

## **Understanding Pension Fund Corporate Engagement in a Global Arena**

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February 27, 2003

We wish to thank Katherine McFate and the Rockefeller Foundation for their assistance and sponsorship of this paper. We also wish to thank Paul Tracey and David Mackenzie for their views and assistance with this paper. All remaining errors are the sole responsibility of the authors. The opinions expressed in this paper are solely those of the paper's authors.

## **ABSTRACT**

Corporate engagement in its broadest definition is the use of one's ownership position to influence company management's decision-making. It brings together four distinct underlying currents in global pension fund and institutional investing. The first undercurrent is growing use of passive index funds. The second is the corporate governance movement growing since the 1980s. The third force is the growing impact of socially responsible investing (SRI) by institutional investors with a focus on the social, ethical and environmental standards of firm-level behavior. The fourth driver is the emerging role of new global standards dictating firm behavior. It is hoped that this strategy provides a long-term view of value both for firm-level managers and pension fund investors, one that promotes higher labor and environmental standards within firms. It is also hoped that such firm-level practices will add share value to investment, thus providing long-term benefits to future pension beneficiaries.

**Key words:** pension fund corporate engagement, corporate governance, socially responsible investment, global standards

## **Introduction**

The influence of today's massive pension funds is being felt in every capital market in the world. The result is not the pension fund 'socialism' envisioned by Peter Drucker, but rather a reconfigured capitalism (CLARK, 2000; MONKS, 2001). Far from timidity (DRUCKER, 1976), these institutional investors are using their influence to engage and in some cases aggressively challenge the management of corporations in which they invest in order to ensure long-term shareholder value for future beneficiaries. Corporate engagement of this kind reflects a power shift within the firm away from managers and toward shareholders and the institutional investors who represent them.

The struggle for corporate control between owners and managers has a long history in the legal and economic literatures (ROE, 1994). The rise of public corporations that dominated the 20<sup>th</sup> century meant a dispersal of ownership rights across large segments of the population. While the advent of public corporations spread the benefits of capitalism more broadly, owners surrendered control of firm-level decision-making to a cadre of professional managers who administered the firm on their behalf (BERLE AND MEANS, 1933). Much academic work focuses on firm-level decision-making examining the components of the production function, the impact of location, sunk costs, and path dependence on such decisions. Within this framework, managers are

assumed to be the dominant actors in the decision-making process with the owners' role reduced to that of capital providers awaiting the pay-off of managers' decisions.

But today's pension fund institutional investors are shifting decision-making roles within the corporation. They are re-aggregating previously dispersed shareholders with concentrations of ownership unseen since the great industrialists of the 19<sup>th</sup> century (CLARK, 2000; DAVIS and STEIL, 2001; HAWLEY and WILLIAMS, 2000; MONKS, 2001). They are using this concentration of shareholder power, and the resulting lowered transaction costs, to actively engage company management in order to raise firm-level standards of behaviour across a range of issues, including, accountability, transparency, social and environmental standards. The term employed herein to describe this new phenomenon is corporate engagement.

Corporate engagement in its broadest definition is the use of one's ownership position to influence company management's decision-making. It brings together four distinct underlying currents in global pension fund and institutional investing. The first is pension funds' growing use of passive index funds. As a result, institutional investors lose their ability to exit firms with which they are dissatisfied. This lock-in creates a tension between those money managers who advocate a hands off approach to investment decisions and those who want to see the market power of their retirement capital used in a more socially-motivated manner, one that shapes market outcomes. For this later group of investors, the result of indexing is an increased awareness on their part of the standards, accountability and transparency of the firms in which they invest.

The second driver of pension fund corporate engagement is the corporate governance movement, which has grown rapidly since the early 1980s. Initially focused on issues of board governance such as the role of independent directors, senior management compensation, and the use of poison pills, today corporate governance tackles much broader areas of firm-level transparency and accountability. The third force propelling institutional investors toward corporate engagement is the growing impact of socially responsible investing (SRI) by institutional investors with a focus on the social and environmental standards of firm-level behaviour. This strand has developed both as a result of the newly introduced British SRI disclosure legislation and out of institutional investors' concerns for the long-term share value of their investments. Many pension funds believe SRI considerations lower the risks associated with an uncertain future. The longer the time-horizon over which pension funds hold their investments, the higher the standards of firm must be in order to minimize risks in the future.

The fourth and final driver of pension fund corporate engagement is the globalisation of financial markets combined with the rise of international social, environmental and accounting standards that are beginning to dictate the scope of action available to both nation-states and individual firms.

The terminology of corporate engagement is ill-defined and would benefit from greater clarity of its goals and understanding of its experiences to date. Currently such corporate engagement can range from quietly discussing issues 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 the pension fund investment portfolio (a recent and contentious CalPERS' decision).

