

# **NO SMALL CHANGE**

**PENSION FUNDS AND  
CORPORATE ENGAGEMENT**

**Tessa Hebb**



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*For Bill*

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## Acknowledgments

Many people ask me why I look at pension fund investment activity and its impacts on financial markets and the firms they invest in. What makes pension funds so important? My answer is the same as that of the famous U.S. bank robber Willie Sutton when asked why he robbed banks, “because that’s where the money is.”

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**NO SMALL CHANGE**

# I.

## **Understanding Pension Fund Corporate Engagement**

Pension funds are not the new moral conscience of the twenty-first century, but they are significant owners of today's corporations. They are also institutions that pay out retirement benefits over long periods of time. Think of the twenty-five-year-old worker who retires at age sixty-five and draws his pension for the next twenty years. Given the length of such commitment, pension funds have to carefully consider companies they invest in over a long period of time and be increasingly aware of the long-term risks from the environmental, social and governance (ESG) factors in their investment portfolio.

Few risks are greater than the environmental risks companies face today. Considering that eight of the last ten summers in the United States were the warmest on record (Gore 2006), it is not surprising that investors are asking companies how they plan to manage climate change risk over time. The same holds true for social risks such as exposure to conflict zones, as is the case in the Sudan, or the potential reputation-ruining risk Wal-Mart is facing from numerous employee lawsuits. Anticipation and mitigation of long-term risks is key to pension fund corporate engagement. A growing number of pension fund trustees and managers have come to believe that, in the long run, ESG considerations lower the risks associated with an uncertain future. They believe companies that behave with certain ESG ethical standards maintain, and even gain, value over time.<sup>1</sup> To this end, pension funds are increasingly engaging companies in their investment portfolio in an effort to raise their ESG standards.

Two forces converged in the late 1990s and early 2000s that strengthened the role of institutional investors.<sup>2</sup> The first was their newfound willingness to act in coalition. The second was the combination of increasing managerial excesses and declining stock values. While absentee owners were seen as part of the

problem, renewed corporate governance and managerial oversight by shareholders were touted as the panacea to cure the ailing markets (Deakin 2005).

In widely held capital markets, such managerial oversight by shareholders is possible when large institutional investors aggregate the authority of previously dispersed beneficial owners. Pension funds are increasingly playing this role.

There are two types of pension funds. One is the defined benefit (DB) plan, which pays the retiring plan members based on years served and salary earned. The other is the defined contribution (DC) plan, where retirement payments are based on the amount of annual contributions. These differences are important in determining whether a pension fund will use corporate engagement.<sup>3</sup> Pooled DB pension plans, administered by boards of trustees are able to act as unitary economic agents within capital markets. As a result they lower the transaction costs of monitoring firm-level behavior. In contrast, the individualized nature of DC pension plans makes such actions difficult, though not impossible.

Although both types of pension funds hold significant assets (\$9.4 trillion), DC plans are growing while DB plans are shrinking. In 1979 DB plans accounted for 62 percent of all U.S. pension fund participants. By 2005 that percentage had shrunk to 10. For DC plans (401-K plans) the numbers of participants grew from 16 percent to 63 percent over the same period (EBRI 2007).

The same trend is evident with pension plan assets. In 1985 66 percent of total pension assets were held in DB plans, and 34 percent were held in DC plans. By 1996, DC plans held half the total pension assets. From then on DC plans have outpaced DB plans in both numbers and size. By 2005 DC plans held 61 percent of all pension plan assets (Conference Board 2007).

In absolute terms the current assets of large, DB pension plans continue to dominate financial markets. Of the two hundred largest pension plans in the United States, 80 percent of the assets are held by DB plans (Pension and Investments 2007). This may well be the apex of Anglo-American, trustee, defined benefit pension plans' growth and thus influence within the financial market. The power of these pension plans may wane in the future, but with assets totaling \$2.7 trillion their size makes them effective in influencing firm-level decisions.

Within the pension fund universe, there are public sector pension funds, private corporate funds, and Taft-Hartley or multi-employer funds. With only a few notable exceptions private corporate funds do not become active owners

and do not use corporate engagement to raise the standards of firms in which they invest. In most cases these corporate-sponsored funds do not exercise scrutiny over other corporations, fearing that will bring the same treatment in return. This means a considerable amount of U.S. pension fund assets (close to \$5 trillion) are not used for active ownership.<sup>4</sup>

Most U.S. “activist” pension funds tend to be large DB funds in the public sector where these plans continue to grow. These funds increased in absolute size from \$200 billion in 1980 to \$2.7 trillion in 2005. As a share of total institutional investment, activist public employee funds rose from 7 percent to 11 percent.<sup>5</sup> That said, not all activist funds are drawn from this pool. TIAA-CREF, with \$437 billion (as of September 2007) assets under management for colleges and universities, is the best example of an activist DC private plan in the United States.<sup>6</sup>

A key actor among the activist DB pension funds is the California Public Employees Retirement System (CalPERS), the largest U.S. DB pension fund, with assets totaling \$245 billion as of June 2007. CalPERS and other activist pension funds are leading the attempt to shift power away from corporate managers back to shareowners.<sup>7</sup> This book traces CalPERS’ corporate engagement strategies beginning with its activist stance on corporate governance in the 1980s through 2007.

