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Getting Values for Your Money

By Kelly Candaele

Politics and managing pension funds don't often mix. That's a lesson I learned shortly after my appointment late last year to the board of the Los Angeles City Employees Retirement System by Mayor Antonio Villaraigosa. At a new-trustee orientation, I heard cautionary tales about the folly of allowing "politics" or "missions" to influence pension-fund investments. The bottom line for the city's \$9.7-billion fund — return on investments — is the bottom line.

It has not been an easy lesson to follow. During my college years, I spent many afternoons picketing the local Bank of America demanding that it divest from apartheid South Africa, and my political activism has not waned.

Some public pension funds do rule out certain investments because trustees consider them socially and economically irresponsible. For instance, San Francisco's city fund bars investments in tobacco companies, and the California Public Employee Retirement System, or CalPERS, does not directly invest in Russia or China. But few pension boards adopt strict social guidelines for investing, both for legal and practical reasons.

Although the federal Employee Retirement Income Security Act of 1974 does not apply to public-sector funds, its cautious spirit permeates the fiduciary environment. The act requires a diversity of investments — stocks, bonds, domestic and international equities, for instance. And in California, the state's Pension Protection Act of 1992 stipulates that retirement boards "shall discharge their duties ... solely in the interest of, and for the exclusive purposes of, providing benefits to participants and their beneficiaries. . . ."

Practically speaking, if every investment had to satisfy social or moral criteria, it's easy to see that a case could be made for divesting from U.S. companies that operate, say, in India's caste society or in communist China. But those markets are some of the world's highest performing. Prohibiting investments in them on social or moral grounds might jeopardize a pension fund's ability to deliver on its financial promises to current and future retirees and subject trustees to potential litigation.

When it became clear decades ago that institutional owners — pension funds, foundations, mutual funds — would become the largest source of investment capital in the United States, the policy implications of that dynamic were urgently debated. Today, American public and private pension funds, along with mutual funds, own about 40% of the publicly

traded stocks in the U.S., which gives them enormous financial clout and the potential to shape public policy.

Leftist writers such as Jeremy Rifkin and Randy Barber have contended that private and public pension funds (legally defined as deferred wages) should be a source of capital to rebuild communities and create local jobs. But management guru Peter Drucker worried that such “pension fund socialism” would drain entrepreneurial energy from the U.S. economy by channeling investments toward “dying” industries.

Some academics, investment managers and fund trustees are working on an investment strategy that is defensible on both fiduciary and social grounds. Their organizing principle is called “universal ownership.” According to James P. Hawley and Andrew T. Williams, authors of “The Rise of Fiduciary Capitalism,” large pension funds are universal owners because they invest in every area of the world, across economic sectors and have a long-term time horizon. As such, fund managers or trustees should weigh the effects of their investment decisions on the economy as a whole, rather than simply concentrate on the short-term performance of this or that company or this or that sector.

So, in considering an investment in, say, a company that fouls the air, the trustees and fund managers would also factor in the clean-up costs it imposes on other companies or society at large. That burden could work to retard the overall growth of the economy. Investing in the polluter might thus be equivalent to robbing Peter to pay Paul, which is not a viable approach for increasing shareholder value and strengthening pension funds.

The universal owner ethos does not regard divestiture as the primary strategy for changing corporate practices. Instead, it calls for investors to engage corporate managers as share-owners and stewards of the economy through proxy policies, corporate governance initiatives and the public shaming of bad actors.

The \$210-billion pension fund CalPERS annually publishes a list of poorly performing and ineptly managed companies. The list has brought about changes in corporate governance and policies that served to increase shareholder value. For instance, it was one factor in the creation last year of a more independent board of directors for Walt Disney Co.

CalPERS is also a significant force in directing future economic activity. It pioneered a \$200- million private equity fund that invests in firms working on environmental technology and committed another \$500 million to build a portfolio of public companies that use environmental criteria in deciding how to grow in the future. These investments will attract more capital to the clean sector of the economy, thereby increasing their value. CalPERS California Initiative, designed to funnel capital to state companies that create local jobs, is showing good returns on investments as well.

The Los Angeles City Retirement Fund is already making prudent investments in Los Angeles clean energy firms and we are looking at

investments in local workforce housing. The theory of universal ownership can become the practice of wise investing – generating solid returns and meeting dire local needs.

Most of the questions at our pension-fund meetings concern how to achieve superior returns while weighing potential risk. These are important, and it is the responsibility of the trustees to ask them. But in a conversation at a recent conference on universal ownership, Mike Musuraca, Designated Trustee of the New York City Employees Retirement System, asked a different kind of question. “Is it possible for institutional investors to pool our capital and develop policies and guidelines that both provide a strong return on our investments and also change the way that corporations do business in a more progressive way.”

The answer to his question is yes, it is possible. Following through may very well involve “politics,” I suppose. But more importantly, it also involves values and common sense, two qualities that no-one should surrender, whatever the position they may temporarily hold.

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