

5. PENSION FUNDS

PROFILE

Pension funds are a means for individuals to save for their retirement. Employers are often mandated or encouraged by governments to establish pension funds to supplement publicly managed social security by providing other sources of retirement benefits or to promote national savings. Pension funds encompass a broad array of savings plans ranging from social security to individual contribution-defined or benefit-defined company plans. Contribution-defined plans are those in which the employee and/or employer put in a set amount each month or pay period; benefit-defined plans guarantee the employee a set benefit upon retirement. *Figure 5.1* summarizes four key characteristics of pension funds of particular importance to the public interest community.

Size and Leaders

After commercial banks and mutual funds, pension funds represent the third largest global pool of private capital available for lending or investment purposes. In the United States alone, they represented more than US\$3 trillion at the end of 1993 and US\$4.7 trillion by 1996. The California Public Employees' Retirement System (CalPERS) is one of the world's largest public pension funds, representing US\$128 billion in assets. Other large U.S. pension funds include the New York Common, College Retirement Equities Fund (CREF), and General Motor's and General Electric's pension funds.

Key Features

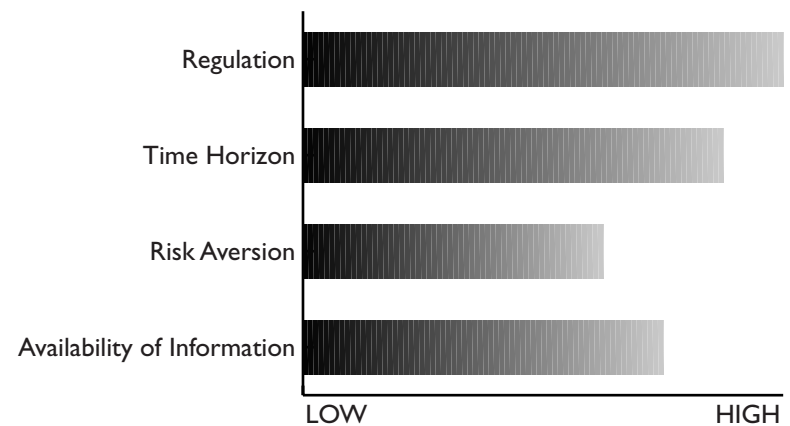
The governance and investment policies of a pension fund determine

how it can invest in the following categories: a company's own securities, international securities, stocks, bonds, and real estate. Pension funds tend to have long-term investment time horizons, because they have relatively stable and known inflows (contributions) and outflows (benefits). Because they represent individual savings for retirement, pension funds have traditionally been managed passively, for low risk, and have concentrated their investments in highly secure stocks and bonds. However, regulatory changes in the United States (see below) and a surge in available capital have encouraged pension funds to diversify into some higher risk and international investments. According to a survey on U.S. institutional investors, 30 percent of all foreign equity investments by U.S. investors are held by 25 U.S. pension funds (1). By 1995, pension funds were committing approximately 5 percent of their assets into "alternative" investments, such as timber and farmland, oil and gas, venture capital, and leveraged buyouts (2).

Regulation

In comparison with other institutional investors, pension funds are heavily regulated. In the United States, the 1974 Employee Retirement Income Security Act (ERISA) is the principal instrument for government regulation of pension funds, and the Securities and Exchange

Figure 5.1 Key Characteristics of Pension Funds



Commission (SEC), the Internal Revenue Service (IRS), and the Department of Labor govern rules of operation and required information disclosure. The following regulatory changes have made an impact upon pension fund investing:

- In 1979, introduction of the “Prudent Man (Investor)” rule allowed pension funds to begin to diversify into higher-risk investments.
- In 1980, the “Safe Harbor” regulation enabled pension funds to shift investments into venture capital by limiting the institutional risk borne by the pension fund.
- In 1988, courts ruled that pension funds were obligated under ERISA to vote corporate proxies in a manner consistent with the fund’s governance requirements.

Each pension fund has specific operating and investment guidelines that are established during the incorporation process and are periodically updated based on shareholder resolutions, trustee actions, and some government guidelines. Voting procedures of any pension fund can be altered by employee vote or a change in voting guidelines administered by the Board of Directors. Some pension fund managers such as CalPERS and CREF may actively acquire stock and sponsor shareholder resolutions. For example, CREF filed a shareholder resolution in February 1998 that demanded a reconfiguration of Walt Disney’s Board of Directors. The resolution received support from 35 percent of Disney’s shareholders (3).