While corporate engagement shares these approaches with socially responsible investors, the primary concern of the pension fund investor is the long-term share value of the company. Therefore corporate engagement does not ask the firm to sacrifice long-term profitability but rather to raise its standards in order to reduce risk over time. It uses tools already available to owners within the corporate structure and represents a claim of the rights of owners to establish standards of firm behaviour. Until recently this claim of ownership was held at arms-length by fund managers whose primary concern was for quarterly earning statements with only limited oversight for company standards and behaviour. However recent events demonstrate higher degrees of oversight being demanded of institutional investors. In effect institutional investors are redefining the power relationships within the firm. A fuller investigation of pension fund corporate engagement is needed in order to judge the extent to which this oversight is being exercised by pension fund investors and its success in moving companies from short-term to longer term 'best practices' both domestically and internationally.

This article addresses both the drivers of corporate engagement and its targets in an effort to better understand corporate engagement and its potential to anchor capital in certain communities, civilize human resource practices within firms, and encourage compliance with labour and environmental standards domestically and internationally.

## **The Fifth Stage of Capitalism**

While current financial markets continue to exist within a nexus of nation-state regulatory controls, they operate with global reach and global impact. In essence the financial system is in transition to a truly global market. While there appears to be tacit agreement among policy makers and the public more generally about the benefits of a global financial system, part of this understanding is predicated on a growing demand that international rules and standards of behaviour be established to serve a broader societal interest beyond simply those of financial elites (STIGLITZ, 2002). What differentiates these global demands from the national frameworks of the past is the inclusion of environmental and labour standards in addition to financial regulatory regimes. The impact of this transformation from a national to a supra-national configuration is a contested status, simultaneously national and global in scope and scale, for the proper arrangement of the financial system.

Not only are we grappling with spatial change in financial markets, but we are also witnessing a change in the dominant actors within the system. We suggest this shift represents a new stage of capitalism, one in which institutional investors play the key role as they not only aggregate shareholders' interests within a broadly dispersed capitalist system, but are also beginning to use their position to exert control over the corporations they hold in their portfolios.

Robert Clark in his paper “The Four Stages of Capitalism”<sup>1</sup> offers an interesting model to examine how capitalism has changed over time. See Figure 1 for our version of Clark’s stages of capitalist change. Four distinct phases of capitalism can be neatly traced through the last two hundred years of history. In the first stage the entrepreneur was the primary actor and the object of his activity was the private corporation. The second stage saw the professional business manager usurping the role of entrepreneur and his object of attention was the publicly-held corporation, ideas central to the Berle and Means analysis of the 1930s managerial economy.

The third stage of capitalism witnessed the ascendancy of the portfolio manager with the rise of financial intermediation in the capital supply chain. The fourth stage of capitalism, which emerged in the 1970s and 80s, heralded the beneficiary as the principal actor and the professionalizing of the savings function as the object. Peter Drucker (1976) went so far as to call this stage the *Unseen Revolution* positing such power in the hands of beneficiaries that he attached the term socialism to the new role they were to play. Each of these distinct stages procreates the next, with the object of action becoming the primary actor of the next generation. In the fourth stage beneficiaries are the principal actor, who for both R. Clark and Drucker, represent an era of ‘pension fund socialism’ with mass control of the financial system. But neither thinker fully articulates the mechanisms by which such dispersed ownership would act in concert. In contrast, we posit a fifth stage not in terms of socialism, but rather in terms of pension fund capitalism, with single large institutional investors who represent broad share ownership,

but who are in fact single industry players whose very presence in the market dwarfs and dominates the financial system.

If we think of the 19<sup>th</sup> and 20<sup>th</sup> centuries in terms of Clark's four distinct stages of capitalism, we contend that the 21<sup>st</sup> century is witnessing a fifth stage in that evolution. This fifth stage of capitalism belongs to institutional investors who mediate beneficiaries' future claims against the actions of firms today. The professionalized savings function of yesterday becomes today's institutional investors whose decisions while taken in the interest of the beneficiaries, are no longer controlled by them. Despite the envisioned 'revolution' of pension fund capitalism developed by Peter Drucker or Robert Clark, the inability of beneficiaries to sustain their role as central actors marks the transition to the fifth stage of capitalism. Like the 'silent majority', it turns out beneficiaries are often referred to but seldom seen in the world of pension fund management.

In the fifth stage of capitalism, the power of institutional investors is the direct result of their ability to aggregate the interests of broadly dispersed beneficial owners combined with their newfound ability to represent that interest through a single course of action. In the name of long-term share value, institutional investors are seeking increased control over firm-level decision-making.

