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The Universal Owner's Role in Sustainable Economic Development

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Toward the end of the twentieth century, ownership of corporate equity in the United States and Great Britain has once again become relatively concentrated, but this time in the hands of institutional owners such as pension funds and mutual funds. An important implication of this concentration is that ownership has become professional and, because these institutions are fiduciary institutions, subject to the fiduciary duties of loyalty and care. Furthermore, because of an institution's size or because of an explicitly policy of indexing, many institutions have become "universal owners". A universal owner owns a small, but representative fraction of most of the companies in an economy. Thus, its ability to satisfy its fiduciary duties depends heavily on overall macroeconomic efficiency and performance rather than on the performance of any particular firm that it might own. Consequently, universal owners have a natural interest in issues of sustainable development because they receive the benefits from positive externalities generated by portfolio firms and are likewise harmed by their negative externalities.

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One of the most striking characteristics of market capitalism in the United States and Great Britain is the way that corporate ownership has evolved over the past 100 years. In the U.S., early in the last century, ownership was concentrated firmly in the hands of founders such as Carnegie, Dupont, and Ford, and their companies were identified with and run by them personally. But as the 20th century progressed, important changes occurred as a multitude of individual share-

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holders came to replace the founders. This led to what Berle and Means famously characterized as the "divorce of ownership from control".[1] Thus, for most of the 20th century American capitalism was viewed as "managerial capitalism" in which the major decisions about the course of corporate America were made by professional managers hired to run the companies within the constraints provided by big labor and big government and with minimal input from shareholders, the nominal "owners".[2]

Beginning in the 1970's and accelerating through the remainder of the century a reconcentration of ownership took place as fiduciary institutions – mutual funds, insurance companies and, most importantly, public and private pension funds – came to own a larger and larger fraction of corporate equity. As recently as the 1970's the household sector owned about 80% of U.S. corporate equity. However, by the end of the 1990's their holdings had fallen below 45% while institutional holding had risen to almost 50%.[3] A similar trend occurred in the United Kingdom where institutional ownership peaked at about 60% in 1994. Its decline since then stems from the increasing equity holdings of non-U.K. individuals and particularly of institutions. These currently stand at about 30% of the British equity.[4]

Fiduciary Duties

This shifting pattern of ownership away from individual ownership and toward institutional ownership has a number of important implications because institutional owners exercise almost all of the rights and responsibilities that normally go with share ownership. They decide to buy or sell the stock of individual companies. They vote and submit proxies, and they can directly lobby management for changes in the way companies operate. What the institutions cannot do is profit directly from their activities. Instead these institutional owners are "professional" owners. That is, they are hired by individuals to act as agents in certain specified situations. In the U.S. and other English common law countries these institutional owners are fiduciary institutions and, hence, their operations are subject to the very high legal standards of "loyalty" and "care" imposed on those responsible for managing other peoples' money.[5]

Institutional owners are fiduciary institutions and…subject to very high legal standards…

The duty of loyalty, often referred to as the "exclusive benefit" rule, requires a fiduciary to only take actions that are to the exclusive benefit of the individuals who are the beneficiaries of the institution, for example, retirees and potential retirees of a pension fund. Institutional investors have often strictly interpreted the duty of loyalty to prohibit consideration of any factor other than those directly related to maximizing shareholder wealth. The duty of care requires the fiduciary to act as a prudent person in the exercise of its obligations, that is, to only take action which, after due consideration and with the care a prudent person would take in a similar situation.[6]

These two duties have contributed substantially to the way ownership of U.S. corporate equity is exercised. Just as the management of corporations became professionalized earlier in the 20th century, so has the ownership of equity become professionalized late in the century. Professional owners are trained – typically in law or business schools – to exercise legal ownership on behalf of others and to fulfill their fiduciary duties. They are paid for performing these duties and their performance is judged on how well they do in their execution of those duties. For example, professional owners are obligated to study and consider proxy proposals and the various U.S. Securities and Exchange Commission (SEC) filings of the companies they own or to delegate that responsibility to money managers whose performance they must monitor.

Universal owners have a particular stake in superior macroeconomic performance.

