Heartland Capital Strategies

CORPORATE GOVERNANCE

HOLDING THE BOSS’S FEET TO THE FIRE

KEY TAKEAWAYS

- Good corporate governance is about making the boss accountable
- By using their collective voice as shareholders, pension plans can give workers a voice in the governance of their companies and capital markets as a whole
- Responsible corporate governance should be in the interest of all stakeholders, not just shareholders
About Heartland Capital Strategies

Since 1995, Heartland Capital Strategies (HCS) has been mobilizing workers' capital, i.e. pension funds, in the U.S. and Canada towards greater responsible investments. We do so by convening events, highlighting investment opportunities in the real economy, educating capital stewards, and laying the foundation for bringing together a new generation of responsible investors.

Based in Pittsburgh, Pennsylvania, HCS is a partnership launched by the Steel Valley Authority (SVA), an innovative regional organization that has been successfully restructuring troubled manufacturing firms in the American rust belt for more than 30 years. Heartland's predecessor, the Heartland Labor/Capital Network, was co-founded by the Steelworkers, the AFL-CIO HIT, AFL-CIO IUC and SVA to bring together labor's capital stewards to explore ways to rebuild our economy and reclaim workers' capital. In the aftermath of the 2007-2008 financial markets crash and recession, HCS was re-booted to align its goals with the responsible investment movement and reflect a broader category of services offered.

Heartland's Mini-Handbook Series

In July 2016, HCS staff authored *The Responsible Investor Handbook: Mobilizing Workers' Capital for a Sustainable World*. The Handbook helps pension trustees re-align their governance and investment strategies with the long-term interests of plan participants (the workers) and their beneficiaries by incorporating responsible investment practices into the investment decision-making process for plan assets.

Heartland's mini-handbook series takes important topics from the Handbook and breaks them down into individual mini-handbooks, each focused on addressing barriers to the integration of responsible investments in pension fund portfolios. Topics discussed range from clarifying fiduciary responsibilities to highlighting good corporate and pension fund governance practices to showcasing responsible investments across asset classes to creating effective investment policy statements that take into account responsible investment practices.

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Introduction

In the aftermath of the financial crises of the last 15 years, corporate governance practices have been placed front and center in the minds of investors. As the Organization for Economic Cooperation and Development’s (OECD) 2015 report on the Principles of Corporate Governance states, “The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions”.

An interest in corporate governance began in America in the mid-1900s when the ownership and management of corporate America began to change hands from founder-owners to institutional investors and investment professionals. The change led to a separation of interests between owners and managers. During this time, dozens of American public companies were “busted” due to widespread corruption practices, prompting concerns about managerial accountability. In the 1980s and 1990s, concerns grew that weak corporate governance and managerial shortcomings had contributed to America’s economic decline relative to Germany and Japan.

Further fracturing occurred in the next 15 years when “Executives in U.S. public companies stood accused of forsaking the production of dependable, worthwhile products in favour of pursuing hasty growth by acquisition and ... counterproductive diversification to (offset) business setbacks,” and CEO pay “sky-rocketed to unprecedented and highly controversial levels.”

Simultaneously, by the mid-1980s, institutional investors such as pension funds began in earnest to exercise their rights as owners, holding management accountable on a variety of issues impacting their investments (from board governance and financial management issues to broader ESG matters). One important result of these efforts was the formation of the Council of Institutional Investors (CII) in 1985 by “a group of 21 visionaries, most public pension fund officials, who believed that the companies in which they were investing their members’ retirement assets needed more oversight by shareholders.”

Despite advancements in corporate governance, there continues to be a division among the interests of shareholders, managers, and employees of corporations. This increasing separation means that “the balance of power at public companies has been gradually shifting away from shareholders to management, the day-to-day agents at these companies.”

Supported by investors’ concerns, the Sarbanes–Oxley Act of 2002 and the Dodd–Frank Act of 2010 (passed as a result of the 2001 accounting scandals and the 2008 financial market crisis, respectively), were enacted to increase corporate board involvement and objectivity and improve accountability to shareholders. Many of the provisions within these Acts have come under constant attack by vested corporate and political interests (most recently resulting in a rollback of a part of the Dodd Frank Act that oversaw a large segment of the banking system) which if dismantled could again, to soon, lead to the kind of crises the Acts were supposed to prevent.