Attention to Environmental Issues

Pension funds do not typically incorporate environmental considerations into investment management decisions. However, the portion of pension fund investments now being channeled into “socially responsible” (SRI) funds is growing. Nevertheless, the obligation to maximize returns within broad risk levels, as governed by the fund’s guidelines, is often cited as a limit to socially responsible investing.

Relevance to Developing and Transition Economies

Pension fund creation has been encouraged in developing and transi-

tion economies through structural economic reforms promoted by multilateral financial institutions such as the World Bank and the International Finance Corporation (IFC). These reforms have urged developing countries to privatize government social security schemes to encourage higher domestic savings and foster the development of local capital markets. Pension fund creation has supplemented privatization efforts by increasing the amount of domestic capital available towards investing in privatizations of state-owned enterprises. The countries of South America, with Chile leading the way, are experiencing significant growth in pension fund creation. The IFC has provided technical assistance and has invested capital into pension funds in several countries, including Peru and Argentina.

U.S. pension funds that invest internationally now have an average allocation of 15 percent invested abroad; U.K. funds average 30 percent (4). Pension funds have contributed significantly to the flow of capital towards “emerging markets” through investments in mutual funds (*see Chapter 4, Mutual Funds*) and private equity funds (*see Chapter 8, Venture Capital*). CalPERS has invested US\$250 million in Asian private equity funds primarily through the Asian Development Bank (5). Pension fund investors are fueling the growth of funds such as the Asian Infrastructure Fund and the Global Power Investments Company Fund.

PENSION FUND DIAGRAM

Figure 5.2 illustrates the operation of a pension fund. In general, the employer identifies the need for a pension fund or is required by law to establish one for its employees. When a fund is established, several key questions arise regarding its **design/creation**:

- Will the **pension fund** be contribution-defined or benefit-defined?
- Will it be funded by the **employee** and/or **employer**?
- Will it be voluntary or mandatory?
- What are the potential **tax savings** and **government regulations** involved?
- Will the investment portfolio be managed internally or externally?
- What investment guidelines will be given to the **treasurer** and the **money managers**?

