

Fair Pensions Lecture

The Great Committee Room, House of Commons

« In the Wake of the Financial Crisis : Rethinking Responsible Investment »

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- Many thanks to Fair Pensions for the kind invitation to speak to you this evening on what sounds a daunting theme : rethinking responsible investment in the wake of the financial crisis. We're fortunate to be joined by many in the field, labouring mightily on this issue, not least, Lord Myners, who has been pressing for improvement for many years.
- Grand themes are best tackled with some humility. You will recall the question posed by an eager news reporter to Mahatma Ghandi upon his visit to the Lancaster cotton mills « What did he think of Western Civilisation? » He answered : «It would be a good idea. »
- That then can be our start for this evening. Responsible investment would be a good idea, and perhaps the question is not how good the idea is or might be, but more what is holding it back. What would cause « responsible investment » to lose its rather platitudinous moniker – « responsible » and simply become « investment »? If markets are efficient, because information is sufficient and investors are rational, then responsible investment would be nothing worthy of comment. Irresponsible investment would represent the occasional excess, indiscretion or folly. The prayer of St Augustine would be in order (Lord, please reform me, but not until tomorrow.)

- The situation appears more complex. The problems more intractable. We have a tragedy of the commons in capital markets. The proposition is that « responsible investment » can provide some guidance on how to navigate this complex terrain. Given our gathering of the party faithful on the subject here this evening, I'm not sure we need to rehearse a definition of what « responsible investment » is – or spend time on the variations between socially responsible investment, ethical investment, responsible ownership, environmental, social and governance (ESG) investing.
- All of these approaches attempt to do something beguilingly simple: ensure an optimal outcome for those benefitting from and affected by the investment process. The alphabet soup (ESG, RI, SRI, CSR – etc) is based on the proposition that current arrangements do **not** lead to optimal outcomes. They may be more efficient, in the short term, or for certain players, but more is needed to ensure that investment meets its best purpose: allocating capital to where it is needed, and can best be deployed. The invention of the corporate form, and systems of finance to support its growth, have evolved like most else in human history, as ways to meet human needs and want. The system has been prone to crisis and overhaul at regular intervals from the start. « The Recurring Crisis in Corporate Governance » (Millstein and MacAvoy) reminds us of this. The reaction to collapse and disaster has at times been extreme. The Bubble Act of 1720s banned incorporation for over a century, in reaction to the South Sea crisis. The Joint Stock Company was pieced together over several decades after ill tempered debate and disagreement in Parliament over what was necessary for capital accumulation, and sufficient to protect the public from the wild excesses and risks of the corporation.
- When I first studied economics in the late 1970s it was considered the study of large, complex but essentially mechanistic processes. School children were shown models of

levers and pulleys to explain money supply and inflation. The task of government was to ensure those cogs and pulleys were set to proper place. The task of the company was to behave rationally in response to these mechanisms which would determine costs and profits. The investor simply needed to understand something that could probably worked out with the stub of a pencil on the back of an envelope. The discounted rate of return, relative to the opportunities and the investor's need for cash versus capital over the period. This was all very pleasing. World problems could be solved with simple arithmetic – a little algebra at worst!

- My economics tutor at St Hilda's was a gentle, but formidable woman who at six feet tall, towered over her students, and strode around the college in tweeds and men's shoes. She had advised the national government during the war and the Labour government in the aftermath. We were enthralled by the subject and by our don who had not only grappled academically with the subject of economics, but had also been in public service during a time of great crisis. She understood all too well the limits of her subject. How could those equations describing the workings of the economy, of employment, inflation, taxes, the very well being of nation, ever be relied upon? The 1970s were marked by inflation, industrial conflict, political strife, protest against war, military dictatorships and oppression, poverty and scandal were in the headlines regularly. This was not captured in those equations. For a start, why was an « X » always inserted and what did it represent ? Miss Watts replied « X, my dear has no real value in the equation. Think of X as human nature.» In other words, all of our equations explaining markets, economic efficiency and the sum of of it all, would work if we could only control for human nature.
- Controlling for human nature in economics has since become a respectable subject for enquiry – Nobel prizes have been awarded for as much. Suffice to say that concern with