As universal owners, “meaning that their financial performance is tied to the overall health of the economy and to.. environmental, governance and social practices and standards”, pension funds have the capacity to hold corporations accountable even in the face of loosening regulations. By wielding their collective clout as representatives of thousands of shareholders - the workers and retirees on whose behalf the investments are made - pension funds can have a say in affecting corporate change as active shareholders. In so doing, pension funds can choose to engage in “Wall Street Talk” over “Wall Street Walk”. In addition, pension funds should seek to integrate material ESG considerations alongside financial indicators into the investment decision-making process for their investments.

As such, in this mini-book, we highlight good corporate governance practices that trustees of pension funds should seek from their plan investments. We also discuss available responsible investment strategies, particularly those related to active ownership, that can enable trustees to positively influence corporate behavior.
Under the Dodd-Frank Act of 2010, publicly traded American companies are required to hold an annual, biennial or triennial advisory vote on pay to top executives. As Segal Marco Consulting notes, “The votes are advisory, but when a majority of shareholders vote against a company’s compensation plan, the company typically responds by more tightly aligning pay with performance.”

In 2017, shareholders supported by the say-on-pay institutional investor working group voted at 146 companies in the Russell 3000 to move to an annual vote on executive compensation from a once in three year vote. As AFI-CIO President Richard Trumka noted, “Annual say-on-pay votes are an important safeguard to prevent excessive executive pay…for too long, CEOs have rigged the system in their favor while refusing to lift the wages of the workers that make their businesses run.”

As we have pointed out before, campaigns such as say-on-pay votes, and the fight-for-15, aimed at increasing low-wage worker pay (particularly within the fast-food industry), are rightfully shifting the focus from “profits at all cost” to more responsible business practices.
Assigning Responsibility for the Opioid Crisis

In 2017, Eric Eyre of the Charleston Gazette-Mail won the Pulitzer Prize for investigative reporting for his coverage of the opioid crisis in small-town West Virginia, according to Eyre’s home newspaper. The Pulitzer judges said Eyre won the prize “for courageous reporting, performed in the face of powerful opposition, to expose the flood of opioids flowing into depressed West Virginia counties with the highest overdose death rates in the country.”

Eyre’s investigation found that, over six years, drug wholesalers dumped 780 million hydrocodone and oxycodone pills onto the state while 1,728 West Virginians fatally overdosed on those two painkillers. Over five years, the nation's largest drug wholesalers flooded notorious “pill mill” pharmacies in West Virginia's smallest towns and poorest counties with hundreds of thousands of painkillers, according to court records the companies had sought to keep secret for more than a year.

Following increased attention on the crisis, Investors for Opioid Accountability (IOA), a group of 30 treasurers, asset managers, faith-based, public and labor funds with over $1.3 trillion in assets is filing multiple shareholder proposals to increase board oversight of business risks related to opioids at 10 opioid distributor and manufacturer companies. As part of these proposals, the IOA is asking the independent board of directors at these companies to investigate how they are responding to the resulting increased business risk and encouraging them to implement good corporate governance practices going forward that traditionally serve as risk mitigators.

“The opioid epidemic is destroying American families. We need drug companies to step up and take action now. If they fail to do so, not only will families across the country continue to lose loved ones, but drug companies will likely face more lawsuits, government regulations, and financial consequences in their stock prices.”

-Illinois State Treasurer Michael Frerichs
What is Good Corporate Governance?

Corporate governance is about how companies are directed and controlled. It involves many different actors who have a stake in the ownership and control of companies, including shareholders, management, corporate boards, workers and their unions, and other stakeholders. The question of governance influences everything about how a company is run.

As the California Public Employees’ Retirement System (CalPERS) has noted, corporate governance is about making “the boss” accountable.

