national union

pensions backgrounder #13

Socially Responsible Investment (SRI)

Part 13 in a Series

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BACKGROUNDER #13

Socially Responsible Investment (SRI)

The traditional approach to the investment of pension funds has been focused on the sole and narrow strategy of maximizing return and minimizing risk. However, the pension fund landscape is changing. Plan members are now asking why fund assets are not managed in ways that more closely reflect their values. It is also becoming clear that the social goals of the plan members and beneficiaries can be integrated into the investment decision-making process in a manner consistent with trustees' duties as fiduciaries.

One tool that can be used in the pursuit of workers' goals funds is *Socially Responsible Investment (SRI)*.

••• What is Socially Responsible Investment (SRI)?

SRI refers to a strategy of adopting social or ethical goals in addition to the rate of return objective in pension fund investing. It really represents a multi-dimensional understanding of financial investment practices that advances the broader and long-term interests of plan beneficiaries – workers who contribute to the plan on a regular basis. The most important objective of SRI is to maximize long-term market rates of return to ensure adequate retirement payments for workers. In this regard, the SRI view does not differ from conventional investment priorities.

But the SRI view departs from conventional investment practices by expanding the options, methods and principles that guide capital allocation decisions. It's critical that we recognize that capital markets are neither perfectly efficient nor value-free.

Therefore, those who seek to advance the long-term interest of workers inside financial markets must look beyond both the array of choices these markets presently offer and the narrow band of information conventional investment managers provide.

Alternative investment practices and vehicles can better reward both the pension fund beneficiaries (workers) and the broader community to create wealth in the long-term. A growing body of evidence shows that there does not have to be a contradiction between SRI practices and the fiduciary duties of pension trustees to plan beneficiaries. Fiduciary duties extend beyond short-term financial return and pension trustees can and should consider broader interests when making plan investment decisions.

••• Environmental, Social and Governance (ESG) Issues

The concept of SRI within the field of pension investments is relatively new and is constantly evolving. In the last year we have witnessed SRI terms making way for new terminology that appears to be gaining attention and respect within the pension investment community. This new terminology refers to a fiduciary duty of trustees to consider environmental, social and governance (ESG) issues in their investment decision-making. Increasingly the links between ESG factors and financial performance are being recognized.

The National Union is committed to staying on top of these new developments and we will adapt our work with the use of terminology that is considered most broadly accepted and inclusive. Regardless of the language we use, our objective remains the same: to advance a larger social agenda for pensions that includes social, environmental and good governance factors being a part of pension investment decision-making.

••• Advancing a Social Agenda for Pension Investment

Pension funds can advance a larger social agenda reaching beyond simple individual returns. The SRI or ESG view is not value-free, but neither are the institutions that currently control these funds. To hold, as many pension fund managers do, that the quality of an investment depends solely upon its risk and return profile with little or no consideration of the impact upon workers, the environment and communities – is certainly not value free. Rather, it is to advance one particular value, the risk-adjusted rate of return, above all others. To claim a single-minded focus on risk-adjusted rates of return advances no agenda. Such a view simply reinforces the narrow values associated with conventional investment practices, discourages debate and reduces transparency.

••• Collateral Benefits versus Collateral Damage

We know there are many inefficiencies and systematic negative consequences of contemporary financial market practices. Just as carefully SRI / ESG investments can yield 'collateral benefits' beyond monetary rates of return, contemporary financial investment practices can result in 'collateral damage'. How often have we witnessed the 'collateral damages' such as corporate downsizing, overseas job flight, employee lay-offs, and mergers and acquisitions resulting from such narrow-minded investment choices that concentrated on rapid stock turnover and leveraged buy-outs?

••• The Three Pillars of Socially Responsible Investment (SRI)

There are three basic pillars that an SRI strategy must rely on to be successful, each of which the National Union and its Components build its capacity around in terms of understanding, commitment to and the ability to advance:

- Ethical screening
- Shareholder activism
- Economically targeted investments (ETIs).

••• Ethical Screening

Ethical screening, often called social screening, involves the application to an investment of social and ethical screens – either negative or positive. Certain features can be screened in or out of an investment portfolio. However, most individuals and institutions that practice ethical screening also take a proactive approach, implementing positive social screens. For example, they may seek out investments in companies that demonstrate leading-edge environmental practices or companies with a good labour relations record. While ethical screens are new for pension funds, they have been used in a class of mutual funds known as ethical mutual funds, and have been shown not to damage the rate of return.

In analyzing the social and environmental performance of companies or their labour relations record, it is possible to draw from a comprehensive array of sources. These include corporate documents; national and international press; periodicals, journals, and trade publications; government publications and databases; and the Internet. Another mechanism is to conduct interviews with a wide variety of stakeholders, including community, company, industry, government and union contacts.