Activist pension funds are shifting the power dynamic between owners and managers. In the past, the cost of corporate engagement, when measured against possible gains, meant that few minority shareholders were willing to monitor corporate management. But today’s pension funds hold such large stakes in individual firms that they are able to bear these costs alone and, more important, act in coalition with other pension funds. As a result, corporate engagement is a potent force in representing owners’ interests in today’s companies. This new representation is changing the principle–agent debate (Clark and Hebb 2004).

Previously owners have been widely dispersed and therefore essentially powerless to control corporate managers and boards (Berle and Means 1933). But the large holdings of pension funds and their newly found ability to form coalitions mean that corporate engagement is a potent force in aligning managerial interests with those of shareholders.

Such coalitions are possible because changes in securities laws allow for easier communication between shareholders and because transaction costs of both monitoring and coordinating responses have been lowered when mea-

sured against the increases in share value such activity generates. In the past pension funds were deemed ineffective as corporate monitors, and were identified as “lone wolves” in their attempts to provide oversight of corporate decision making. In the early 1990s this tendency toward isolation was seen as the major drawback to pension funds’ effectiveness as corporate monitors (see, for example, Coffee 1991, 1997; and O’Barr and Conley 1992).

Although CalPERS and other large activist pension funds are important individual players, it is the institutional investor coalitions that have the greatest opportunity to influence and engage corporate management. From 1980 to 2005 U.S. institutional investors increased their holding of outstanding U.S. equities from 37 percent to 61 percent. By 2005 activist state and local funds held close to 10 percent of all U.S. equity. Thus when these funds act in coalition they wield considerable influence.

Given their history as “lone wolves” it is little wonder we see some tensions in these large institutional investor coalitions. While prepared to act in coalition, pension funds simultaneously seek to keep their own management costs as low as possible and therefore resent the “free riders” who benefit from increased corporate standards but do not bear the costs of the endeavor. “Making the interventions in the investment system that will have the maximum positive impact over the next decade calls for asset owners and their investment advisors to undertake a steep learning curve and above all, to collaborate far more effectively than they have to date” (Thamotheram and Wildsmith 2007, 443).

There is an increasing number of effective coalitions on which to model future action by these key actors. These new coalitions cluster around ESG issues. The Carbon Disclosure Project (CDP) representing \$41 trillion in assets (as of February 2007), the United Nations (UN) Principles for Responsible Investment (PRI) with signatories representing \$8 trillion (as of April 2007), Institutional Investors for Climate Risk, and Coalition for Environmentally Responsible Economies (CERES) are four examples of effective coalitions working on environmental standards. The Extractive Industry Transparency Initiative and the Sudan Campaign are two examples of coalitions of investors focused on social issues. The Council of Institutional Investors and the International Corporate Governance Network are two long-established corporate governance coalitions. All of these institutional investor coalitions have strong records of success in influencing companies to raise their standards. Most use some form of corporate engagement to achieve their goals.

At its best corporate engagement offers a long-term view of value that both promotes higher environmental, social, and governance standards and adds share value, thus providing long-term benefits to future pension beneficiaries. At its worst it diverts the attention of pension fund officials from their primary responsibility of ensuring the retirement benefits of their members, and encourages pension funds to usurp the rightful responsibilities of corporate managers. This book examines corporate engagement and its impacts on firms in an effort to see how the potential from this newly emerging force is being realized.

### **Pension Fund Power**

Pension funds and other institutional investors have been growing in size and influence in financial markets since the 1980s. Collectively U.S. institutional investors hold \$24 trillion in assets and control \$11 trillion in equities, roughly 60 percent of outstanding equities in the United States (Conference Board 2007). Of those equity holdings, pension funds hold \$5 trillion, and activist state and local pension funds hold \$2 trillion.

In the 1980s and 1990s most pension funds behaved no differently from the rest of the financial market. They pushed companies to deliver a steady stream of quarterly earnings in order to meet standard industry benchmarks. But as pension funds grew, they lost their ability to sell stock when dissatisfied with performance (a practice known as the “Wall Street Walk”).