human happiness, social welfare and even « sustainability » has been a fundamental concern since commerce and its friend, financing for that commerce, began. So too have codes of conduct, and decent business behaviour. These were not the sole preserve of religion. The Hammurabi scripts, several thousand years BC, from Mesopotamia, are one of the earliest surviving examples. The price and quality of goods is set out, with punishments specified for spoiling of property (goods, animals, slaves, wives and children included at different rates of exchange). The Domesday book records for this country important business standards the most detailed of which address the serious matter of watering beer.

- The current round of debate on standards in commerce, finance and trade has long roots, to the origins of the corporation and trade. It is easy to be seduced with the suggestion of progress – but we are still wrestling with how to meet human need and wants, and to harness the animal spirits of the market to that cause.
- The scale of the financial crisis has illustrated that investors are not only continuing to be challenged on long standing issues of concern (despoiling of the environment, degrading of resources, the unfair treatment of labour, customers and even corruption of government). Investors are also being challenged on their ability to discharge responsibility for routine matters: managing risk, overseeing conflicts of interest, being competent or even efficient in allocating assets to match liabilities.
- Also the basic architecture of the financial system is creaking. Markets are global, complex, and too often, opaque. The governance systems for managing this are 19th century in design. The truth is that those concerned with Responsible Investment will not make progress unless these wider issues of safe and soundness in the capital markets are addressed.

- The task for the movement for Responsible Investment is to engage with the mainstream. Here are some vital issues where we need some joined up thinking: the regulatory framework, accounting and auditing, pension deficits, retirement security across the population, asset allocation against a backdrop of lower growth and higher volatility, fees, incentives and governance across the chain of intermediaries. If time allows, I would be glad to talk more in the question and answer session about why these particular issues are so important. For now, let's take the difficult question of investment strategy against a backdrop of pension deficits, with lower growth and higher volatility. If we don't grapple with the consequence, those calls for pension funds to address critical issues in Responsible Investment will be crowded out by more pressing concerns – it is the capital markets version of Maselov's hierarchy of needs. Survival comes first.
- The landscape for pension funds is shifting – and the situation continues to be uncertain and treacherous. What is happening to these primary savings vehicles sets the scene for what can be expected of them as shareholders.
- Underfunding – pension deficits have ballooned. CalPERS own situation is fairly typical. In a decade the fund has gone from having more than 100 percent of funds to meet its liabilities, to the current situation where funding stands north of 60 percent. The pressure to get investment right is intense. It is the main source of funding for benefits.
- This is the fragility which was met by the assault of the financial crisis. When CalPERS first approached me to ask if I would consider joining the team, the fund's assets stood at well over \$240 billion. By the time I arrived less than a year later, in May 2009, the assets stood at \$165 billion. The pressure on investment returns is intense.

- Another shift in the pension landscape affects the RI world – the shift in pension vehicles from single employer, defined benefit schemes, to private individual holdings. This has increased risk for individuals, driven up the costs of administration and fragmented the ownership base that can effect change.
- That fragmentation has been exacerbated by intermediation in the investment chain. The distance between ultimate owners and companies appears insurmountable when ownership and control are not only separated but made tenuous through complex instruments and holding vehicles which lack clear disclosure.
- Some argue that the notion of ownership is simply misplaced – surprisingly, the Tomorrow’s Investor report. I rather disagree. We may consider the legal and technical niceties exclude the owners of shares from being conflated as ownership of companies, but whilst equity providers have the right to hire and fire the board, can wind up the enterprise, vote on its fate, and are entitled to the residual returns, we have a close approximation. There is also the delicate question of the alternative. If not shareowners, then who? Govt does not shine in the role. Employees have a legitimate place in many governance systems, but they are rare. Management? Banks? I prefer to work with the imperfect realities than philosophise around an abstract test.
- Responsible Investment rests on the simple premise that owners of capital have an alignment of interest with wider society. In turn, they have been granted rights and powers in many markets which enable them to hold companies to account. This should not be overstated. Diversified portfolios means small holdings, and fragmented power. Exercising influence requires collaboration, which is time consuming and difficult, even if ultimately fruitful. Many markets do not allow investors to exercise basic rights. The US is slowly

