Social Investing

Dan M. McGill, *Editor*

1984
Published for the
Pension Research Council
Wharton School
University of Pennsylvania
by
RICHARD D. IRWIN, INC. Homewood, Illinois 60430

ISBN 0-256-03170-3
Library of Congress Catalog Card No. 83-82624

Printed in the United States of America

1 2 3 4 5 6 7 8 9 0 MP 1 0 9 8 7 6 5 4

Pension Fund Investments: Union Goals

5

by Howard Young*

Introduction

The AFL-CIO 1980 document on union participation in the management of pension funds deserves to be treated as the authoritative trade union view, because of both its source and its content.

After pointing out that the "primary purpose of pension funds is, with prudent investments, to secure retirement benefits for workers," the following policy objectives are identified (to be achieved consistent with that primary purpose):

> I. To increase employment through reindustrialization including manufacturing, construction, transportation, maritime, and other sectors necessary to revitalize the economy.
>
> II. To advance social purposes such as worker housing and health centers.
>
> III. To improve the ability of workers to exercise their rights as shareholders in a coordinated fashion.
>
> IV. To exclude from union pension plan investment portfolios companies whose policies are hostile to workers' rights.

* A paper by Howard Young, special consultant to the president, International Union UAW, for February 17-19, 1983 Conference sponsored by the Work in America Institute and the Industrial Union Department of the AFL-CIO. Reprinted with written permission of author and Work in America Institute.

For discussion purposes, this paper presents a perspective on those goals from a viewpoint developed in the environment of an industrial union which—over more than 30 years—has advocated strongly-held concepts regarding pension funding.[1] To help evaluate this perspective, it is useful to identify some of that union's concepts: (a) avoiding direct day-to-day participation in the management of pensions funds[2] (even though the union has bargained for joint administration of other plan operations, in almost every one of the thousands of pension plans it has negotiated); (b) a preference for professional pension fund management[3] (frequently it has negotiated plan provisions which require delegation of investment discretion to a bank trustee or insurance company); (c) advocacy, for at least 15 years, of "socially useful investing" of a relatively small part of the fund (but without seeking decision-making authority with respect to specific investments); and (d) contractual commitments for "actuarially sound" funding[4] have been negotiated in almost all of its plans in an attempt to provide greater assurance that benefits would be paid (although experience with Studebaker and others, led the union to be the initial advocate of federal guarantees; that ultimately led to enactment of ERISA and establishment of PBGC).

Thus, this viewpoint recognizes the tension which can result from efforts to insulate pension funds from undesirable manipulation, and also to maximize their utility as a capital resource as well as a source of investment earnings and ultimately of benefit payments. Nevertheless, we assert that it is feasible to implement the latter without compromising the former, and therefore to achieve the policy objectives outlined by the AFL–CIO within the primary purpose recognized by it.

[1] Of course those concepts of that union (UAW) are not invariant; they are often reviewed in light of new developments and ideas. Perhaps the conference will be such a stimulus.

[2] It is not suggested here that the philosophical and pragmatic concerns would apply or be viewed similarly in other unions. Also, there is little value speculating whether this union could have negotiated such participation if it tried.

[3] One of the concepts brought into question by recent experience.

[4] At least one lengthy strike occurred in the 1949–50 formative period due to this specific demand.

Public Policy

Although there has been much analysis of the extent to which ERISA permits consideration of social criteria in making pension fund investment decisions, that is not controlling at this point; the issue here is not what public (i.e., legislative and regulatory) policy is, but rather what the unions feel it should be.[5]

Of course, most of the fund management provisions of ERISA reflect noncontroversial public policy judgments and provide an acceptable framework within which the unions' objectives should be achieved. For example, diversification of investments and restrictions on self-dealing reflect basic economic and ethical principles to which few (if any) people object.

On the other hand, insistence on a "market rate of return" from investments on which plan participants (speaking through their union) place a high social value—and which may even provide a direct benefit to active or retired participants—is a controversial requirement. Many union people feel that it would be appropriate to accept some lower rate of return on such investments, and thus to subsidize them to some extent. That question is covered more fully later in this paper; the point to be noted here is that public policy debate on this, and similar issues, cannot be settled by reference to the current provisions of ERISA.