### **Corporate Control by Fifth Stage Capitalists**

Control of firm-level decision-making by institutional investors reverses the long-term trend of managerial control of the corporation first documented by Berle and Means

(1933) at the beginning of the last century. They traced the wide dispersal of share ownership through publicly held corporations and demonstrated that this ownership structure effectively transferred control of decision-making to managers. Though nominally the massive ownership power of beneficiaries identified in the fourth stage of capitalism shifts control of the corporation back toward shareholders, in reality that power has only been felt in the fifth stage as beneficiary interests are re-aggregated through institutional investors (CLARK, 2000; DAVIS, 2002; FUNG *et al.*, 2001; GUILARDUCCI, 1992; HAWLEY and WILLIAMS, 2000; MONKS, 2001).

Institutional investors derive their power as central actors from their ability to represent large numbers of beneficiaries combined with their day-to-day control of investment decision-making. The object of their attention is the firm in which they invest in order to deliver future streams of revenue against which beneficiaries have a prior claim. In essence this means that stage five capitalists are value investors who derive long-term share value from the fundamentals of the firm rather than through the growth of the stock or sector. What differentiates these investors from the earlier stage four as envisioned by Robert Clark, is that they not only seek out firm fundamentals as the key driver of future growth, but in addition are beginning to bring their influence to bare on firm-level standards and management oversight in order to ensure these fundamentals are maintained when faced with the uncertainty of future events.

Beneficiaries' ownership power allows institutional investors to lower the transaction costs of monitoring firm behaviour and taking subsequent action. In the past

the costs associated with corporate engagement when measured against the possible gain in share value, meant that few individuals were willing to take on company management no matter how dominant shareholders were deemed to be in theory (COFFEE, 1997). Corporate engagement, as with so many socially desired outcomes, suffers from the free rider problem. Action undertaken by one shareholder benefits all shareholders if the result of such conduct is a rise in share prices. Because today's institutional investors hold such large stakes in individual firms they are able to bear these costs alone or in coalition with other institutional investors making corporate engagement a more potent force than in the past (BECHT AND MAYER, 2001).

What further separates pension fund institutional investors from the earlier third and fourth stage portfolio managers is the long-term decision-making time frame necessary to realize retirement claims. Stage three and four capitalists were defined by their ability to use financial intermediaries and capital market instruments that prized liquidity above control (COFFEE, 1991). While these market-mechanisms no longer required in-depth knowledge of their traded securities, the rise of pension fund institutional investors as the central drivers of the system removes this intermediation. The long-term temporal nature of their investment decisions require stage five capitalists to have greater information than their predecessors about the underlying fundamentals of the firms in which they invest. As value investors they are also required to hold these securities in their portfolios for longer periods of time in order to realize gains in shareholder wealth.

Added to the temporal requirements of pension fund management is the spatiality of today's pension funds in capital markets. Clusters of nation-states, particularly within the Anglo-American axis, have large pools of capital no longer anchored solely in the nation-states of the pension fund beneficiaries, but rather roaming the world in search of both portfolio diversification and increased rates of return (all be it with higher associated risk). Stage five capitalists are caught between the nation-state rule-setting that so heavily influences pension fund regimes and the supra-national flows of pension fund capital in a global financial market (CLARK, 2003).

In addition to the spatiality of capital flows we also find the enormous size of today's pension fund capital pools denies them the ability to exit from firms in which they are invested even in the face of dissatisfaction with firm performance (COFFEE, 1991; 1997). Pension fund managers must continue to hold firms in their portfolios either because they are part of a passive market index or because their size of ownership would erode share prices on exit. As a result institutional investors are increasingly resorting to voice in order to influence investee firms and ensure long-term shareholder value for beneficiaries (HIRSCHMAN, 1970). The use of voice over exit that results from indexation is a key driver of pension fund corporate engagement. Figure 2 demonstrates the massive holdings of US-based defined benefit pension plans in passive index funds over the 1990s. The use of voice over exit is a form of corporate control that represents a further departure from fourth stage capitalism in the relationship between the actor and object acted upon (KOSTANT, 1999).

## **The Long-Term versus Short-Term Debate**

Through 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. In the face of the collapsing stock market bubble, there remains considerable debate as to the impact of the 'new economy' on global productivity and wealth as articulated by Jorgenson (2000) and Shiller (2000). Regardless of the outcome of this debate, the 1990s witnessed the impact of huge pension fund investors active in financial market decisions. While 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. Ways that reflected the prevailing wisdom of the decade and have subsequently been seen to favour short run stock prices at the expense of long-term value.

