment banks to comply with a series of “Investment Protection Principles” that essentially mirrored the agreements undertaken by Merrill Lynch following a well-publicized suit brought against the company by Spitzer’s office. The principles require, among other things, that banks:

• sever the link between compensation for analysts and investment banking.

• prohibit investment banking input into analyst compensation.

• create a review committee to approve all research recommendations.

• require that upon discontinuation of research coverage of a company, firms disclose the coverage termination and the rationale for such termination.

• disclose in research reports whether the firm has received or is entitled to receive any longer compensation from a covered company over the past 12 months.

• establish a monitoring process to ensure compliance with the principles.

The state treasurers also threatened to cut off all state business with banks that refused to comply.

Angelides, McCall, Moore and Spitzer followed this announcement with a meeting last August of financial leaders from 17 states and the District of Columbia (who together manage more than $1 trillion in assets) with the goal of coordinating activism on corporate governance. The treasurers not only endorsed the principles put forward by Angelides, McCall, Moore and Spitzer, but said that the states would crack down on companies that register off-shore “in name alone” to avoid paying U.S. taxes. This “egregious conduct,” they said, not only robbed America of taxes, but also served to
weaken shareholder protection.”

After the August meeting, both Calpers and the California State Teachers Retirement System (CalSTRS, the third largest pension fund in the country) also agreed to help uphold the principles put forward by the state treasurers. Together, this amounts to hundreds of billions of dollars worth of pressure on investment banks. Then, in October, Angelides announced that his office would no longer do business with one bank, HSBC Securities, because it had failed to comply with the principles. He further said that relationships with 22 other banks were under close review. It was the first time that an investment bank had been barred from working with a state for failing to meet corporate governance standards.

The state treasurers have pretty solid support for their initiatives on corporate governance. John Bogle, the founder and former chairman of the Vanguard mutual funds (one of the largest private money-management firms in the U.S.) says he agrees with the need for stronger corporate governance across the board. In fact, he says he would like to see private pension fund and index fund managers join their public pension fund colleagues in calling for reform.

“As owners, we need to speak up for our interests,” he says. “We have been silent and we have gotten the corporate governance we deserve.” He calls the private mutual fund industry, and the index funds in particular, a “sleeping industry” that owns most U.S. corporations – an industry that, because of this ownership, could have a fundamental impact on the U.S. financial system if it decides to make its views known. Bogle is, in fact, busy trying to create an entity called the Federation of Long-term Investors to help these sleeping giants do just that.

He acknowledges that convincing private money managers to criticize corporations will not be easy. “They are the investment managers for corporate America, so it is going to take courage for them to risk offending some of their customers,” he says. But he is optimistic. He believes that Enron and WorldCom served as a loud wake-up call for Wall Street and that increased vigilance is a “definite long-term trend.”

Bogle, however, doesn’t see the private money managers moving strongly into social and environmental issues. “I can see why public pension funds do it,” he says. “There is tremendous political pressure on public pension funds to invest in their communities. But private mutual funds just can’t do that. Unlike public pension funds, private mutual funds need to be concerned with liquidity, with the fact that shareholders could redeem the entire fund overnight. There are different pressures and interests at work.”

He argues that it is “naïve” to think that socially responsible investments will outperform the market. “I am an indexer at heart,” he says, “so I’m skeptical. Besides, if we put out of business all the companies that pollute, we wouldn’t have any electricity.”

Angelides sees things differently. “Post-Enron,” he says, “the notion that we can divorce
investor decisions from a critical look at how companies conduct themselves in society needs to be discarded.”

He also points to the energy industry: “Companies that gamed the market for their short-term benefit to the detriment of society have ended up damaging themselves and the entire sector.” Institutional investors, he suggests, have an obligation to push to tear down the “false wall” between social performance and financial performance.

If he is right, companies may find that the Greenpeaces of this world are the least of their worries. Those who ignore social and environmental concerns will increasingly have to answer to more powerful forces: their mega-shareholders, institutions such as Calpers, Vanguard and TIAA-CREF.

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