The existence of PBGC introduces some valid additional public policy restrictions on pension fund management, since PBGC effectively guarantees against asset loss as well as lack of funding.[6] Thus, any increased probability of asset loss, or of less investment income than otherwise achievable, might result in increased cost to PBGC if the pension plan terminates. While this

[5] Thus, if ERISA (and/or the regulations issued with respect to it) were deemed a bar to otherwise desirable action, legislative change would be appropriate. This comment is not meant to indicate that ERISA is such a bar, nor to imply reduced support for ERISA, but rather to highlight its relation to this discussion of policy—as distinct from implementation—options.

[6] Much of the discussion of risk-related premiums for PBGC coverage focus only on the unfunded liability risk. It is interesting that the early legislative proposals (by Senator Hartke) included a two-part premium: one based on unfunded liabilities, and one based on assets.

potential impact on PBGC should not be overstated, it does deserve some consideration in deciding on the extent to which social criteria (and even subsidization, as indicated above) should be permitted to modify "economic" evaluation of investments.

Perhaps the minimum funding concept in ERISA could provide a reasonable basis for deciding when PBGC's interests should outweigh those of the plan decision makers, and vice versa. In effect, if assets exceed the minimum funding level required, they produce a voluntary (or at least optional) reduction of PBGC's exposure; therefore a willingness to accept less than "market yield levels" might apply to not more than the amount of assets in excess of the minimum funding requirement. That limitation would not apply to preferred investments which are expected to produce market yield levels. In any event, whether due to public policy considerations or simply to pragmatic evaluation of the opportunities available, most advocates of including social criteria in deciding which investments a pension fund should make suggest they apply to a relatively small portion of the fund; that limitation does not apply to decisions about which investments should be excluded.

Of course, any standard based on economic evaluation of investments—and reference to maximum or optimal levels of return in relation to risk—must recognize that those are ambiguous criteria, on which "investment professionals" disagree. Recent evidence indicates that professional investment management often falls short of satisfactory performance. The standard caution that most stock market transactions occur because the buyer and seller have different evaluations of the stock's prospects (rather than because either of them has to buy or sell stock) is a good reminder of the judgments involved in investment decision making. Therefore, strictures such as "applying social preference only between otherwise equivalent investments" or "not sacrificing investment yield in relation to risk" are essentially inoperative rules. People can say that they do—or would like to—impose such strictures, but in practice how would anyone determine whether that has been done correctly? It may be more reasonable to simply say that the same type of evaluation and decision-making criteria (perhaps even with additional safeguards against "wishful thinking," as well as self-dealing or other unethical actions) should apply to the socially preferred category—in order to avoid unreasonable situations, and to arrive at some rank ordering within that category—without implying that evaluations really can determine whether two investments are of precisely equal value, or the precise difference (e.g., in terms of rate of return) applicable to them.

Housing and Other Community-Oriented Facilities

Unions have urged for many years that pension funds invest in residential mortgages, preferably on homes in which active or retired plan participants would live, and at interest rates more favorable than otherwise available.[7]

That advocacy has stemmed partially from a general concern about the residual (and therefore inadequate) role which usually applies to mortgage financing in the capital-allocation processes of the U.S. economy, and also from a desire to provide plan participants with a significant benefit—lower home mortgage payments—in addition to the actual pension payments that are made from the pension fund. (Although such mortgage financing also could have a job-creating impact, by stimulating home construction, that generally has not been the goal of this consumer-oriented, pension-investment concept; pension investing for job creation and other economic development is discussed in the following section).

Since there is now fairly widespread support for the idea of investing pension funds in residential mortgages at market rates, little need be said about that here: the interesting—and controversial—question is whether the fund should provide such mortgages on a subsidized basis.[8] In the simplest terms, the issues involved are (a) the implicit or explicit impact on employer cost and/or pension-benefit levels (or other provisions), and (b) the possible impact on benefit security in the event of plan termination or otherwise.