Examples of issues that are appropriate subjects for shareholder activism by pension plans under ERISA as identified by the U.S. Department of Labor (DOL):

- Independence and expertise of candidates for the corporation’s board of directors
- Assuring that the board has sufficient information to carry out its responsibility to monitor management
- Appropriateness of executive compensation
- Corporation’s policy regarding mergers and acquisitions
- Extent of debt financing and capitalization
- Nature of long-term business plans
- Corporation’s investment in training to develop its workforce

In addition to the active participation of pension plans in corporate governance, there are also many complementary workplace practices that protect workers’ rights, engage and empower workers, and facilitate productivity and higher bottom-line results. These include:

- Responsible employment relations
- Workforce participation & ownership
- Workforce training & knowledge sharing
- Empowerment & diversity strategies

The Trade Union Advisory Committee (TUAC) to the OECD asserts that corporate governance principles should not accept the status quo standards that contributed to the 2008 crisis but should instead aim for aspirational governance standards to achieve the long-term interests of a company. TUAC’s proposals to strengthen corporate governance principles and practices include the fundamental principles listed below.

Worker's Voice
- Recognizing workers’ right to information, consultation, representation and negotiation based on the OECD Guidelines for MNEs and the UN Guiding Principles on Business and Human Rights
- Protecting workers’ creditor claims
- Promoting sustainability and tax reporting

Investment Chain
- Ensuring transparency and accountability of asset managers and other intermediaries to asset owners and addressing conflicts of interest
- Reducing the reliance on performance-related pay

Shareholder Rights
- Securing shareholders’ right to hold board accountable
- Promoting responsible use of shareholder rights to help curb short-termist market behavior
- Recommending merger and takeover rules to be subject to the long-term interests of the company

Board Organization and Duties
- Setting principles for board diversity (gender, minority, and employee representation)
- Enhancing the duties of directors and risk management to account for the growing complexity of businesses and their responsibility via-a-vis all stakeholders
- Adopting the separation of CEO and board chair functions as a principle

Executive Pay
- Reining in executive pay to rebuild confidence and trust in executive management by reducing the reliance on performance-related pay and designing remuneration packages that are in line with the long-term interests of the company
- Ensuring disclosure of individual pay and CEO/worker pay ratio, and approval by shareholders and independent directors
Why Is Good Corporate Governance Important?

Pension trustees should promote good corporate governance because:

1. **There is a strong business case for good corporate governance**

   - Study after study has shown that responsible governance can lower the cost of capital and encourage more efficient use of resources.

   - Being a good corporate citizen and responsible business—that is, taking into account the firm’s impact on society and the environment as well as the economy—can provide many business benefits.

   - These benefits include positive impacts on brand value and reputation; employees and future workforce; operational effectiveness and efficiency; risk reduction; access to capital; organizational growth; and business opportunity.

   - Pension funds should support businesses that integrate responsible practices into their operations. Businesses that embrace such practices will survive and thrive; those that do not—think Enron, Massey Coal—may not.

2. **It pays to give workers a voice in the governance of corporations, both as employee stakeholders and as investors**

   - Good corporate governance helps to promote accountability throughout the company’s operations, including the company’s obligations to respect the human rights of workers – who are the owners of pension assets!

   - Workers are stakeholders and investors, and their human “capital” should be stewarded like all other forms of capital.

   - Much research-based evidence demonstrates a correlation between strong Human Capital Management (HCM) and shareholder returns .

   - For good corporate governance to work, shareholders and managers need to treat workers as valued stakeholders.

### Good corporate governance initiatives by a labor bank

Amalgamated Bank, New York’s first labor bank, was born out of the principle to offer hardworking people and their families access to affordable banking. Today the bank has nearly $38 billion in assets under trust, including over $13 billion in assets in its LongView family of funds. Of the latter, nearly $11 billion, or 89%, is in investment funds or vehicles that follow responsible investment guidelines. The bank is also a founding signatory to the Principle for Responsible Investing (PRI).

Through its LongView funds, the bank has undertaken many successful corporate initiatives and aggressive shareholder actions to hold corporations accountable to rigorous ESG standards while delivering on sound investment returns over the long term. In so doing, the bank has taken a strong stance on responsible investing, shareholder returns, golden parachutes, and other important governance issues, to get corporations to return capital to investors and all stakeholders.