One pension fund in Canada that has a systematic screening regime in place is the OPSEU Staff Pension Plan. It has a labour screen in place that rates the performance of Canadian companies based on approximately 25 criteria, which reflect both positive and negative attributes. They look at things like level of unionization, labour practices, job security and benefits, number of strikes / lockouts and diversity issues.

••• Shareholder Activism

The second pillar of SRI is shareholder activism. This is a way that shareholders (the members of pension plans) can collectively claim their power as pension fund owners to influence a corporation's behaviour on pension fund investment policies. Shareholder activism involves a whole range of approaches to influencing corporate behaviour ranging from writing letters, to drafting resolutions for annual meetings, to pulling shares – all in an attempt to hold corporations accountable.

Increasingly, workers are recognizing that they do in fact have the ability to influence management decisions of large companies. Some unions with joint trusteeship have injected labour priorities into corporate governance agendas around issues such as training, executive compensation and the creation of sustainable shareholder value through high-performance workplace practices. Labour's shareholder activism has the potential to promote the establishment of standards to measure and disclose corporations' human resource values, thereby aligning the interests of workers and plan beneficiaries (who as we know are most often one of the same). The result is usually increased transparency, stronger corporate governance, and greater accountability on the part of management.

In addition, like all 'owners', union pension funds need to be concerned about the potential that the management teams running the corporations in which they have invested do not have the same objectives as the owners – and on strictly financial grounds. For example, pension funds are usually invested in companies for the long-term and need to ensure that the company is concentrating on long-term creation of wealth rather than the short-term fixation with stock prices that often determines executive compensation.

Some unions have even developed proxy voting guidelines for their trustees that address corporate governance issues. Proxy voting refers to the fact that most pension funds hold blocks of shares within a company. Union trustees then insist that their pension fund vote this block of shares in a way to influence corporate decisions so that they reflect the long-term interests of pension plan beneficiaries. Proxies are typically voted on in relation to the following categories:

•Board of Directors' proposals (such as the election of Board members, their compensation, and / or their term of office);

•Corporate governance and changes in control (for example, deciding on whether the Board should be increased or on the appropriate compensation packages for Board members and Executives);

•Worker-related proposals, such as the extent to which workers should be actively involved in decision-making; whether compensation should be linked to performance; or whether the firm should use part-time or contractual employees to the exclusion of full-time employees; and

•Corporate responsibility, for example, in the company's human rights record.

••• Economically Targeted Investment (ETI)

The third pillar of SRI is referred to as *economically targeted investment (ETI)*. ETI is an investment designed to produce a competitive rate of return commensurate with risk as well as create economic 'collateral benefits' for a targeted geographical area, group of people, or sector of the economy.

Unions have a history in operating such funds, ranging from large commercial and residential funds that support union-built construction to more recently established funds that specialize in private equity.

As an example, the Carpentry Workers' Pension Plan has a subsidiary non-profit housing cooperative which uses a portion of the pension funds to build quality, affordable housing in B.C. using unionized workers. Another example is the specialized fund pooling vehicle, the Vancouver Land Corporation which provides capital to build moderately priced housing in

Vancouver. This corporation was established by the Telecommunications Workers Union, the International Woodworkers of America and other B.C. unions.

There are also Labour Sponsored Investment Funds (LSIFs), which are pools of venture capital that invest based not only on just financial criteria, but on social and environmental parameters as well. They exist in six provinces: British Columbia, Saskatchewan, Manitoba, Ontario, Quebec and New Brunswick. These funds look closely at employee relations, environmental performance, business practices, the products / services provided, impact on communities, etc. Overall these funds had combined assets of over $6 billion in 2005, representing 51% of the venture capital market in Canada.

The Ontario government however announced in September 2005 that at the end of 2005 it was ending the 15% tax credit it has offered since 1991 to Ontarians who put money into LSIFs. There were 46 LSIFs in Ontario with a total of $3-billion in assets under management.

ETI funds aim to generate 'collateral benefits' in addition to yielding market-based rates of return. Such investment approaches are said to have a double bottom line because they generate not only conventional returns, but also additional benefits for stakeholders such as more and better paying jobs, affordable housing, well-funded pension plans, and reduced environmental degradation. Collateral benefits can include enhanced workplace cooperation leading to increased productivity, or the delivery of products and services that might not otherwise occur without some intervention to correct a capital market failure.

The greatest obstacle facing ETI investing today is the lack of education and expertise among pension plan trustees and their advisors, therefore preventing them from making informed decisions regarding ETIs. Many find that investment professionals and management trustees discourage ETIs out of unfamiliarity or perceived risk aversion.

• • • Conclusion

It is critical that we expand our knowledge base of these three important pillars of progressive pension fund investment. The National Union needs to raise the level of comfort and understanding of our leadership and our pension plan trustees on the prudent and strategic use of these SRI / ESG practices to create 'collateral benefits' to our members and the broader community.