It could be argued that these are theoretical issues with little practical impact, since—as noted previously—unions generally have urged that only a small portion of the pension fund be used

[7] Although the DOL has defined certain conditions under which favorable mortgage interest rates can be provided to plan participants, those are fairly restrictive.

[8] With, as noted above, permissive changes in ERISA if necessary.

in this way; hence the impact on total plan earnings would be small. Furthermore, as discussed before, "economic" decisions regarding investments are sufficiently imprecise that it would be hard to know for certain whether the substitution of such subsidized mortgages for other fund investments (which ones would be displaced?) would have any significant impact on overall investment results.

However, even if one accepts the theoretical conclusion that such subsidized mortgages would have some impact, unions have a right to assert (as part of their bargaining discretion, which ultimately is validated by the bargaining-unit members) a preference for such mortgage benefits, instead of somewhat higher pension benefits or other economic gains. That is, since unions have flexibility with respect to the pension benefits for which they bargain, and always are faced with a trade-off between benefit levels and eligibility provisions,[9] they also have the right (subject as usual to reaching agreement with the employer) to utilize some of the economic value for another by-product of the pension plan: to provide participants with more available and less costly mortgages. Even the criticism that such mortgages could only go to a small portion of the participant group isn't a bar if the selection procedure is nondiscriminatory and the entire group agrees to the arrangement.[10]

It is important to understand that—in most negotiated plans (and in others, as well)—even those already retired are more dependent upon continuance of the plan, and future contributions to it, than on earnings from assets already accumulated. That is, retirees usually are not drawing interest and principal from "their" pool of assets; rather, they are part of a group mechanism which usually provides them larger benefits than would result from contributions made prior to their retirement. That applies particularly where benefits are increased after retirement; few plans include cost-of-living or other automatic increase mechanisms. Thus, those already retired are not "outside" the trade-offs which the union can make; in fact, increased benefits to retirees usually mean lesser pension or other benefits (including wages) that otherwise might go to current employees.

---

9 For example, should "full" retirement benefits be at a higher level or available earlier?

10 Many similar subgroup benefits are negotiated: whether controlled by chance (e.g., insurance), status (e.g., shift premium), or otherwise.

Although the preceding logic is valid for defined contribution (as well as defined benefit) plans, its acceptability is weakened somewhat by the individual account philosophy of those plans.

The benefit security issue is somewhat more troublesome, since there is an ethical obligation to provide that promised benefits will be payable when they become due. However, as was suggested earlier, the minimum funding standards specified by ERISA might be viewed as an indicator of acceptable risk levels. Whether or not subsidized mortgages (and whatever reduced security that might involve; but it must be emphasized that is a questionable assumption) are acceptable for a plan with only the minimum permitted assets, that reservation should not apply to more adequately funded plans.

A somewhat related issue is that of targetting such investments to plan participants, or even to specified income groups or geographic areas. Any of these are reasonable goals and should not be prohibited categorically by public policy.[11] A minor concern is the ability of participants to continue mortgage payments in the event of plan termination or other adverse economic developments. That is essentially a diversification of risk issue, and is manageable in the usual way: by limiting the portion of plan assets invested in that way. Just as a portion of plan assets can be invested in securities of the employer,[12] a portion can be invested in secured obligations of the participants.

In addition to housing, participants often see a value in financing community-oriented facilities such as nonprofit child care centers, nursing homes, etc. Those facilities usually have difficulty in getting access to the traditional investment management decision makers. Thus financing is often unavailable, or at high rates (because of inadequate supply of available capital). While some improvement can result simply from getting the investment managers to review such proposals with a more receptive attitude (i.e., broadening their horizons), the issue of favorable ("subsidized") rates of return is similar to residential mortgages. The union has the same right to seek preference for both categories of investment.

---

[11] Any specific loan should be subject to restrictions on self-dealing or other conflicts of interest.

[12] Note that when IRS (which must first consult with PBGC) permits a waiver of the minimun funding requirement, the amount waived is effectively lent to the employer (without security).