The bank has also begun to take stronger actions to protect workers in the garment industry after a number of successive accidents within the industry in Bangladesh. In 2013, as part of a coalition of institutional investors with combined assets of over $1.35 trillion, the bank called on fashion and apparel companies to better track their suppliers, ensure compliance with safety standards, and fully disclose their supply chains. The tragedies also spurred the bank’s efforts to improve individual companies’ manufacturing and supply chain policies. While the bank recognizes the initial progress made, it is focused on making a long-term commitment to bring about lasting change.
Responsible Investment Approaches

- Indexing
- Proxy Voting
- Shareholder Activism
- -/+ Screening
- Divestment
- ESG Integration
Indexing is a long-term passive investment strategy that seeks to achieve the risk–return attributes of a chosen index of securities. Investors can follow an indexed strategy through investments in separate accounts or pooled funds. Indexing is an important investment strategy for many large institutional investors, particularly pension funds, whose portfolio performance is impacted not only by the performance of individual stocks, but also by the performance of the whole economy. Pension funds with an indexed investment strategy naturally lend themselves to incorporating responsible investment criteria in their investment portfolios. Passive investors can exercise their proxy voting rights through external investment managers or specialized service providers, or through in-house staff. While an indexed strategy is not suited to exclusionary screening (unless the assets are invested in an ethical index), divestments, or focused ESG integration, passive investors can nonetheless deploy activist strategies such as using proxy voting rights and other shareholder actions to have their voices heard on a range of corporate matters, from financial and governance to sustainability.

Active ownership by passive investors

The pursuit of active shareholder tools by large passive investors was trail-blazed by CalPERS, though not without challenges, as illustrated by the following story:

Prior to 1986, CalPERS had a commitment to a passive investments strategy; it did not vote its proxies. Furthermore its investment approach tended towards a long-term commitment of funds, with a high level of diversification. In 1986, alarmed at a downturn in stock that seemed to be caused by inept corporate management, CalPERS demanded corporate accountability but was routinely ignored by corporate management. The combination of a long-term investment horizon and a passive investment approach began to look like a recipe for disaster. As a result, CalPERS launched its first corporate governance campaign by targeting ten of the poorest-performing companies in its domestic stock portfolio for improvement.

This was the genesis for the CalPERS focus list, a list of the worst-performing companies that the fund tries to engage with and request improvements of, supplementing their efforts with shareholder resolutions that promote positive corporate governance change. The list was made public in the past, whereas it is now kept private. In combination with active ownership strategies by the pension fund, such focus lists continue to make a positive impact in having shareholder voices heard and pressing nonperforming corporations to improve their performance.

The California State Teachers’ Retirement System (CalSTRS), the second-largest public pension plan in the U.S. after CalPERS, has about 80% of its U.S. investments in passive investment strategies. In order to mitigate the risk associated with its investments, CalSTRS has developed a list of 21 risk factors that it requires to be included by its staff and external investment managers in their investment decision-making. Among the 21 risk factors are transparency and corporate governance, human and worker rights, and the environment. As noted by the pension fund, “this list is not exhaustive and does not attempt to identify all forms of risk that are appropriate to consider in a given investment transaction; however, they do provide a framework of other factors that might be overlooked.” The risk factors are applied to the pension fund’s investments in all asset classes, both within the U.S. and globally.
Proxy Voting

When invested in the public equities of a company, shareholders obtain the right to vote on various corporate matters related to how a company is run, regardless of whether the investors pursue a passive or active management of their assets. In lieu of their physical presence at annual meetings where these matters get voted on, shareholders have the option to vote by proxy. In the case of pension funds, the board of trustees is responsible for deciding how these proxy votes should be managed. Trustees may delegate proxy voting authority to another fiduciary, such as an investment adviser or a specialized proxy voting consultant, or retain their ability to vote proxies in-house.

For pension funds and other institutional investors, proxy voting has emerged as a powerful tool for engaging in corporate governance matters. The DOL has included proxy voting rights as part of a pension fund’s assets, thus requiring all votes to be cast according to the fiduciary duties of loyalty and prudence as applied to a plan’s financial investments. Under Employee Retirement Income Security Act (ERISA), this requires the trustees and the voting fiduciary to make voting decisions that are in the long-term economic best interest of the plan’s participants and beneficiaries.