The U.S. Department of Labor through its famous "Avon letter" has defined proxies as plan assets and, therefore, as something toward which institutions governed by the Employee Retirement Income Security Act (ERISA) must exercise their duties of loyalty and care.[7] Recently, the SEC has issued what may become known as the "super Avon letter" in which it extends the fiduciary duty to vote proxies to all investment advisors. In that letter, the Harvey Pitt, Chairman of the SEC stated, "We believe ... that an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with ... its fiduciary duties under federal and state law to act in the best interests of its clients".[8] Thus mutual funds companies such as Fidelity Investments or the Vanguard Group are now required to be more active and responsible shareholders. In this vein Domini Social Investments called on the SEC to mandate not just viewing proxies as assets, but the release of how each fund votes its proxies.[9]

Universal Ownership

While all institutional investors in the U.S. are subject to the twin duties of loyalty and care, some institutions have grown to such a size or have adopted indexing strategies for such a large fraction of their portfolios, that they have, in effect, become "universal owners". Because of their widely diversified portfolios universal owners effectively own the economy as a whole by owning a small portion of almost every company with marketable equity. As such, their portfolios' performance – hence their ability to provide for beneficiaries – depends more on the overall health of the economy than on the fortunes of any particular company. Contemporary examples of universal owners are large state pension funds such as the California Public Employee Retirement System (CalPERS) and the CREF portion of Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), the retirement system for academics. CalPERS has assets of about $150 billion dollars and most of the equity portion of its assets are invested in index funds. CREF, the equity portion of TIAA-CREF, is invested in over 4,000 different equity issues.[10]

Combined with the fiduciary duties of loyalty and care, the fact that a universal owners' portfolio's performance depends on overall economic performance suggests that a universal owner should act in particular ways. In addition to performing due diligence with respect to individual firms and engaging in traditional forms of institutional investor activism centered on corporate governance issues, a universal owner should be mindful of the interactions between various elements of its portfolio-particularly the positive and negative externalities thrown off by portfolio companies. Thus, universal owners have a particular stake in superior macroeconomic performance – and in the policies and programs that promote it.

This is in stark contrast to the traditional view where an investor picking individual stocks may profit by investing in companies that try to increase profits by shifting some production costs to other companies or to society at large in the form of negative externalities like pollution. Likewise, traditional investors may avoid investing in companies that generate positive externalities such as education and training because the firm captures only part of the benefit, but bears all of the cost.

In contrast, a universal owner experiences no profit from a portfolio company's negative externality since the externality will be transferred to some other portfolio company. In the same way it benefits from positive externalities because its other portfolio companies are the beneficiaries since the gains from a better educated and more highly trained workforce, for example, benefit all companies, even if the company making the investment cannot capture all of the benefits. These impacts are particularly important to universal owners since the benefit of a negative externality in the form of lowered costs may be much less than the social cost it imposes on the rest of the portfolio. Similarly, the benefit generated by positive externalities may exceed the cost to the company generating it.

Sustainable Development

Sustainable development, of course, has many meanings to many individuals. In the classic words of the Brundtland Report for the United Nations published in 1987 it is "development that meets the needs of the present, without compromising the ability of future generations to meet their own needs".[11] The European Foundation for the Improvement of Living and Working Conditions web site defines it as "the achievement of continued economic and social development without detriment to the environment and natural resources",[12] while the Organization for Economic Cooperation and Development (OECD) notes, "Economic growth is a fundamental driver of human welfare, and a key component of sustainable development".[13]

Clearly sustainable development is a broad concept, and includes many different definitions and possibilities.[14] At its core, however, it suggests that human welfare is best served by being sensitive to the implications of current economic activity for both current and future generations. Universal owners, particularly pension funds because of their long time horizons, share the sustainable development movement's concern for utilizing resources efficiently – in the broadest sense – and for taking into account the impact of current decisions not only on other actors on the current economic scene, but on future generations as well. They are well positioned to appreciate the need to develop policies toward portfolio companies that encourage sustainable economic development. The over production of negative externalities and the under provision of positive externalities clearly undermines a society's ability to achieve sustainable economic development.