Economic Revitalization

Allocation of some pension fund assets to investment in economic development projects, especially those which increase employment, is another union goal.[13] Although so far action has primarily involved pension funds set up by state and local governments and those in the construction trades,[14] they have demonstrated some of the potential benefits of this approach.

Issues related to *whether* such investments should be given preference are similar to those involved in connection with housing and other community-oriented facilities. However, there probably is more emphasis on making capital available, than on a subsidized rate of return; actually, it is even more difficult to identify for these economic investments what the unsubsidized (i.e., "market") rate of return would be if capital were available to them from other sources.

Of more specific concern for this category of investments is *how* they should be made; that will be the focus of these comments. As compared with mortgages discussed previously, individual economic development investments are more likely to: (*a*) be large in relation to the size of many pension funds, (*b*) involve significant risk,[15] and (*c*) require substantial subjective judgments in the selection process. As a result of such considerations it would be desirable to have pooling mechanisms which could spread the risk (with respect to any specific investment, and also among the pension plans utilizing that pool) as well as to assist the individual pension funds in, and insulate them from, the evaluation and selection process. The mechanics of pooled investment funds are well known; in this case, the only special characteristic—aside from specializing in the economic development activities which the unions advocate—would be a board of directors representing labor, business, consumers, and other important constituencies. The pool would employ appropriate

[13] This is part of the unions' broader interest in industrial policy, development banks, changing the capital allocation processes and other economic revitalization actions.

[14] Perhaps because the participants involved in those funds are more directly affected by such economic development, and they have greater influence on decision making: through the political process in the case of public employees, or the Taft-Hartley structure in the construction trades. Also ERISA does not apply to the public funds.

[15] The overall group of such investments need not be high risk, but variance within the group will be high: there are likely to be failures as well as outstanding successes.

technical personnel, and the main function of the board would be to assure that the goal of investing for economic development doesn't get obscured by whatever selection procedures validly are required to assure responsible and ethical management of the pool's assets.

There probably should be several such pools in order to give various criteria the relative priorities that will be desired by various unions.[16] For example, there will be interest in favoring investment in certain locations, industries, or types of activity. However, the importance of diversification—and of the need to provide a balanced revitalization of the entire U.S. economy—must not be ignored.

National policy considerations should be assured by government participation on the board or otherwise. In addition, there should be federal guarantees with respect to the investments, in view of the favorable effect which revitalization will have on the federal budget (e.g., through reduction in unemployment), in addition to alleviation of hardship and other improvement in the general welfare. As a practical matter, such guarantees probably are necessary to make such pooling feasible, even though the pooling is possible otherwise. Such guarantees need not apply to individual investments; instead they could apply to the overall functioning of each of the pools. Of course, provision of a guarantee would entitle the federal government to impose eligibility requirements on the investments to be made by the pools (both with respect to individual investments, and to the overall operation of the pool) and to collect a risk premium. As an alternative mechanism, the federal government might make the investments with the revenue from special government bonds sold to pension funds; the structure of a democratic decision-making agency to determine such investments is beyond the scope of this paper.

Even though some of the individual investments will fail,[17] each pool should be sufficiently diversified to require only minimal recourse to the federal guarantees, and in the overall the guarantee program should be self-supporting.

Finally, if such guaranteed pooling mechanisms are estab-

[16] Also, that might be needed to comply with variations in state investment laws; unless they are fully preempted by ERISA.

[17] Absence of any failures would be evidence that the selection criteria are too restrictive.

lished, it would be appropriate to require that each pension fund invest at least some specified portion of its assets (e.g., 10 percent, to be achieved over a period of time from cash flow, so as not to require any divestitures) through those arrangements.

Investment Prohibitions

The arguments for the union's right to bargain investment prohibitions are essentially the same as those applicable to investment preferences. Furthermore, if the prohibitions refer to a relatively small portion of all qualified investments and setting aside the question (which is covered further below) of whether divestitures of assets should be required, it is hard to see how prohibitions would have any significant impact on the expected investment performance of the fund. Of course, it is the expected performance (rather than "Monday morning quarterbacking") which must be considered in evaluating the impact of prohibitions, just as is true for preferences. The mere fact that a prohibited investment subsequently proves to be a big winner (or a big loser) is irrelevant; the performance impact must be measured against whether the prohibited investment would have been purchased, how the substitute investment behaved, and what the alternative chain of subsequent events would have been (if the prohibited investment had been made) as opposed to what it was (in relation to the substitute investment).