In addition, ERISA does not preclude fiduciaries from taking into account collateral impacts—such as those involving social and environmental concerns—in their proxy voting decisions as long as the voting fiduciary can articulate a clear basis for concluding that the proxy vote is more likely than not to enhance the economic value of the plan’s investment before expending plan assets. The important point is that trustee fiduciaries should establish plan documents that are in compliance with prevailing laws, comply with those documents in conducting their duties, seek independent advice where required, exercise oversight, and document all processes and procedures followed.

The AFL-CIO’s Proxy Voting Guidelines: Exercising Authority, Restoring Accountability (2012) is a comprehensive and excellent resource for capital stewards wishing to learn more about how to effectively exercise their proxy voting rights on issues of corporate accountability and governance, as well as those of social and environmental importance.

In order to perform their fiduciary duty as it relates to proxy voting, trustees may wish to adopt comprehensive written proxy voting guidelines similar to an investment policy. The guidelines should establish which fiduciaries—trustees themselves, delegated asset managers, or specialized proxy voting agents—have proxy voting responsibilities. While proxy voting guidelines are expected to provide advice to the voting fiduciary on a list of identified proxy issues, the guidelines do not necessarily need to direct managers or specialized agents in how the votes are ultimately cast.

Until the 1990s, many investors, particularly asset managers, either did not cast proxy votes or they reflexively voted with corporate management’s recommendations (AFL-CIO, 2012). With DOL’s formal position taken in 1988 that proxy voting rights are plan assets, trustees began to recognize the importance of proxy voting as a means of holding corporations accountable on a variety of financial and non-financial matters. As is evident from the example of CalPERS, even pension funds in passive investment strategies can positively impact corporate behavior by committing to a thorough proxy voting strategy.
Shareholder activism refers to proactive actions by shareholders to influence the behavior of the companies in which they have invested—above and beyond proxy voting. In her book, *Pension Power*, Isla Carmichael defines shareholder activism as actions that are “directed at bringing about social change in the corporation’s relationship with its shareholders, employees or community.”

These actions can range from private letters or meetings with companies to formal shareholder proposals presented at a company’s annual meeting. Given the role of pension funds as universal owners and the potential costs of untimely divestments, responsible trustees and fiduciaries can create better value for their investments, and in capital markets as a whole, through active engagement and dialogue, to the extent possible, with the companies they are invested in.

As with proxy voting, shareholder activism may include issues related to governance, such as CEO compensation, board of director selection, and mergers and acquisitions, as well as nonfinancial corporate sustainability issues such as human rights, diversity, and environmental pollution. Though shareholder proposals are nonbinding, through such actions trustees and other fiduciaries can bring attention to and support those issues that are expected to contribute to the long-term economic best interest of plan participants and beneficiaries. The DOL has endorsed shareholder activism by pension plan fiduciaries under ERISA, as long as the benefits of shareholder activism for the pension plan are reasonably expected to exceed the costs involved.

Rather than engage in the “Wall Street Walk” by selling their shares of companies, pension plans can help create value by engaging in shareholder activism to encourage good corporate governance and corporate responsibility.

**Example of shareholder activism**

The $160 billion New York City (NYC) Pension Funds has a long and proud history of shareholder proposal engagement in areas such as greenhouse gas emissions and political spending. The NYC Pension Fund is incrementally working to make companies more transparent and corporate boards more responsive.

For instance, among its many successful responsible shareholder initiatives, the NYC Pension Funds, along with CalPERS, led the public “VOTE NO” campaign in 2014 against the board of directors of Duke Energy after its coal ash spilled into 70 miles of a river in North Carolina. As Michael Garland, Assistant Comptroller of Corporate Governance and Responsible Investment, noted, this was the first time that owner investors decided to hold the board responsible over an environmental issue. While the board, composed of four representatives with no relevant experience in the committee they oversaw, was reelected at the company’s annual meeting, “the circumstances served as a wake-up call to investors regarding the need for relevant director expertise to oversee environmental risk management in the energy industry”.

In particular, selling shares of companies with poor governance or irresponsible practices is not a viable alternative for pension plans who employ passive indexing strategies. As noted, these passive investors can still be “active” owners through shareholder activism and proxy voting.