Three trends directly affected the ability of pension funds to sell corporate stock when they were unhappy with financial or corporate performance. First, their sheer size meant pension funds held large equity positions that made them increasingly vulnerable to the performance of the market as a whole. This phenomenon has been dubbed the “Universal Owner” (see Hawley and Williams 2000 and 2007).

Second, during the 1990s many pension funds began to use passive stock indexes (such as the Standard and Poor’s 500) for their equity investments. As a result they could no longer sell stock because it was part of a broader index in their portfolio. The trend toward indexing grew during the 1990s with stock markets returning 20 percent and more on an annual basis. It became increasingly difficult for active money managers to “beat” the market, particularly once their fees were taken into consideration. Many pension funds moved from active money management to passive money management in the belief that it is hard to pick stocks that consistently outperform the market as a whole.

Third, selling large holdings can result in lower stock prices, a practice that would run counter to pension funds' fiduciary responsibility. As Georg Siemens, the nineteenth-century founder of Deutsche Bank, said, "If you can't sell, you have to care" (cited in Monks 1995, 1).

Because these three trends are driven by pension fund size, CalPERS and other large pension funds took advantage of this phenomenon first. Pension funds realized that key to their fiduciary duty was a long-term view of value within their investment portfolio (Freshfields Bruckhaus Deringer 2005). CalPERS incorporated the concept of long-term value into its core Principles of Corporate Governance: "Corporate directors and management should have a long-term strategic vision that, at its core, emphasizes sustained shareowner value. In turn, despite differing investment strategies and tactics, shareowners should encourage corporate management to resist short-term behavior by supporting and rewarding long-term superior returns" (CalPERS 2007b).

However, a long-term view of value remains a somewhat difficult task for pension funds and their money managers who still rely on quarterly earnings reports as indicators of "success," and in a period of declining equity premiums many short-term investment practices are being utilized that are hard to marry with the pension funds' stated long-term investment philosophy.<sup>8</sup>

Pension fund managers must inevitably be concerned with both short-term returns, as part of the benchmarking process fundamental to fiduciary duty, and long-term value, as expressed through raising firm-level accountability, transparency, social and environmental standards.<sup>9</sup>

In the past, many researchers found pension funds to be dominated by short-term, myopic investors whose impatience often eroded share value (Bushee 1998; Romano 2001; Shleifer and Vishny 1988). But these findings were based on short-term examinations of stochastic shocks measured around specific corporate announcements rather than examinations of pension fund investment behavior over longer time horizons (Bauer et al. 2003).

Pension funds have been found to have a lower stock turn over rate when compared to other institutional investors (Brancato 1994). Other studies indicate that pension fund investors value long-term investment in research and development as well as other capital expenditures (Jarrell et al. 1985; Majunder 1994; Marsh 1990; McConnell and Muscarella 1985). Pension fund managers are prepared to reward analysts who consider environmental, social, and governance factors in their analysis. The Enhanced Analytics Initiative (EAI) whose signatories manage \$2.4 trillion of assets, is a good example of the trend

toward a long-term view of value. Signatories to the EAI commit a percentage of their analysts' mandates to those who use extra-financial as well as financial criteria in investment selection (Thamotheram and Wildsmith 2007).

### **Pension Fund Corporate Engagement Drivers**

Pension fund corporate engagement is a legitimate use of the owners' rights in a company to provide oversight and protect shareholder value. But it does not mean that owners interfere in day-to-day management decision making. What activist pension funds seek from management is greater accountability to shareholders, greater transparency, and higher standards of corporate behavior.

Corporate engagement itself can range from quiet discussions with management and the voting of proxies to more contentious approaches such as mounting dissident shareholder resolution campaigns and public removal of firms and even whole countries from investment portfolios.

Corporate engagement does not ask companies to sacrifice long-term profitability. It seeks higher corporate standards in order to reduce risk over time. Though such corporate standards are often referred to as corporate social responsibility (CSR), it is important to note that pension fund corporate engagement concerns itself solely with the long-term interests of shareholders. Although corporate engagement aligns corporate managers with shareholders' long-term interests, CSR suggests that companies respect all their stakeholders including clients, employees, community, governments, suppliers, and customers, as well as its shareholders. In contrast, many pension fund investors argue that greater regard for the long-term and increased corporate social responsibility reduces risk, adds share value, and in the end serves shareholders' interests.

The first driver of pension fund corporate engagement is the growing asset size. Large holdings alone would not be sufficient to foster corporate engagement, but it would be when combined with a long-term investment horizon and active ownership.