Indeed, beginning with the collapse of the TMT stock bubble in 2000 and the corporate governance scandals of 2001 and 2002, we are starting to see a potentially seismic shift in Wall Street's 'conventional wisdom', a shift partially driven by pension funds' need for long-term value. This shift in conventional wisdom is marked by three changes in investment behaviour. The first is a shift in investment style away from 'growth' and toward 'value' investing. The second is increasing awareness among pension fund investors about their apparent short-term myopia and the prospects for a longer-term investment horizon necessary to realize increased share price from 'value' investing. The third change is a return back to active investment management over passive investment strategies. All three investment strategies require both the need to

seek firm fundamentals that deliver value over time, and a lengthening of investment time horizons in order to realize equity premium increases over the long run.

Higher standards of accountability, transparency, social and environmental behaviour are all core firm-level fundamentals receiving more attention from pension fund investors in the post-Enron, post-WorldCom business environment. Seeking these firm-level attributes in a period of low equity premiums runs directly counter to much of the short-term myopic behaviour exhibited by pension funds in the 1990s. In fact some say pension fund managers' tendency toward short-term investment stands in direct contradiction to the long investment period necessary to realize gains from high standards of corporate behaviour. It is well documented that pension fund managers measure performance on a quarterly basis and trade aggressively in the face of small short-term declines even when these declines are associated with long-term firm-level improvements. Robert Shiller (2002) in his recent paper "Bubbles, Human Judgment and Expert Opinion" eloquently chronicles the herd-like, short-term instincts of pension fund managers who continued to invest in the TMT bubble in 2000 even in the face of the findings detailed in *Irrational Exuberance* (2000). Shiller argues that in the current period of expected low equity premiums, institutional investors need to focus on underlying fundamentals in their investment portfolio, and lengthen the time horizons necessary to achieve positive equity return.

We believe that 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. There is a considerable body of research that finds Anglo-American pension funds to be dominated by short-term, myopic investors whose impatience often eroded share value (BUSHEE, 1998; ROMANO, 2000; SHLEIFER and VISHNY, 1988). Institutional investors' tendencies toward short-termism are not simply hallmarks of the Anglo-American financial system. Becht and Mayer (2001) examined corporate control in Europe and concluded that given the myopic tendencies of pension fund investors, only projects with short-term realization periods benefit from market control of firms, while projects with long realization periods benefit from management control of firms. But many of these findings are based on short-term examinations of stochastic shocks measured around specific corporate announcements rather than examinations of pension fund investment behaviour over longer time horizons (BAUER GUNSTER, 2003).

We contend that many of today's institutional investors are in fact lengthening their investment time horizons (DAVIS, 2002; MONKS, 2001), contrary to the view of some observers (MILES, 1993; POTERBA and SUMMERS, 1992). This conclusion is reinforced by studies that demonstrate institutional investors value long-term investment in research and development as well as other capital expenditures (JARRELL *et al.*, 1985; LEVIS, 1989; MARSH, 1990; MCCONNELL AND MUSCARELL, 1985). While pension fund managers will continue to use quarterly benchmarks as measurement of short-term gains, fifth stage capitalists, contrary to a decade ago (COFFEE, 1991), are beginning to favour control not instead of, but in addition to, liquidity in their portfolios.

During the extraordinary rise of the bull market, active fund managers found they could not outperform the market as a whole. The message to institutional investors was to move away from active fund management with its additional costs, and toward passive management that mimics major stock market indices. With Standard and Poor's average annual returns of seventeen percent through the 1990s, most institutional investors were happy to oblige. This change from active to passive portfolio management marks a shift away from the 'value' style of investing with its detailed investigation of each firm's fundamentals, toward the 'growth' investment style that depends on sector and company future expectations of productivity advances. Predictions of a Dow Jones Industrial Index at 36,000 fueled the belief that such index driven growth was possible (GLASSMAN and HASSETT, 1999).

Interestingly as pension fund capital made its way into index funds in the 1990s (see Figure 2) there was a both a simultaneous pull away from the active investigation of firm-level fundamentals, and a corresponding drive toward increased pension fund corporate engagement. While seemingly paradoxical, pension funds found the lack of liquidity that resulted from their passive market investments meant the 'Wall Street walk' was unavailable when they became dissatisfied with corporate performance.

Albert O. Hirshman's seminal work *Exit, Voice and Loyalty*, published in 1970, assumes that when exit is no longer an option, individuals and organizations turn to voice, or as Robert Monks said, "If you can't sell, you have to care" (MONKS, 2001).

The result of the illiquid holdings of large and powerful pension funds, particularly public sector funds, forced these institutional investors to seek ways of influencing management decision-making particularly in under-performing firms within their indexed holdings. In the United States coalitions of institutional investors, most notably the Council of Institutional Investors (CII), began to play a key role in using tools such as corporate governance to improve returns of under-performing companies from which they could not exit.