Overall, institutional investors have much bargaining power when it comes to affecting positive change among their investment holdings through shareholder proposals. According to a 2012 Deutsche Bank report, institutional investors filed 2,392 proposals between 1997 and 2009. Of these, 810 (33.9%) were withdrawn before the annual meeting—a reflection of a satisfactory agreement having been reached.
Screening

Exclusionary or negative screening

Screening out investments based on one’s ethics or values is the oldest and most basic way to engage in responsible investing. Depending on investor preferences and/or available investment products, investments may be screened out to exclude companies engaged in certain products or practices. Investors may either completely avoid investing in such companies or set a materiality threshold for exclusion, such as companies deriving more than 10% of their revenues from such activities. Investments may also be screened out to exclude companies with poor environmental and/or human rights records.

Such screening out of investments has a long history in the faith-based and socially responsible investor worlds. In addition to accommodating their moral considerations, some hope that by not investing in certain companies they may be able to put downward pressure on a company’s stock price and/or upward pressure on its cost of capital. They may also be able to bring attention to the harmful effects of the companies’ products and/or practices.

However, skeptics argue that negative screens may not have the desired impact on the stock price or availability of capital for excluded companies. For every investor who sells shares based on a negative screen, there is an investor ready to buy undervalued shares. For example, tobacco screens are being used by nearly 200 ethical mutual funds. However, tobacco stocks have tended to outperform the S&P 500 index. Moreover, public companies do not generally raise additional capital by issuing new shares. Instead, they tend to make capital investments out of retained earnings or by issuing corporate debt. For this reason, any changes in the company’s stock price may not necessarily impact the company’s access to capital.

For pension plan fiduciaries who must seek competitive risk-adjusted investment returns, the use of negative screens can reduce the investable universe and impacts portfolio diversification. In addition, given the complex and global dynamics in which businesses operate today, few companies can claim to be 100% compliant with ESG best practices, further limiting investor options.

Pension plan fiduciaries who are interested in screening investments should first seek legal and financial advice to ensure they do not sacrifice investment returns. But this advice should also include a balanced discussion regarding risk.

Despite limited benefits, negative screening can be a useful approach for responsible investors who wish to apply ethical or moral considerations to their investment portfolio, especially in conjunction with best-in-class or positive screening as well as other active shareholders practices. In fact, some academic studies have found return advantages for portfolios that combine negative screens with best-in-class over portfolios limited to negative screens or even conventional portfolios.

Best-in-class or positive screening

Best-in-class or positive screening is the opposite of exclusionary or negative screening in that it seeks to make investments in companies that show leadership in ESG matters when compared with their peers. Instead of excluding investments in whole industries or sectors, this approach enables investments to be made in companies based on their track record in social and/or environmental practices—companies that may have otherwise been screened out under exclusionary approaches.

While exclusionary screens tend be more black and white, the best-in-class method requires the analysis of a company’s practices in a variety of areas, such as environment, workplace diversity, and supply chain management, vis-à-vis its peers. This approach can be applied to small-, medium-, or large-capitalization companies. Through private equity or venture capital investments, it can also be applied to companies engaged in providing novel solutions to social and/or environmental problems, such as clean energy, waste management, products and services for under-served communities, and sustainable agriculture. In the case of public companies, the best-in-class method can help determine which companies in a particular sector or industry have better corporate policies.
Divestment

Divestment refers to the sale of an investment with the aim to influence corporate behavior or policy around a financial, governance, or ethical issue. The most famous example of a divestment campaign is the sale of stock by large institutional investors in companies doing business in South Africa in protest of the country’s apartheid regime. More recently, a variety of public pension plans and university endowments adopted divestment policies for companies that did business in Sudan after the Darfur genocide. Because investors cannot directly influence the policies of entire countries that have systemic human rights abuses, country-level divestment campaigns may be the only viable strategy for some responsible investors.

Pension plan trustees may wish to consider divestment from companies who are listed and primarily operate in countries where there are systemic human and labor rights concerns. The International Trade Union Confederation (ITUC) publishes an annual Global Rights Index that provides background on workers’ rights concerns in countries around the globe. The ITUC Global Rights Index supersedes previous editions of the AFL-CIO Country Watch List that many pension plans incorporated into their investment policies for international equity investments.