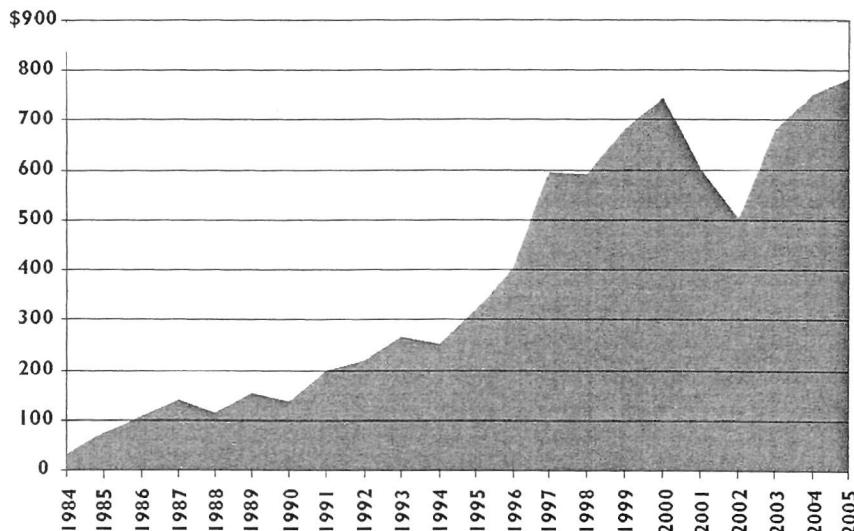
Throughout most of the 1990s, the bull market roared through the Anglo-American financial system, reinforcing the myth of the "new economy" and its attendant stock market riches. The 1990s also witnessed the impact of huge pension fund investors who were active in financial market decisions. Although the power and potential influence of pension funds was present

through the boom, for the most part pension fund trustees and money managers used their market position in very conventional ways.

However, following the 2000 collapse of the technology, media, and telecommunications (TMT) stock bubble and the corporate governance scandals of 2001 and 2002, there was a shift toward pension funds' need for long-term value. This shift is marked by two changes in investment behavior. The first is a shift in investment style—away from “growth” and toward “value” investing. The second is increased awareness among pension fund investors regarding their apparent short-term myopia and the prospects for a longer-term investment horizon necessary to realize increased share price from “value” investing.

The second driver of pension fund corporate engagement is the amount of assets held in passive indexes that restricts pension funds' exit from companies that have poor standards or are underperformers in the market. In 1984, two hundred largest DB pension funds in the United States held only \$50 billion in passive index funds; twenty years later this amount had grown to almost \$800 billion (see figure 1.1).

With the phenomenal run up of the stock market in the 1990s it became increasingly difficult for money managers to “outperform” the stock market.

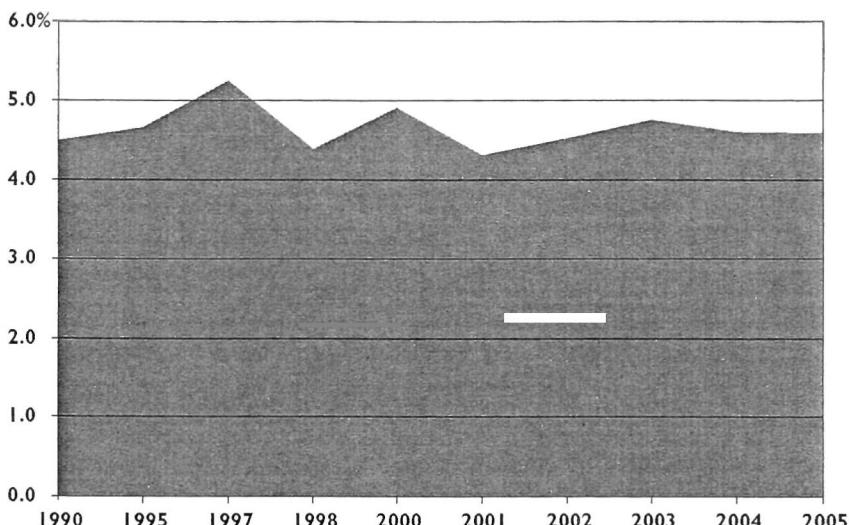


**Fig. 1.1 Growth of indexed assets of the top two hundred U.S. defined benefit plans (billions)**

Source: Pensions and Investments (2006).

Consequently, many pension funds, including CalPERS, moved increasing amounts of assets into passively managed index funds that mirrored the market. The Standard and Poor's 500 Index, comprising the largest five hundred companies in the United States by market capitalization, had annual growth rates of 20 percent during this period (see figure 1.2). However, owning an index fund means you must hold every company in the index. As a result pension funds were not able to sell stock of individual companies even when unhappy with their governance or financial returns.

Corporate engagement's third driver is found in the growing evidence of a correlation between strong environmental, social, and governance standards, and share value outperformance (see Gompers et al. 2003, Anson et al. 2003). Increasingly pension fund investors look to ESG indicators as proxies for long-term performance. These factors are sometimes referred to as extra-financial as they are often not part of the required annual financial statements and filings. Some companies have chosen to report separately on these issues as part of their voluntary corporate social responsibility or CSR reports. Because pension funds and other institutional investors see these factors as bearing on risk there is increased pressure to have them included in the mandatory annual statements as material to companies' performance.