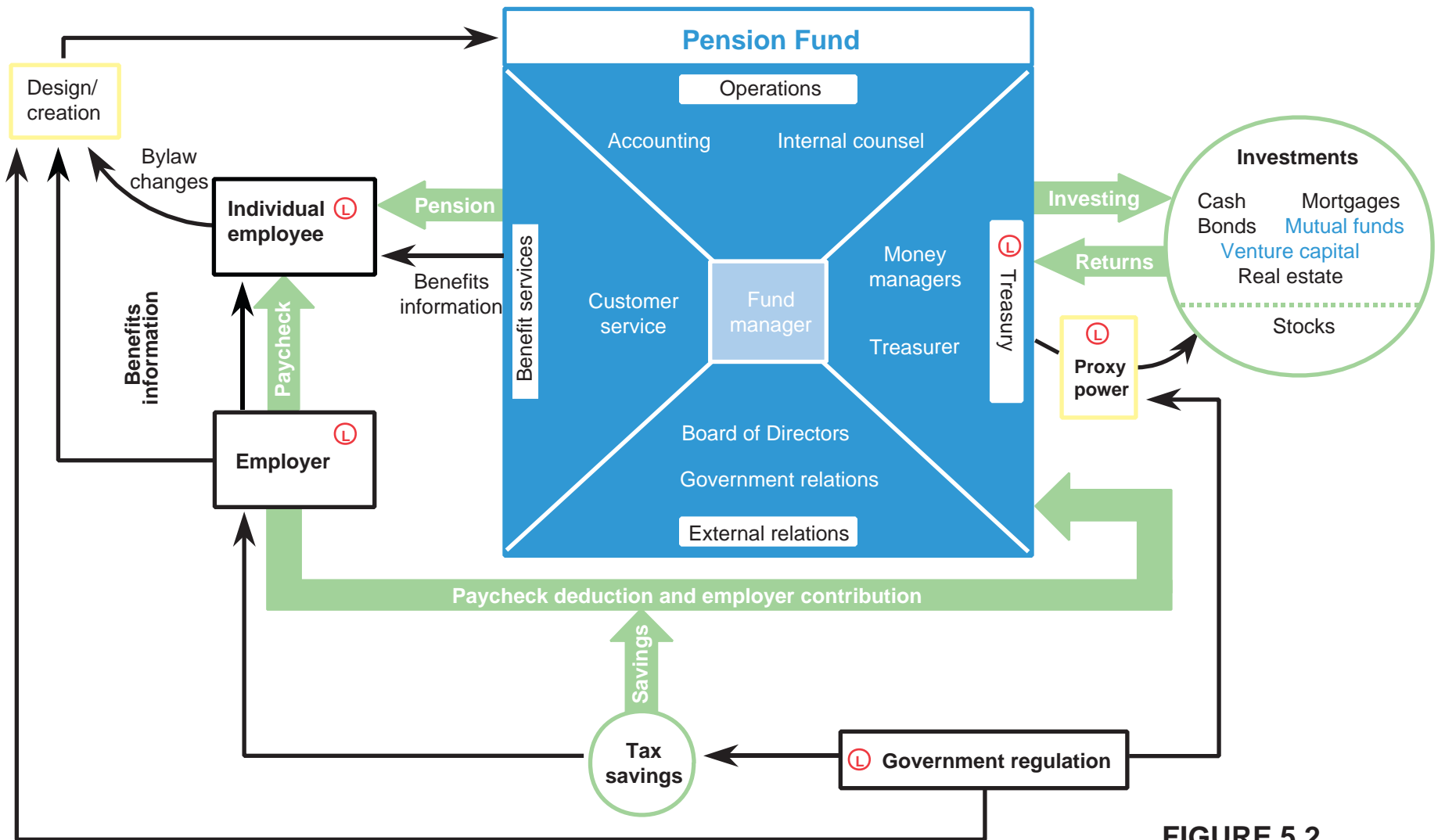


FIGURE 5.2
PENSION FUND

The answers to these questions are codified in the fund's bylaws or incorporation documents.

Once the fund is legally established, an institution is set up or hired to manage the various aspects of the **pension fund**. These areas consist of **benefit services** (responsible for customer service with the **employee**), **operations** (**internal counsel** and **accounting staff** responsible for compliance with all standards), **external relations** (**government relations**), and **treasury**. All of the functions are managed or coordinated by the **fund manager**.

The flow of **benefits information** to an **individual employee** is governed by the fund's bylaws or incorporation documents.

A **deduction** is made from each **paycheck** towards the **pension fund** and may be matched with an **employer contribution**. This money is then managed by the **treasurer** or **investment committee** of the pension fund and invested by **money managers**. Most funds have specific guidelines laid out in the **bylaws** defining the **investment** objectives for the fund's **money managers**. These guidelines traditionally cover risk and expected rates of return.

The **power of the proxy** and **shareholder resolutions** are tools that pension funds can use to influence companies whose stocks they own. The process by which a pension fund votes its proxies is determined by its voting guidelines and procedures, which can be altered through **bylaw changes** by employee vote or a change in voting guidelines administered by the **Board of Directors**.

Government regulation is significant to the pension fund on three fronts: in the initial **design**, in the power of the **proxy**, and in laws that have an impact upon **tax savings**. Besides ERISA, the SEC, the IRS, and the Department of Labor are the key U.S. government agencies involved with pension funds because they can influence the rules by which the funds operate as well as what information they disseminate to fund beneficiaries.

LEVERAGE POINTS

Treasury—*Bottom-line leverage*. The treasurer and money managers apply the fund's investment strategy. Because pension funds require predictable investment returns, these individuals should be willing to consider evidence that integrating environmental considerations into investment decisions makes financial sense over the long run.

Proxy Power/Shareholder Resolution—*Values-based/Reputational leverage*. The proxy is a very powerful tool for pension funds, which are highly visible, long term, and often very large holders of stock, thereby having a significant impact on a company's operating practices and procedures and possibly on the market value of the stock.

Government Regulation—*Policy leverage*. Government policy could be altered to provide incentives to pension funds for environmentally sustainable investments. For example, government policy could encourage pension funds to invest in "climate-friendly" corporations through tax breaks or other incentives.

Employer—*Bottom-line/Values-based/Reputational leverage*. Employers, particularly environmentally oriented businesses and public interest organizations, can offer environmentally screened pension fund options to match the image or the mission of their firm. Employers can also provide greater information about the pension fund to their employees.