### **Corporate Control through Corporate Governance**

Within the corporate governance debate shareholders are generally assumed to be widely dispersed and to hold primarily small minority ownership positions. Because they face high transaction costs, minority shareholders only infrequently act in concert. However today's pension funds own over fifty percent of outstanding equity and exercise levels of corporate concentration unseen since the heyday of 19<sup>th</sup> century industrialists. While some theorists have grappled with the implications of the emerging power of new institutional investors most work on corporate governance has not yet recognized the potential impact of pension funds and other institutional investors on the standard behaviour of minority shareholders (for exceptions see CLARK, 2000; COFFEE, 1997; LAPORTA *et al.*, 1998; MONKS, 2001; MONKS and MINOW, 1995; SHLEIFER and VISHNY, 1997).

LaPorta et al. (1999) provides a map of corporate governance that allows us to understand how varying legal regimes shape diverse systems in different countries. For

example, while Continental Europe has no common law standards of common care, they have evolved structures of mutual care that recognize the rights of stakeholders to a much greater degree than found in common law countries. In contrast, Anglo-American legal regimes continue to place shareholders as dominant actors within corporate governance structures. Beginning in the 1980s, institutional investors' focus on corporate governance marked a shift in Anglo-American corporate control away from managers and toward minority shareholders.

LaPorta et al. (1999) found most countries outside the Anglo-American common law tradition, did not replicate the Berle and Means (1933) described world of strong managers and weak owners. Rather, single majority owners hold power over firms "significantly in excess of their cash flow rights" (LAPORTA *et al.*, 1999 471). Corporate control by equity-based institutional investors is a product of two Anglo-American institutions. The first is large fully-funded pension plans with their attendant massive capital pools and the second is the common law tradition that offers shareholder protection not provided in civil code regimes. Some fear that the drive toward more fully funded pension systems in Continental Europe will result in increased financialisation of the European economy and further erode the role stakeholders have played in their economy in preference to shareholders' rights (ENGELN, 2002).

Much of the discourse surrounding corporate governance concerns the divergence of management interests from those of owners' within publicly held corporations (ROE, 1994). The forty-nine country study of La Porta et al. (1998) found that some

concentration of ownership position provides managers with incentives to work and owners with incentive to monitor (JENSEN and MECKLING, 1976; SHLEIFER and VISHNY, 1986, 1997). Shleifer and Vishny (1997) state that "All these findings support the view that large shareholders play an active role in corporate governance" (p. 755). However further research indicates that ownership concentration at the five-percent level is most closely associated with increased profitability, while concentrations above five percent results in decreases in profitability (SHLEIFER and VISHNY, 1988, 1997). Interestingly corporate ownership at the five-percent threshold is consistent with most pension plan investments, where government regulation often prevents higher ownership concentrations of each firm in the portfolio. At the five percent level of concentration institutional investors have some incentive to monitor and the results of their monitoring are equally shared with all owners (FACCIO and LASFER, 2000)<sup>2</sup>. When ownership concentrations exceed five percent the effects of monitoring tend to be captured for dominant shareholders' exclusive use.

In the past, researchers examining the effectiveness of pension funds as corporate monitors identified the tendency of such funds to act as 'lone wolves'. In the early 1990s this tendency toward isolation was seen as the major drawback to pension funds' effectiveness as corporate monitors (COFFEE, 1991, 1997; O'BARR and CONLEY, 1992). One of the significant changes between fourth stage and fifth stage capitalists is their newfound ability to work in coalition in order to effect the governance of their investee firms (MONKS, 2001; STRICKLAND *et al.*, 1996). 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 measured against the increases in share value such activity generates. We predict that new coalitions of institutional investors will greatly increase their effectiveness as corporate monitors in the future.

Initial forays into corporate governance by institutional investors, particularly large US public pension plans, were limited to issues of direct concern to shareholders. The separation of board chair from CEO, the use of anti-takeover poison pills by management, and executive compensation levels tied to performance were classic examples of institutional investors exercising internal control on corporate decision-making (see Figure 3). These early corporate governance campaigns were strengthened in the US by pension fund regulatory requirements to vote annual shareholder proxies as plan assets, reinforcing the concept of beneficial owners' shareholder rights exercised through institutional investors (US D.O.L., 1994).

Once engaged directly with firms through corporate governance over longer time periods, institutional investors began making linkages between the underlying fundamentals of the firm, its day-to-day decision-making process and long-term shareholder wealth (DAVIS, 2002; DEL GUERCIO and HAWKINS, 1999; KANG, 1999; SMITH, 1996; STRICKLAND *et al.*, 1996; WAHAL and MCCONNELL, 1996). Such increases in shareholder wealth as a direct result of corporate governance campaigns suggest that pension funds are indeed effective monitors of firm management behaviour.