Divestments need to be carefully planned as untimely stock sales can negatively impact portfolio performance. In addition, divestment are believed to have had limited impact on the stock market performance of target companies. As with negative screens, pension plans considering a divestment should seek legal and financial advice to ensure they do not sacrifice investment returns. Because divestment is unlikely to impact the divested company's cost of capital, some consider divestment to be a less effective method of changing corporate behavior.

As a result, pension funds, in their capacity as universal owners, have been encouraged to engage in “Wall Street Talk” over “Wall Street Walk.” As mentioned, once shares in a company have been sold, investors lose their ownership and voting rights, and hence a chance to affect positive corporate change through active ownership.

While the authors are not generally endorsing specific divestment campaigns, they do acknowledge the passions of students, citizens, and capital stewards engaged in the carbon divestment movement, which started in campuses and has grown rapidly in the offices of mayors, endowments, and institutional investors cross the country and globally. We are, with this mini-book, focusing more on the “invest” side of the divest/invest coin.
ESG Integration

The integration of ESG considerations in traditional investment analysis to determine the intrinsic value of a company is perhaps the holy grail of responsible investment approaches. Rather than excluding companies with poor ESG performance or being limited to companies that appear better investments only in comparison with their poor-performing peers, pension funds can invest in businesses that are truly operating in a manner that is accountable to all stakeholders, particularly workers, and respectful of the environment and society.

To effectively integrate ESG considerations into the investment analysis process, pension funds should select ESG factors that are material to the financial performance of their portfolio and analyze them alongside traditional risk–return indicators. Once an investment has been made, pension funds may continue to actively engage with management on these material ESG issues through proxy votes and shareholder activism, as mentioned above, ensuring that their investments meet portfolio goals.

The establishment of the PRI in 2006 has galvanized tremendous support for the inclusion of ESG considerations in institutional investments. The PRI has created several working groups that are focused on various asset classes, providing tangible guidance and peer-to-peer examples on how to pursue responsible investing. One such working group is the PRI Listed Equities ESG Integration Working Group, which in February 2013 published an excellent report on the application of traditional research methods to the integration of ESG factors in investment portfolios. The box below provides five key stages through which pension funds may make ESG integrated investment decisions. Though applied to listed equities in the report, elements of this methodology may also be useful for other asset classes.

Five stages of integrating ESG analysis into listed equity analysis

- Economic analysis: understanding how ESG factors affect economic growth and macro themes, such as resource scarcity
- Industry analysis: understanding how ESG factors influence consumer preferences and regulatory change, such as environmental legislation
- Company strategy: understanding how a company manages ESG risks and opportunities, for example in supply-chain management
- Financial reports: understanding how ESG factors impact on earnings growth, operational efficiency, intangible assets, and underlying cash flows
- Valuation tools: understanding how analysts are integrating ESG considerations into valuation tools such as discount rates and economic value added
These principles (first published in 1999 and revised in 2004) have long been among the most influential sources of corporate governance guidelines for regulators, stock exchanges, investors, and companies worldwide, and continue to be referenced as a benchmark for good governance practices.

**Ensuring the basis for an effective corporate governance framework.** The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and ensure effective supervision and enforcement.

**The rights and equitable treatment of shareholders and key ownership functions.** The corporate governance framework should protect and facilitate, the exercise of shareholders’ rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

**Institutional investors, stock markets, and other intermediaries.** The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.

**The role of stakeholders in corporate governance.** The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

**Disclosure and transparency.** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

**The responsibilities of the board.** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.
Good governance is important not only in terms of managing companies efficiently, but in ensuring that companies pay workers a living wage, respect their right to organize, and pay attention to their health and safety. Shareholders and stakeholders alike must also play a watchdog role, as mistakes can cost lives.

On April 24, 2013, Rana Plaza, an eight-story garment factory near the Bangladeshi capital Dhaka, collapsed, killing over 1,100 workers and injuring 2,500 more. It was one of the most tragic industrial disasters in modern memory and focused western attention on the terrible safety conditions that underlie the global garment industry. The American public first came to understand workplace safety issues a century ago after a similar disaster, the Triangle Shirtwaist Factory fire tragedy in Manhattan, killed 146 garment workers, mostly women. Dozens of American workers have continued to die, even in modern times, from mining and drilling disasters in recent years. These include the BP offshore oil derrick explosion in the Gulf of Mexico, the largest environmental disaster ever, and the Massey Energy mine explosion in West Virginia, both in 2010.