**Fig. 1.2 Indexed assets of the top two hundred U.S. defined benefit plans as a percent of U.S. market capitalization**

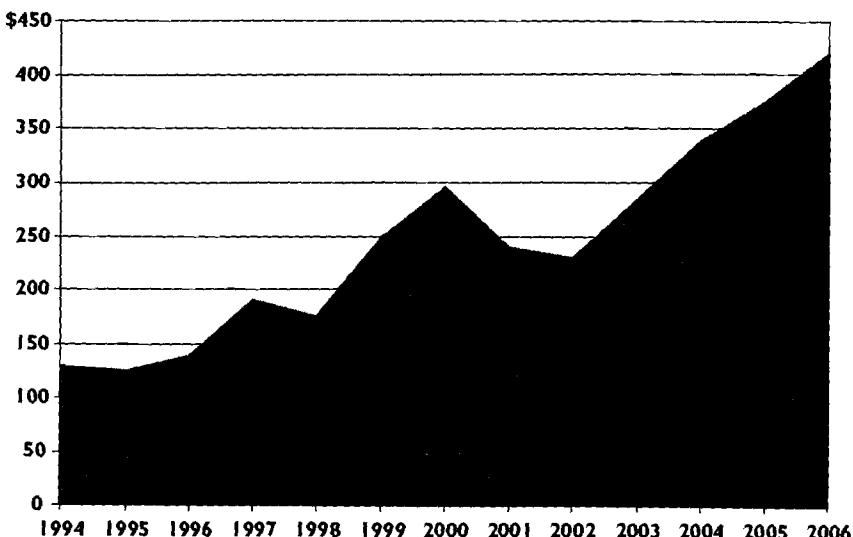
Source: Pensions and Investments (2006), and U.S. Government Statistics.

Thus, ESG issues would be part of the material disclosures in corporate annual reports.

Measuring extra-financial corporate behavior used to be the domain of a few boutique rating agencies. But interest in these aspects of corporate behavior is becoming more mainstream with rating companies such as Standard and Poor's, Moody's and Fitch establishing metrics by which to measure corporate environmental, social, and governance standards of firm behavior. Not only do activist pension funds rely on ratings agencies for analysis of the risks from these extra-financial indicators for investment decision making, they also use rating agency reports to indicate opportunities for corporate engagement.

The fourth driver of pension fund corporate engagement is the increasing amount of international equity held by pension funds (see figure 1.3). In 2005, the largest twenty-five U.S. pension funds held close to 14 percent of their assets in international equity.<sup>10</sup> With increased international exposure, long-term pension fund investors are becoming sensitive to the need for companies to conduct business in the framework of global standards.

Equally dramatic is the increase in pension fund investment in emerging markets around the world where ESG risks are often greater than in more developed markets (see figure 1.4).

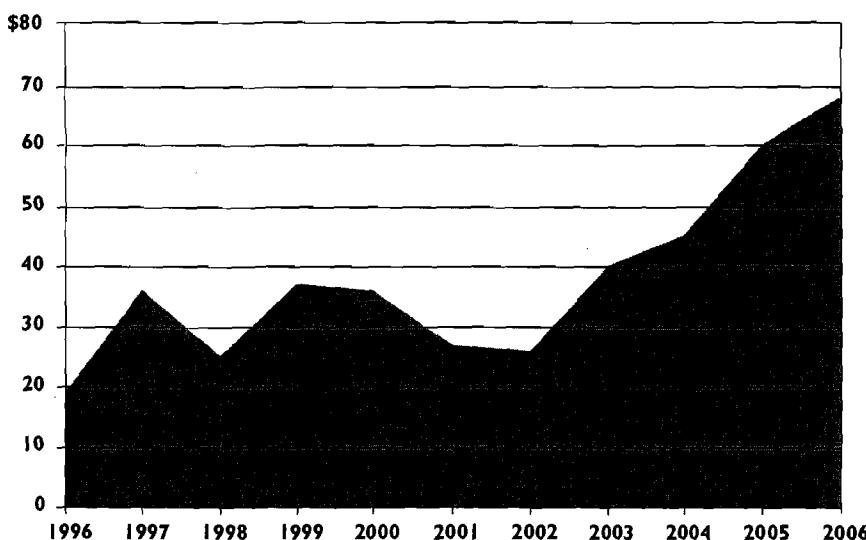


**Fig. 1.3 Growth of international equity assets of the top two hundred U.S. pension funds (billions)**

*Source:* Pensions and Investments (2007).