Employee—*Bottom-line/Values-based leverage*. Employees with defined-contribution plans can demand more information about how their retirement funds are being invested, and can change the guidelines governing management of their savings. Employees can also become more active by being elected or appointed as a member of their pension fund's investment committee.

Box 5.1 Two Pension Funds Balance Fiduciary Responsibility and Responsible Investing

Background: Since 1990, the Maxxam Corporation has been embroiled in legal struggles over its logging of old-growth redwood forests in northern California. In May 1996, the federal government brokered a deal to protect a portion of the forests in exchange for unhindered logging access to the rest. This deal angered nongovernmental organizations (NGOs) active in the litigation who had been urging a “debt-for-nature” swap, which entailed protection of the entire old-growth holdings in exchange for forgiveness of Maxxam’s corporate debt. In late 1996, the balance of forces tilted. Two large public pension funds with holdings in Maxxam were persuaded by employees’ unions and NGOs to add their voices to the debate—the California Public Employees Retirement System (CalPERS), which has assets of US\$107 billion, and is the largest pension fund in the United States and is the second largest Maxxam stockholder with US\$13 million (3.7 percent), along with the California State Teachers Retirement System (CalSTRS), which has \$65 billion in assets, and is the tenth largest Maxxam stockholder with US\$3 million (0.82 percent).

Action: First, the Rose Foundation for Communities and the Environment led an outreach campaign to teachers’ and public employees’ unions, which highlighted Maxxam’s environmental record as well as its questionable labor practices. Rose charged that Maxxam was paying off a bank loan by diverting funds from its employees’ pension fund and that interest on junk bonds was paid by accelerated logging. In a series of letters, the unions expressed their concerns over Maxxam’s logging activities to CalSTRS and CalPERS, supported promotion of a debt-for-nature swap and, as a last resort, urged that the funds divest from Maxxam stock. Next, the pension funds were the subject of a hard-hitting media campaign that proclaimed: “We hear the retirement funds of California State employees and teachers are making a real killing.”

Outcome: CalSTRS and CalPERS responded that their primary duty is to maximize financial returns to their members and that investments cannot be dictated by social or environmental concerns. Yet both took measures that suggest they heeded the values-based concerns of their members. In early 1997, the President of CalPERS sent a strongly worded letter to Maxxam’s CEO, warning of a public outcry and legislative backlash in response to continued logging, adding that he would be “perceived as a pariah, unable to easily raise new capital.” In late 1997, CalSTRS divested from Maxxam stock, noting that although the decision was based on financial performance, the teachers’ actions had “brought attention to the stock.” Finally, in 1998, CalPERS co-sponsored a shareholder resolution with the Rose Foundation proposing changes to provide more shareholder influence, which was supported by 14.4 percent of votes cast.

Analysis: The Rose Foundation and the various public employee unions urged CalSTRS and CalPERS to act based on values-based and reputational arguments. They simultaneously brought reputational pressure to bear on Maxxam Corporation, with considerable bottom-line implications. The pressure enabled the pension funds to engage Maxxam on financial grounds, which allowed them to voice social and environmental concerns while maintaining their fiduciary responsibility to beneficiaries.

Source: Personal communication with the Rose Foundation, CalSTRS, CalPERS, and various press clippings.

NOTES

1. Tracy Corrigan. “Pension Funds Holdings Boost for Governance.” *The Financial Times*. February 19, 1998.
2. “Alternative Investments Gain.” *Pension Management*. March 1996.
3. Christopher Parks. “Disney: Shake-up Urged by Institutions.” *The Financial Times*. February 25, 1998.
4. “10.8% and Climbing.” *Global Finance*. January 1997.

5. David Pohndorf. “The Fine Art of Making Equity.” *Global Finance*. April 1997. p. 42.

AVAILABLE INFORMATION

The Council of Institutional Investors: <http://www.ciicentral.com>
Interfaith Center on Corporate Responsibility (ICCR), New York,
(212) 870-2600

CalPERS pension fund: <http://www.calpers.ca.gov>

Teachers Insurance and Annuity Association—College Retirement
Equities Fund (TIAA-CREF) pension fund: <http://www.tiaa-cref.org>

Proxies for People: <http://host.envirolink.org/ebic/pfp/index.html>

Trade periodicals:

Pensions & Investments

Pension World

The Journal of Investing

Pension Management

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