This conclusion contradicts findings by Bushee (1998), Duggal (1999), Karpoff *et al.* (1996), and Romano (2000) who argue that pension funds are ineffective corporate monitors. These studies focus primarily on short-term stock price changes around specific public targeted corporate governance events. These conclusions were based mainly on short-term price changes and volatility. Clearly, more work is needed which links long-term stock price changes and volatility with firm-level accountability, transparency, social and environmental standards, and the ability of pension funds to act as effective monitors in raising these firm-level standards.

We should expect to see greater awareness of the impact of corporate governance on long-term share value in the post-Enron, post-WorldCom financial environment. Between 2000 and 2002 it is estimated that investors worldwide lost half a trillion dollars through corporate irresponsibility from just eleven US firms. Figure 4 gives a clear picture of the scale of loss directly connected to several US corporate governance failures. Recent findings by Clark and Wojcik (2002) on German ownership concentration and the impact of corporate governance reinforce the theory that firm-level value is associated with strong corporate governance systems and monitoring and the availability of information to external investors.

### **Corporate Control and Socially Responsible Investing**

While accountability and transparency within firms' governance structures have tended to dominate the corporate governance debate, issues of corporate social responsibility

(CSR) with an emphasis on the social, community, and environmental impacts of the firm, also play a role in determining investment fundamentals (PARKINSON, 1993; SMITH, 1990; WILLIAMS, 1999). In contrast, many mainstream theorists contend that the unique legal structure of the trustee relationship, defined as fiduciary duty, limits pension funds from a taking issue with broader community and social concerns (LANGBEIN, 1995, 1997; POSNER, 1981; ROMANO, 1993). Increasingly there is debate as to the interpretation of pension funds' use for the exclusive benefit of plan beneficiaries. It is argued that long-term corporate governance, social, and environmental standards are appropriate concerns for pension plans in order to ensure long-term returns to members and therefore fulfill rather than detract from their fiduciary duty (COLLIER, 2000).

While it has always been acknowledged that shareowners have the right to determine the standards of Board behaviour, investor concern for non-financial attributes of the firm is a relatively new phenomenon. Previously pension fund corporate engagement on broad social and environmental issues was limited to single issues such as the South African divestment campaign of the 1970s and 80s. But pension fund investors are increasingly engaged in raising firm-level standards in much broader areas of social and environmental concern.

For many the question at the heart of the CSR debate is in whose interests the corporation ought to be run? While some hold the view that firms ought to serve the broad interest of society rather than simply shareholders, even at a direct cost to

themselves (GALBRAITH, 1967; NADER, 1973; SEN, 1985; SMITH, 1990), the new institutional investors do not necessarily agree. Many pension fund investors argue that their greater regard for the long-term impacts of firm decision-making and increased corporate social responsibility reduces risk, adds share value, and in the long run serves owners' interests better than short-term decisions based strictly on financial data.

The drive toward a deeper investigation of the underlying fundamentals of the firm lies at the core of both value investing and active fund management. This investing style argues that the market is inefficient and thus requires increased information flows between investors and firms to accurately assess the long-run value of the firm (SHLEIFER, 2000). The current financial market circumstances of Enron, WorldCom and other corporate scandals have brought the need for greater mandatory information disclosure to the fore. Interestingly it is not simply greater financial disclosure that is being called for, but also mandatory disclosure of social and environmental aspects of firm behaviour (WILLIAMS, 1999).

Disclosure itself is an interesting tool that both ensures information in the financial market and serves to align corporate behaviour with public expectations (WILLIAMS, 1999). In the light of the loss of confidence in current financial markets, the public is once again demanding a more socially responsible role for today's corporations, combined with greater disclosure of both financial and non-financial information. A 2002 survey by the Canadian research firm Environics polled twenty five

thousand individuals in twenty-five countries and found twenty-nine percent reported punishing companies because of poor social performance<sup>3</sup>.

Concern for social and environmental standards of firm behaviour is the third driver of pension fund corporate engagement. Unlike the second driver, corporate governance, this undercurrent extends the reach of owners into day-to-day decisions of the firm. However, while pension fund investors seek control to increase social and environmental standards, they are not acting solely in response to broad societal demands for corporate awareness of external stakeholders. Rather they adopt this course of action because increased social and environmental standards lower risk and uncertainty over the long run and hence have the potential to pay off for these investors over time. In fact, while corporate engagement and traditional socially responsible investing (SRI) utilize the same tools, each seek very different outcomes. Pension fund investors look for increased shareholder wealth within the traditional corporate paradigm, while more traditional SRI seeks to make corporations more responsive to society as a whole rather than simply serving the narrow interests of shareholders. This dynamic tension within corporate engagement's third driver requires further exploration.