In other words, a true evaluation of the performance impact of prohibitions would have to involve something like the following, with each action (or prevented action) documented at the time it would have been taken, rather than on the basis of some after-the-fact review of the portfolio: (*a*) which prohibited investment would have been made and when; (*b*) when would that prohibited investment have been disposed of, and what subsequent chain of acquisitions and dispositions would have occurred with those proceeds; (*c*) what substitute investment was held in lieu of the prohibited investment; and (*d*) when was that substitute disposed of, and what subsequent chain of investment activity was generated by that disposition. Of course, even that complicated analysis ignores the secondary impacts such as: (*a*) what differences in investment returns (e.g., dividend or interest payments) resulted from the substitution and how they were (or would have been) utilized and (b) what impact, if any, did the substitution have on management of the rest of the portfolio.

It just is not credible to assert that—in the absence of prohibitions—investment managers analyze every possible investment whenever making a purchase decision, nor that some relatively small narrowing of their horizon could have a significant—or even measurable—impact on the results they expect to achieve by each decision.

Any specific prohibitions (e.g., do not buy the securities of Nasty, Inc.) could be unilaterally specified by the union, thus sparing the corporate sponsor of the pension fund any need to implicitly or explicitly endorse the union's determination that Nasty, Inc. has some objectionable characteristics.

In principle, it would not be necessary to specify in advance any criteria for such prohibitions, nor for the union to explain—publicly or privately—why it objects to Nasty, Inc.[18] However, if the union is interested in affecting the behavior of Nasty, Inc., then it would make sense for the union to (a) indicate the reason the investment will be prohibited; (b) publicize its intention; and (c) even if only in the interests of due process, provide Nasty, Inc. with advance notice before making the prohibition final and give it an opportunity to correct the situation if possible. After all, just as the investment prohibitions have no significant impact on the pension fund, they cannot have any significant direct impact on Nasty, Inc. The union's desired effect can only occur as a result of the Nasty, Inc.'s concern over the publicity involved and the possibility that other investors will invoke similar prohibitions.

Of course, the union should have the right to revoke a specific prohibition at any time.

As noted previously, divestiture of prohibited investments involves different considerations. Since the union's prohibition could have a detrimental impact on the value of the investment involved,[19] it would not be prudent to require the investment manager to immediately implement what might be a distress

[18] Presumably, if the plan sponsor had any legitimate interest in circumscribing the reasons for, or choice of, a prohibited investment it would point those out.

[19] The union is not under any obligation to avoid actions (whether it be the prohibition, or more direct conflict) which might adversely affect pension fund investments. That also applies to the plan sponsor; to believe otherwise would imply that the sponsor should prohibit investment in competitive firms or else modify its business actions.

sale. Certainly the investment manager should be conscious of the union's concern and should watch for appropriate opportunities to dispose of the investment (perhaps by switching to an "equivalent" investment) at an appropriate time. That timing decision must be left to the judgment of the investment manager.

Finally, for practical considerations, the prohibition might be waived with respect to any "flow through" impact: that is, the investment manager would not be expected to avoid use of a pooled fund solely because it holds a prohibited investment. On the other hand, the union could specify that a pooled fund itself be a prohibited investment, if whatever prohibition criteria the union is using applied to that fund.

Ownership Rights

There should be a procedure which would allow unions to affect decisions regarding ownership rights relating to assets of the pension fund. While some argue for exercise of such rights by plan participants directly, at least in negotiated plans it is more appropriate (and probably more effective) to have the union exercise those rights; that is fully consistent with the union's other functions as elected representative of the participants.

Only assets which the fund otherwise owns, for "investment reasons," are involved; it is not suggested that assets be purchased solely in order to be able to exercise these ownership rights.[20] The ownership rights referred to are those—such as stockholder proxy voting—which essentially are by-products of the basic investment management functions of deciding whether and when to buy or sell fund assets. Thus the manner in which those ownership rights are exercised rarely would have a significant impact on the expected investment performance of the asset; if the investment manager believed there would be a detrimental impact, it would have a fiduciary duty to oppose the action.