Previously, pension fund corporate engagement on international social and environmental concerns was limited to single issues such as the South African divestment campaign of the 1970s and 1980s (examined in greater length in chapter 2). Often these campaigns were driven by legislative demands rather than by the pension funds themselves. Over the past twenty years some U.S. state legislatures have mandated pension funds to divest from South Africa, from tobacco products, and since 2005, from the war-torn Sudan. Pension funds are within their fiduciary duty to divest these stocks from their portfolio (*Board of Trustees vs. City of Baltimore* 317 Md. 72, 562, A.2d 720 [1989]) and state legislatures are increasingly making such demands. By 2007, eighteen U.S. state legislatures had called for their state pension funds to divest from companies doing business in Sudan.<sup>11</sup>

Three initiatives highlight the influence investors have internationally: CDP, UNEP PRI, and the Extractive Industries Transparency Initiative (EITI). The CDP asks institutional investors to support a request for greater corporate disclosure of greenhouse gas emissions. As of February 2007 this initiative had signatories representing \$41 trillion of assets globally (Carbon Disclosure Project 2007). The influence of this initiative is being felt by corporations because of the greater transparency requirements and the need for increased



**Fig. 1.4 Growth of emerging market market equity assets of the top two hundred U.S. pension funds (billions)**

Source: Pensions and Investments (2007).

sensitivity to their impact on global climate change. The newly formed UN PRI (2007), with signatories representing \$8 trillion of assets, proposes a set of guidelines for investors seeking to advance long-term sustainable global markets. Meanwhile the EITI calls for greater transparency in the global extractive industries with a particular emphasis on reducing bribery in emerging markets around the world. All three initiatives are new, global, represent large coalitions, and address the social and environmental concerns of institutional investors. All three initiatives seek greater transparency from corporations and use corporate engagement as their preferred form of interaction. These initiatives are part of pension funds long-term investment strategies and are prime examples of pension fund corporate engagement at work.

Given the growing power of pension fund international investment flows, it is little wonder that global activists see pension funds as potential points of leverage to reach global equity and social justice goals. A new generation of international activists is drawing the world's attention to the deepening divide between developed and developing nations and more explicitly, the growing gap between the world's wealthy and the world's poor. The protests against the World Trade Organization, World Bank, and International Monetary Fund in the late 1990s showed that many believed the goals of social justice, equality, human rights, labor rights, and environmental standards to be unattainable in the rush to serve the needs of global capital.<sup>12</sup> However, since 2002 there has been a growing realization that global capital flows can indeed become a useful tool if investment is harnessed to meet demands for sustainability and global social justice.

Much as we saw during the anti-apartheid divestment campaign of the 1970s and 1980s, the line between long-term financial benefit and social action is being blurred by global pressure to respond to social justice issues around the world. Chapter 5 provides evidence from CalPERS' emerging market screening that backs this claim.

### **Corporate Engagement Typology**

There is a hierarchy of steps through which most pension funds progress as they engage corporations. These steps range from the simplest and easiest activities to the most complex and contentious. Typically it takes pension funds a number of years of active ownership to work through all ten steps (see table 1.1).

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**Table I.1 Ten steps of corporate engagement**

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1. Develop policy statement
  2. Identify areas of major concern in corporate governance, environmental and/or social conduct.
  3. Develop proxy voting guidelines and vote proxies in a manner that addresses concern.
  4. Take membership in coalitions of institutional investors.
  5. Where relevant, include formal codes of governance, social and environmental conduct that address these concerns in proxy voting guidelines.
  6. Engage company officials on extra-financial issues identified above.
  7. Consider extra-financial factors in investment selection and monitoring.
  8. Consider extra financial factors in fund management selection and monitoring.
  9. Relationship investing.
  10. Propose minority shareholder resolutions and develop Focus Lists.
- 

To be successful both the pension fund board of trustees and its senior management must agree to undertake corporate engagement. Each must understand its impact on long-term investments. Without the commitment of both sets of key actors, corporate engagement can become a mere box-ticking activity by fund managers, rather than a way to use owners' influence to raise the environmental, social, and governance standards of companies.

This box-ticking tendency was evident in the United Kingdom, where government legislation requires pension funds to say whether and to what extent they use environmental, social, and ethical standards in investment decision making. With the advent of the legislation in 2000, few pension funds wanted to be excluded. Sixty percent of UK funds indicate they used these standards to judge investment (Mathieu 2000). However, when asked how they used them, over two-thirds replied that they instructed their fund managers to take these aspects of the firm into consideration to the extent that it *did not* impact immediate shareholder value.