In theory conventional investment decisions are made on the basis of the expected risk-adjusted rates of return with the stream of future earnings embedded in current prices (FAMA, 1965; HOUTHAKKER and WILLIAMSON, 1996; SAMUELSON, 1980). But increasingly it is recognized that the longer the time-horizon over which pension funds hold their investments, the higher the standards of firm must be in order to minimize risks

in the future. Corporate control in the fifth stage of capitalism has therefore come to include social and environmental standards that previously were seen as extraneous investment criteria for institutional investors.

The use of non-financial measurement of social, ethical and environmental firm behaviour, known as socially responsible investing (SRI), was formerly the exclusive purview of small individual investors who wished to align their social values and morals with their investment behaviour (BRUDNEY, 1982; ENGEL, 1979; HERMAN, 1981; PARKINSON, 1993). But increasingly institutional investors are also taking SRI seriously as a tool to control risk. What is interesting in the current convergence between those who adopt traditional methods in SRI and the new found interest by institutional investors is that the same concept embraces two quite distinct and somewhat hostile approaches to corporate control. Each approach has different origins, rationale and objectives yet both use the same investment tool to wrestle control of firm-level decision-making away from managers and into the hands of shareholders.

Those concerned with the moral dimension of socially responsible investing seek control of corporations in order to deliver a set of outcomes by the firm that have broad impacts on society. By contrast institutional investors are primarily interested in the financial aspects of SRI. They believe companies that behave with certain social, ethical or environmental standards maintain and even gain value over the long run (ABI 2001, BAUER *et al.*, 2002; EPA 2000, KIERNAN and LEVINSON, 1998; GUERARD, 1997; MONKS, 2001; PORTER, 1995; UNEP, 2001). Institutional investors use the outcomes

of SRI not as ends in themselves, but rather as a set of attributes that add long-term value to the firm and by extension to its shareholders. Because the outcomes of these activities, in terms of firm-level standards, are the same as those sought by traditional SRI advocates, social, ethical and environmental standards create an intersection of interest between traditional SRI advocates and newer institutional proponents (See Figure 5).

The intersection of interest between corporate engagement and socially responsible investing is evident when we examine the impact of the British pension fund socially responsible investing disclosure legislation that came into effect in 2000. Under British law pension funds must disclose within their Statements of Investment Principal “whether and to what extent they use social, ethical and/or environmental criteria in their investment selection” (UNITED KINGDOM, 1999). Initially conceived and advocated by traditional SRI associations such as United Kingdom Social Investment Forum (UKSIF), this legislative agenda has proved to be a powerful driver of pension fund corporate engagement in Britain. While sixty percent of British pension funds now declare the use of non-financial (social) criteria in their investment portfolio<sup>4</sup>, most UK pension funds indicate that they prefer to use some form of corporate engagement to implement these decisions rather than the traditional SRI strategies. In fact only ten percent of UK pension assets are exclusively invested in SRI funds<sup>5</sup>.

While many of these fund managers see traditional SRI techniques such as portfolio screening as potentially damaging to their bottom-line and therefore contrary to their fiduciary duty to plan beneficiaries, they embrace corporate engagement as a sound

mechanism to raise firm-level standards and long-term rates of return. This engagement has led to coalitions of institutional investors such as the large Association of British Insurers (ABI, 2001) to call for increased corporate social responsibility (CSR) reporting by companies through the use of social audits in order to improve transparency and disclosure of these aspects of firm behaviour. However it should be noted that of the sixty percent of British pension funds declaring the use of social, ethical and/or environmental criteria in investment selection, seventy percent indicate that they instruct their fund manager to take this criterion into account, with the proviso that it does not interfere with expected rates of return.

Therefore, corporate engagement should be seen as a tool to raise firm-level accountability, transparency, and social and environmental standards, not as a vehicle for major transformation of the capitalist system.

### **Global Environmental and Labour Standards**

Given pension fund corporate engagement's reliance on shareholders as key actors, it is unlikely these forces alone will radically humanize the capitalist system. But there are other forces on the horizon with the potential to shift pension fund corporate engagement in this direction. Moving well beyond the corporate governance community, these global social forces provide the final driver of pension fund corporate engagement. While this driver is diffuse and currently unformed, its power, if realized, could have far reaching implications for the conduct of corporations and institutional investors alike. Identifying

this broad global societal driver raises more questions than it answers in understanding pension fund corporate engagement in a global arena.

We are currently witnessing a shift away from strict anti-globalisation reactions that favoured nation-states above all other actors, toward a deeper understanding within global civil society of the enormous influence institutional investors wield. There is recognition that with political clout, global capital markets could be brought to serve the broader interests of society as a whole. While institutional investors' primary concern remains limited to the impact of higher firm-level standards on long-term share value, this fourth driver of pension fund corporate engagement is explicitly and unapologetically moral and political in nature.