Activist pension funds joined human rights coalitions to demand supply chain transparency in the Rana Plaza case. In the case of the Massey explosion, shareholder anger from a coalition of pension funds over safety and risk management failures forced the firm’s board of directors to strip the former CEO of his board chairmanship position. Don Blankenship, the longtime CEO of Massey, was later indicted on charges that he violated or covered up critical federal mine safety rules at the company’s Upper Big Branch Mine prior to the explosion that killed the miners. This allowed for responsible shareholders to play a significant role in restructuring the company. A jury of his peers in West Virginia ultimately convicted Blankenship, a rare verdict in a coal state where Blankenship had been accused of rigging the courts.

But who will watch the watchers? Pension trust boards are supposed to play that role, monitoring investments for prudence and appropriateness. However, shareholder interests should not be exercised at the expense of other key stakeholders.

In “Making sense of financialization,” Natascha van der Zwan (2014) argues that the ascendancy of the shareholder value orientation in the pension community is a factor in causing financialization. Clearly, responsible shareholder value is a foundation of good governance, especially when capital stewards fully consider all of the components of ESG. But in the following case, the focus on “shareholder primacy” went too far.
In June 2014, Timken Steel, a profitable, modernized manufacturer of steel and bearings was forced to split into two following a shareholders' campaign. Led by the CalSTRS, a signatory to the UN's PRI, the breakup was a product of Relational Investors, an activist hedge fund founded by protégés of corporate raider T. Boone Pickens. The break-up was forced to supposedly “unlock value.”

However, multiple news accounts relayed the fears of the Timken family, workers, and local citizens that the split was unnecessary. The firm, a good community neighbor whose workers were represented by the United Steelworkers (USW), was reportedly well structured, had low debt, and a healthy pension fund. Soon after the split, Relational Investors sold its interests and walked away with a profit of $188 million, in just over two years as a shareholder. But, three years later, stock prices for Timken Steel have fallen from the $49 range in September 2014 to $15 range in September 2017, a loss of 70%, and for Timken Company from $67 range in June 2014 to $48 range in September, 2017, according to Motley Fool. The two new companies have also badly lagged the trend line for the S&P. So, despite the opposition of Teachers’ Union trustees (on CalSTRS board) and the USW, the decision enriched short-term players, resulted in the loss of long-term share value, destroyed synergies (as feared), and will probably make the company more vulnerable to hostile takeovers in a challenging economic environment.

The above is just one example of the systemic short-termism plaguing America’s capital markets and its productive economy. It is no secret that workers’ pension assets, the assets and savings of teachers, steelworkers, firefighters, pilots, engineers -- everyday working people -- represent the largest shares of global financial stock. In 2017, pension assets were valued at US $41.4 trillion across 22 major pension markets globally. The U.S. pension assets market -- at US $25.4 trillion and representing 131% of the nation’s Gross Domestic Product (GDP) -- is the largest among the global markets.

Isn’t it perverse then that workers’ assets are so often deployed in ways that work against their long-term wellbeing? In Working Capital, Dr. Tessa Hebb, one of the thought leaders in responsible investing, succinctly described this dichotomy: “The earnings that workers defer for a secure retirement inform financial decisions that, in turn, determine the quality of employment and the character of goods and services they enjoy. Yet the institutions and individuals that manage pension funds often pursue narrow goals whose consequences undermine workers who provide the savings they tend.”

Trustees and worker-owners need to be the catalyst to realign incentives with longer-term investment horizons for consultants, asset managers, and other players in the investment value chain. Pension funds should not be engaging in the type of negative, speculative “value-unlocking” activism such as in the case of the breaking up of Timken. Rather, pension funds, as representatives of workers financial and social interests, should engage in responsible activism that is in the interest of all key stakeholders, not just shareholders.
REFERENCES

All material is referenced in The Responsible Investor Handbook. Additional resources for updated information in this mini-book are listed below:

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http://www.uawtrust.org/AdminCenter/Library.Files/Media/501/About Us/$1.3-Trillion-Investor-Coalition-on-Opioid-Accountability-Launched.pdf)

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