Table 1.1 details the steps most pension funds progress through as they engage corporations. In order to begin the process of engagement pension funds take the first step of establishing a policy statement that guides their activity. These statements or policies are developed at the board level of the fund. They are often referred to as policies of responsible investment and are part of the overall statement of investment principles that guide the fund.

Such statements are further refined in step two of pension fund corporate engagement. Here pension funds identify the area of corporate behavior they are seeking to change through engagement. Research indicates that most pension funds identify corporate governance issues when they begin the process of engaging corporations. This area is natural for pension fund investors, as all shareholders have legal rights that allow them input into the governance of corporations. In 2007, many activist pension funds sought a “say on pay” and engaged corporations on the compensation offered senior management. For the first time a “say on pay” shareholder proposal won majority support at a publicly owned U.S. company when 50 percent of shareholders voted to have future compensation packages at Verizon submitted to a non-binding shareholder vote.<sup>13</sup>

It is important to note that several research studies including one by Harvard Business School link strong standards of corporate governance with positive financial performance over time (Gompers et al. 2003).

Standard areas of behavior identified by pension funds for corporate engagement include greater accountability measures such as the separation of board chair from CEO, limits on executive compensation, and nomination of board members. They also incorporate greater transparency from corporations on social and environmental issues. Chapter 3 examines the increasing shift toward transparency demands in pension fund corporate engagement, while chapters 4 and 5 detail investors’ interest in the social and environmental standards of corporate behavior.

Once the pension fund has decided to consistently vote its proxies according to the issues identified in step two, they develop proxy-voting guidelines to govern this activity. This is the third step in pension fund corporate engagement. U.S. pension funds are required by law to vote their proxies, which are seen as a plan asset under ERISA legislation. Although voting proxies is the easiest form of corporate engagement, until 2001 most pension funds and other institutional investors voted their proxies in accordance with management’s wishes. The downturn in the market in 2001 provided a wake-

up call to investors. Pension fund investors began to develop detailed guidelines for voting their proxies and increasingly contract proxy-voting services that both advise pension funds and vote their proxies according to these guidelines. Such guidelines cover a range of corporate governance issues. Although social and environmental issues are often dealt with on a case-by-case basis, several large pension funds have developed proxy-voting guidelines that cover these issues. Many pension funds now post both their proxy-voting guidelines and voting records on their websites to provide greater transparency in their own governance mechanisms.

As detailed throughout this book one of the most important shifts in pension fund corporate engagement is the newly found willingness of funds to work together. Once the pension fund has decided to become active owners they seek out others concerned with similar issues (step four in table 1.1). Many pensions funds are restricted in how much of their own portfolio can be in a single holding, as a result they usually hold at most 1 to 2 percent of their own portfolio in any given large public company. CalPERS is no exception. It holds close to \$2 billion in General Electric (GE) stock and debt, which for the \$245 billion pension fund is its largest holding (as of December 2006). For GE this figure represents only .5 percent of total market capitalization. GE's primary concern lies with satisfying the other 99.5 percent of their shareholders. When pension funds and other institutional investors act in concert, however, they can represent upward of 10 percent or more of a company's holdings. It is at this point that corporate engagement becomes a potent force. Coalitions on corporate governance issues include the U.S. Council of Institutional Investors and the International Corporate Governance Network. Increasingly coalitions of institutional investors have formed on a number of social and environmental concerns, such as the Institutional Investors on Climate Risk, the CDP, the EITI and the signatories to the UN PRI.

In step five, pension fund investors integrate formal codes of behavior adopted by coalitions such as the OECD Codes of Corporate Governance or Guidelines for Multinational Enterprises, the CERES Environmental Standards, the Global Sullivan Principles, or the McBride Principles into their proxy-voting guidelines. As a result, when a minority shareholder resolution calls for a company to adopt these codes of conduct, the pension funds vote in favor of the resolution if the code is relevant to the companies business.

Once pension funds are actively voting their proxies and participating in coalitions, they begin to engage companies directly (step six). This type of

engagement is usually done through private channels and is therefore hard to quantify. Phone calls, letters, and private meetings are all employed as pension fund investors express concern with senior corporate management on issues they believe could have a negative impact on long-term shareholder value. Most of what is known about this type of engagement is anecdotal with either corporate executives or pension fund officials revealing these interactions. Such engagement is not designed to inflict reputational damage on the corporation, but rather to privately convey concerns to management with the hope that the latter will respond voluntarily to the request from a significant shareholder or group of shareholders. Research indicates that when the shareholder is large and influential with significant holdings in the company, management is more likely to respond positively to such engagement.

Ultimately in order for such quiet engagement to work there must be some threat from shareholders if the company refuses to change its behavior. Such threats are usually to the reputation of the company. In most cases senior management fear negative publicity and will often engage rather than run the risk that investors will use the media or mount a dissident shareholder campaign to achieve the changes they are seeking.