allowing a 'no' vote on directors, but in some companies where votes are withheld, directors nevertheless try to stay on the board. (Barbara Judge's position on the board of Massey was an example, until pension funds, in the wake of the mining tragedy last year insisted that she step down).

- Also, in many markets, the pattern of ownership militates against the simple oversight model envisaged by responsible investment. Most markets have concentrated owners – families, the state, corporate cross holdings – which mean that controlling shareholders call the shots. Minority shareholders have become more active – in markets as diverse as Brazil, Korea, Italy and even Russia, but they have their work cut out for them.
- Note that shareholders will have different goals, and time frames. Conflicts of interest prevent some acting, short term investment goals make it rational to ignore anything beyond trading information for others. The rethink needs to start with « realism ».
- This is not a counsel of despair. Quite the reverse. By being honest, and realistic about the problems, we can make sure we become more effective. CalPERS is engaged in its own overhaul of « responsible investment », so in the remaining time I'd like to share with you how we're approaching the issue of « joined up thinking »: to integrate ESG issues with our investment strategy, to be an advocate for market reform (our beta contribution), complemented by company specific engagement (our alpha contribution). We are planning a « total fund » process to ensure that our strategy is effective across all of our asset classes – on the proposition that if ESG strategies contribute to risk management and enhancement of returns, that will hold whenever, and however, we allocate capital. The trick is to ensure that our strategies in certain asset classes (public vs private) or capital forms (debt vs equity) have been well considered and are complementary across the portfolio. If time

allows, I'll give you some examples, but we will be presenting our first phase report on progress to the CalPERS board early in 2011, and we are proceeding via a review of best practices through a peer group exchange with ten global funds.

- First, the numbers. As many of you will be aware, CalPERS is the largest public fund in the United States, and by some measures, the largest defined benefit plan. It has 1.6 million members, and the current portfolio is around \$220 billion. Those members are the public employees of the state of California, despite its current travails, one of the ten largest economies of the world. The members and beneficiaries provide vital services to the economy – law enforcement, the judiciary, fire fighters, care workers, the police, universities and more. CalPERS is also the largest purchaser of health care in the United States.
- As you would expect, the organisation has several thousand employees, including over 250 investment professionals who invest around three quarters of the funds in house (chiefly, global public equity and fixed income) or oversee external contracts with fund managers working for CalPERS (largely in the private asset classes, and specialist strategies). CalPERS board is in the midst of reviewing its approach to asset allocation but the portfolio is positioned to capture the bulk of its growth from global equities – in 47 public markets worldwide. Fixed income - to provide just that – is the second largest asset class. Private equity is 14% and real estate, current being restructured, is less than 10%.
- The duties of CalPERS are set out in the California constitution – the usual duties of loyalty and care – acting prudently, and solely in the interests of the scheme's members – but they also include a duty to minimise contributions to the fund for the employers. These are the

state's local agencies, which are funded by the taxpayer. There is clearly a shared interest between members and tax payers in getting investment right.

- There are some other features of CalPERS to note. The first is the fund's own commitment to transparency. The governing body which oversees the fund has its membership set down by statute. Certain board members are appointed by the legislature and governor's office; others are elected as 'member at large', plus current employees and also pensioners have their representatives.
- Board meetings are largely held in public. Only commercially sensitive information is discussed in closed session. The board holds two meetings a year off site – to travel to different parts of the state essentially to encourage participation by members. Typically some 100 plus members of the public attend meetings. Board papers and minutes are also posted on the internet, as are policies and our voting decisions.
- The investment office is located over the Sacramento branch of the CalPERS benefits office – so every morning coming to work I have the chance to say hello to those waiting to get some help and advice on their benefits. This is a wholly good thing. There is no sense of being remote from those you are working for.
- CalPERS is not just a long term investor, it verges towards permanent. By size, it is a universal owner. This sets the stage for our strategy for responsible investment.