A new generation of international activists are 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. One need look no further back than Seattle in 1999 to understand that many believed the goals of social justice, equality, human rights, labour rights, and environmental standards to be unattainable in the rush to serve the needs of global capital. But the past three years has seen a realization that global capital flow can indeed become a useful tool if investment is harnessed to meet demands for sustainability and global social justice.

This fourth driver of pension fund corporate engagement transcends simple long-term rate-of-return arguments. It recognizes that pension plan members and beneficiaries

who exercise democratic rights within the world's largest capital pools, have social concerns beyond simply maintaining their own standards of living. These concerns include global climate change, sustainable development, human rights, labour rights and social justice issues such as the availability of HIV/AIDS drugs to Southern Africa.

Johannesburg's World Summit on Sustainable Development (2002) provides an example of the search for new supra-national institutions to deliver on the promise of global social justice. Rather than narrow-minded rejection of globalisation in the face of humanity's concerns, global players are being held to global standards with increasing vigor. World agreements such as the Kyoto Protocol are among the new drivers of moral, political and social change. Further evidence of this shift was seen in 2002 when the World Economic Forum was forced to share the spotlight with the World Social Forum. Witness Joseph Stiglitz's recent criticism of the International Monetary Fund and World Bank for serving the needs of the developed world at the expense of the developing world (STIGLITZ, 2002). A shift is occurring, but rather than a retrenchment in the nation-state, there is a search for new global tools to accomplish broadly social and political aims.

Pension funds are not immune to these same forces. Given the growing power of pension fund international investment flows (Figure 6) it is little wonder that global activists see pension funds as potential points of leverage to reach global equity and social justice goals. Recent concern for the availability of HIV/AIDS drugs to Southern Africa where thirty million people are infected with this disease, ties pension fund

investment to the moral imperative and results in pension fund corporate engagement with the world's largest pharmaceutical companies. Much as we saw during the anti-apartheid divestment campaign of the 1970s and 80s, 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.

New global regimes of social, environmental and labour standards create a social/political driver that lies at the heart of the contested status of the proper arrangement of the financial system (HENDERSON, 2000; STIGLITZ, 2002), with pension fund capital pulled between national and supra-national regulatory frameworks. Three standards in particular are often used in emerging market and international pension fund investment; the Global Sullivan Principles (LASHGARI and GRANT, 1989), the International Labour Organization (ILO) Labour Standards, and the Coalition for Environmentally Responsible Economies (CERES) Principles (HOFFMAN, 1996). Each of these global frameworks raises the bar well above levels tolerated by many national governments in terms of social and environmental behaviour.

The fourth driver of pension fund corporate engagement attempts to humanize capital with explicit moral and political objectives. It also has the reach necessary to extend these goals into global financial systems. As the new internationalists shift in their recognition and use of the tools global standards provide, we should expect to see growing use of pension fund corporate engagement in the global arena

## **Conclusion**

The recent downturn in financial markets combined with massive corporate governance failures in the United States have shaken confidence in financial markets around the world. Ranging from the US Sarbanes-Oxley Act, to the UK Company Law Review, governments, industry, and financial markets are seeking answers to ensure the financial system works in the interests of all citizens. Some advocate strengthened regulatory regimes similar to the actions taken after the 1929 stock market collapse, much as John Kenneth Galbraith (1967) proposed in the 1960s. We suggest that pension fund corporate engagement may well hold answers to aligning company managers' decisions with both shareholders and stakeholders through raised standards of firm behaviour. In order to judge the effectiveness of pension fund corporate engagement we need a better understanding of this phenomenon.

We assert that four drivers are pushing pension funds into a new stage of capitalism. One where institutional investors acting on behalf of beneficiaries are able to aggregate their ownership position to influence the management of companies they own. Pension funds with their concern for the long-term, are beginning to use their influence to increase transparency and accountability and to raise social and environmental standards of corporate behaviour. Rather than simply reshuffling the players within the existing framework of the shareholder dominated financial system, it is our contention that pension fund corporate engagement holds new possibilities for humanizing capital in the global arena. Such a bold thesis will require further exploration in order to understand and use this tool effectively.

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## ENDNOTES

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<sup>1</sup> Clark Robert, *The Four Stages of Capitalism*, in *Harvard Law Review*, Vol. 94, p. 561

<sup>2</sup> However we find some difference in opinion as to whether Faccio and Lasfer found such monitoring added value to the firms. Unlike Davis (2002) we do not interpret Faccio and Lasfer in support of the theory that pension fund monitoring encourages firms to comply with Best Codes of Practice or outperform industry counterparts.

<sup>3</sup> Environics. 2002. *Third Annual Corporate Responsibility Monitor*. Toronto.

<sup>4</sup> UKSIF. 2000. *Response UK Pension Funds to SRI Disclosure Legislation*.

<sup>5</sup> *Pensions Week*. November 5<sup>th</sup> 2001. p.10.

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