Generally pension fund investors want to avoid negative publicity, as they do not want to drive down the value of their shareholding but rather to raise the standard of corporate behavior. This is in contrast to socially responsible investors who seek public attention and often mount minority shareholder campaigns based on small amounts of holdings and no initial engagement with the corporation. These investors often use their ownership position to inflict reputational damage even at the expense of shareholder value. For them the change in corporate behavior is a more important goal than long-term share value.

Steps seven and eight—using extra-financial information to select investments and fund managers—take place only when mainstream investment managers accept the importance of extra-financial information in long-term share value. To date most mainstream analysts discount the value of extra-financial data as relevant in investment selection. The investment belief that all information about a firm is already known and incorporated in its current market price is strongly held by both internal and external pension fund money managers and is the view most often taught in business schools around the world. In order to successfully move to steps seven and eight there must be a systematic integration of the importance of extra-financial investment

criteria to the pension fund. This means that responsible investing managers are not public affairs officers, but rather are fully integrated in the investment decision making of the pension fund. It also means benchmarking and financial incentives for both internal and external money managers must be geared to long-term rather than short-term investment horizons.

As with standard financial information, money managers rely on rating agencies to provide them with extra-financial ratings of corporate behavior. In addition to small boutique rating agencies, mainstream agencies such as Standard and Poor's, Moody's and Fitch are providing extra-financial ratings for companies' environmental, social, and governance standards. The EAI is an example of institutional investors valuing such extra-financial information. Signatories to the EAI agree to set aside 5 percent of their trading commissions for analysts who use extra-financial information in their investment selection process.<sup>14</sup> By May of 2007 the EAI had members representing \$2.4 trillion in assets.

Step nine is termed relationship investing. Here pension funds move beyond simple requests for transparency, disclosure, and factoring extra-financial indicators into investment selection. With relationship investing the investor is prepared to hold a significant stake in the company, usually greater than 10 percent, and often takes one or more board positions as well. Relationship investing requires a positive response from senior management to such shareholder engagement. Often the investors' management skills are seen as adding value to the company. For most pension funds such a commitment to a single investment would require more due diligence than they are prepared to make. However, we are seeing specialized investment vehicles (e.g., San Diego-based company Relational Investing) adopt this approach with their investment portfolio. Pension funds such as CalPERS are major investors in this vehicle and have made returns upward of 33 percent since its inception in late 2002 to December 2005, outperforming its benchmark by 18 percent during that period—a testament to the added value of relationship investing.

The most contentious stage in corporate engagement is step ten—the mounting of minority shareholder resolutions and the development of Focus Lists that single out non-complying companies in order to force them to change their behavior. With this step shareholders use their position and influence to inflict reputational damage on the firm. As a result the pension fund investor or coalition of investors is often characterized as a bully. This step represents the most significant power shift between managers and

owners. Management often resents shareholders' power and becomes intransigent in their position when shareholder resolutions are proposed.

Minority shareholder campaigns have two desired outcomes. Either the resolution is able to garner enough support to pass or at least enough support to provide a strong warning to management<sup>15</sup> or it generates negative publicity that has an equally galvanizing effect, particularly if the shareholders are large institutional investors. In 2007, minority shareholder resolutions calling on ExxonMobil to reduce greenhouse gas emissions and Wal-Mart to resolve issues of equity compensation to women and employees of color are good examples of how minority shareholder resolutions can generate negative publicity for corporations even when they do not pass. If management wants to avoid negative publicity they often seek a solution that allows the resolution to be withdrawn before it comes to a vote.

Focus lists identify a group of underperforming companies with serious environmental, social, and governance problems. Both CalPERS and the U.S. Council of Institutional Investors maintain annual Focus Lists of such firms. These lists are designed to generate negative publicity in an effort to change corporate behavior. Chapter 3 provides detail on CalPERS' Focus List and how it is perceived by the companies it targets. When pension funds and other institutional investors use the tools of step ten they are deeply engaged as active owners with the companies in their investment portfolio and are prepared to use their position in financial markets to achieve their goals.

Since 2004, we have begun to see a backlash to shareholder power, particularly in the United States. According to the *Economist*, "What corporate America is facing is a revolution, the end game of which is management-by-referendum" (2007, 15). Despite early optimism in the years immediately following the Sarbanes-Oxley Act, active owners have seen corporate governance power shift back in favor of management. One of the starker examples is the slowing of access to the proxy for shareholder-nominated board candidates by the Securities and Exchange Commission.

## Conclusion

Pension fund corporate engagement is a new and unfolding tool that has the ability to significantly influence and raise standards of corporate behavior. Understanding its origins, drivers, and impacts is important for assessing whether this force can indeed match the rhetoric that surrounds it. Chapter