Key features of the programme.

- We have three work streams. First, market reform. We have an interest in the functioning of the whole system – and have identified 12 areas in the financial crisis where we were profoundly affected. We have our own lobbying firm in Washington to represent our

interests and we co-ordinate closely with other funds, chairing several collaborative initiatives such as the Council of Institutional Investors, and CERES. Historically, we have played a key role as co founders of others, such as ICGN and the UN PRI.

- The priorities for us in financial market reform are: corporate governance (proxy access); systemic risk; credit ratings and asset backed securities; derivatives; sustainability (climate change top of the list); consumer protection; a concern to maintain the full range of investment opportunities; and reform of litigation.
- We have also been closely involved in influencing what we see as the life blood of markets – information. CalPERS sits on the FASB standards advisory group, the audit regulator in the USA, the PCAOB. We co-chair and provide the secretariat to the ICGN’s audit and accounting committee which engages at a high level with the IASB.
- The second stream of work is corporate engagement. At the heart of this is our Focus list program – where we identify significantly underperforming companies in our US portfolio, engage with them and follow up by submitting proposals. We’ve just reviewed this program, essentially to update the approach with lessons learned from the financial crisis, and also to consider the impact of « behind the scenes » engagement versus « name and shame ».
- In this review of corporate governance what were our our chief lesson learned? Risk management has traditionally been ignored by shareholders. Investors don’t fully understand how this should work, particularly for some sectors, nor how risk should be reported, but we do know it went badly wrong.

- To better understand the issue, we had meetings with the chairmen and lead directors of our largest TARP recipient holdings in the financial sector. That was illuminating, as not all had got into deep trouble, and some of those that got into trouble recovered better than others. Those boards were filled with the great and the good – typically, CEOs from major clients in a diverse range of industries, but often with precious little knowledge of the financial sector. Frequently these people had joined bank boards just at a time when even seasoned banking experts were losing their grip on new developments. Robert Reich famously confessed in the NY Times that he didn't understand the mortgage backed securities business at the bank where he was sitting.
- Our conclusion is that form filling in corporate governance must be just the very first step. Real governance appraisal requires appraisal of factors like board quality – we need to move into a much deeper engagement with companies.
- For example, independence criteria tell you nothing about what a director brings to the table in terms of relevant skills and experience. It is a list of what they are not. We need to build up our understanding of what contributes to board competence, and the dynamics that keep this fresh and relevant.
- To that end we have launched a new initiative to support new talent into boardrooms called the Diverse Director Database – or 3D. As we become more actively engaged with companies we are increasingly asked to comment on the board evaluation process, the skills matrix of experience on the board and that needed. We have begun to learn more about this issue through our engagement with United Health, where CalPERS has the right to appoint a director following earlier litigation and also Massey, where we have worked with a group of other public funds on a wide ranging governance overhaul.

- We are also shifting towards a better use of quantitative techniques to expose our portfolio to opportunities created by ESG, recently through allocating \$500m to a global equity strategy underpinned by the HSBC climate change index. We see this as complementing long standing strategies in capital allocation to green technologies.
- To sum up, we are revisiting some of our assumptions in investment, and setting down the path of working out how to make responsible investment simply « our investment strategy ». We're at the beginning of the process, and there is much to do, but I hope in explaining to you what we're doing, and the knotty problems we're wrestling with, the practical example of my own pension fund might be of some relevance to others here.
- We consider that the financial crisis brings a new imperative to responsible investment, but the imperative must be one that drives us towards integration of our work on these issues. Otherwise, next year, as too often before, we'll be back to discuss the importance of responsible investment. Then we can have a new title not 'rethinking' but «It's déjà vue all over again..... ».