Stockholder proxy voting is the ownership right most likely to be affected, but the union should not be obligated to take a position on every proxy issue; just as is true for stockholders, the

[20] Similarly, the asset should not be sold to avoid implementing the union's position. In both situations (purchases or sales), there may be valid "investment" reasons for such action.

union could abstain by inaction.[21] Perhaps the most significant procedural question is how to avoid complete inaction if union and management do not agree on how a specific proxy issue should be voted (assuming that they would have equal authority to provide such input). While reference to an impartial third party—as is done for many other "deadlocked" procedural matters—is a possibility, the fact that shareholder voting need not be treated as an indivisible action provides a more preferable alternative: the union could have unilateral authority with respect to votes for one half of the shares involved, and the same rule would apply to management. Thus, in case of disagreement, each side could neutralize (but not block exercise of) the votes of the other, or could abstain from action on its votes.

Another area of interest is initiation of stockholder resolutions. Since such action only opens the door to any binding requirement on the corporation involved, and generally can be initiated by shareholders with very small ownership interests, the union should have unilateral authority to initiate resolutions; management would also have such unilateral authority.

Both of these matters require that timely information be provided to the union (and management) regarding stock ownership, proxy voting issues, shareholder resolution procedures and deadlines, etc. Unlike performance evaluation information, which is mainly historical and useful even if reasonable time lags are involved, current ownership data is crucial to the effective exercise of ownership rights.

Conclusion

As noted at the outset, this paper reflects a perspective which emphasizes little—if any—union participation in day-to-day investment management. Thus it outlines a modest approach to implementation procedures for the unions' investment goals; others undoubtedly will advocate more ambitious implementation procedures.

Also, except for the possibility of federal guarantees and related actions regarding economic development activities, the

[21] That is, the union could indicate it wants the investment manager to abstain; or the union could leave the matter to the investment manager's judgment.

question of legislative achievement of these union goals is not covered. In fact such legislation is desirable, and perhaps necessary, but that aspect seems peripheral to the basic discussion of those goals.

Similarly, other "secondary" questions have been set aside. For example: how to obtain union input if more than one union represents plan participants and/or if the plan also covers unrepresented workers? Such matters could be resolved in a variety of ways, but that would have to be worked out within the overall implementation framework specifically applicable to that plan. Another "secondary" issue is how to achieve some leverage on other financing sources, in order to multiply the impact of the unions' action.

There should be some consideration of the union's role in selection and retention of the investment manager (of course, that is automatic for Taft-Hartley funds). An active role for the union could involve joint authority to select the investment manager, or might be a veto on management's decisions. The basis for the union's action could be an evaluation of the manager's overall investment selection results, but the issues more relevant to this paper are: (a) the investment manager's implementation of any discretionary functions related to the preferred (and, but less likely, the prohibited) investment categories and (b) general business policies of the investment manager.

With respect to the discretionary functions, unions should recognize any valid reasons—in terms of investment judgment or fiduciary responsibility—the investment manager might offer. However, if those are unsatisfactory, or if there are persistent shortfalls in meeting the union's goals, then a change of investment manager would be justified.

An investment manager's general business policies might be highly objectionable to the union, for much the same reasons as the union uses in determining prohibited investments. As was discussed, in connection with prohibited investments, due consideration would have to be given to the possible impact on investment performance (ruling out the use of one or more investment managers usually would be more significant than ruling out a few specific investments) and to possible remedial action by the investment manager.

Even though pension funds are a by-product and must operate in support of the effort to provide pension benefits, it is wrong for unions to be kept out of the manner in which they are utilized as an investment capital resource. Unions are not indifferent to the types of activity financed by workers' deferred compensation. Their preferences as to investments which should be made with a relatively small portion of the fund and those which should be prohibited, as well as their views on ownership rights, should be part of the policies which guide investment managers as they make their day-to-day decisions.