Institutional investors…have a particular interest in fostering appropriate public policy…"

A Universal Owner's Role in Fostering Sustainable Economic Development

Universal owners should adopt a comprehensive approach to their portfolios as they strive to satisfy their fiduciary responsibilities. Not only should they monitor the economic performance of particular companies – the traditional way to fulfill the responsibilities of duty and care – but they should also engage in "universal monitoring" which attempts to identify important sources of positive and negative externalities. Only by viewing their portfolios as a whole can they maximize the returns on their investments to their beneficiaries.

Universal Monitoring

Universal monitoring can take a number of forms. Fiduciaries can articulate a position on an area such as worker education and training. This would be a natural area of concern for a university endowment fund. The institution can then communicate its position on this issue to portfolio companies as an expression of desired corporate behavior. They can also survey portfolio companies as to their practices in these areas and use the results to develop a report on best and worst practices on an industry-by-industry basis. Highly ranked companies would get recognition and encouragement for their best practices while some fiduciaries might find it useful to meet with poorly ranked companies in order to gain further insight into their poor performance while lobbying for improvements. Other fiduciaries might take a "let the sun shine in" approach and simply publish the results.

Since the mid-1980s major institutional investors...have actively lobbied for good corporate governance practices...

In addition to trying to influence policies at portfolio companies, institutional investors, by virtue of their broadly diversified portfolios and the fact that their beneficiaries often represent a broad cross-section of the population, have a particular interest in fostering appropriate public policy in areas such as accountancy reform, education, health, tort reform, trade policy and environmental policy. As such, they are in an excellent position to form coalitions with other institutional investors with similar interests.

An example of universal monitoring is CalPERS' recent policy decision to set standards for performance in emerging markets in areas as diverse as political stability, transparency, and labor market practices.[15] Clearly many of these factors overlap with issues that are important to sustainable economic development. Under this new policy, CalPERS will abstain from investing in countries that fail to meet their standards. Currently only 13 countries meet the standards while economically important countries such as China, Russia and India are excluded. By making issues such as labor practices and press freedom, along with traditional issues such as transparency, trading costs and taxation criteria for investment, CalPERS has taken a stand on broad public policy issues and is acting as a universal owner.

A similarly important example of universal monitoring is a paper titled "Climate Change: A Risk Management Challenge for Institutional Investors", commissioned by the third largest pension fund in the U.K., Universities Superannuation Scheme (USS).[16] The paper argues that since the fund holds both equity and property that would probably be drastically affected by global climate change, it should develop analysis and policies in this area. The negative externality of adverse climate change would likely force major costs onto portfolio companies and, consequently, a prudent stance on the part of universal owners is appropriate. To respond to these challenges the paper recommends a number of measures institutional investors should take, such as reviewing portfolios for risk, engaging with investee companies, etc.

The USS commissioned paper states, "It is possible to argue ... that long term universal investors have a substantial degree of common interest and purpose with the good of the economy as a whole. This implies that it may be in the narrow interest of institutional investors to press for actions that support the common economic good".[17] Thus the paper recognizes that a universal owner's broad and long-term view place it in a unique position to both engage with firms it owns and to weigh in on public policy issues, acting as a "...bridge between public policy, corporate governance and the well-being of individuals (especially beneficiaries)".[18]

In addition, the report notes that universal owners also have an interest in assessing the impact of special interest lobbying and influence peddling of many of the firms they own. Activity in the public policy process on the climate issue can help to offset such special interest activity. Importantly, universal owners have the potential to "...stand above short-term and vested interests and could play a powerful role in supporting policy-makers to address climate change in the optimal economic and environmental way". In conclusion the USS strongly suggests that from a strategic universal investor perspective "...there is a case for institutional investors to adopt a more strategic approach to climate change risk. This is to intervene in the policy debate (nationally and internationally) to encourage governments to take action to address climate change".[17]

The Traditional Corporate Governance Approach

The approach to universal monitoring is also similar to the approach institutional investors have successfully taken on issues of corporate governance. Since the mid-1980s major institutional investors led by CalPERS and the New York City funds as well as by state pension funds from states such as Colorado, Florida, and Wisconsin have actively lobbied for good corporate governance practices at portfolio companies. At times they have achieved a considerable measure of success as, for example, when they lobbied the board of the Westinghouse Corporation to abandon a disastrous diversification strategy of the 1960s and 1970s that led to a company with 135 divisions and almost bankrupted the company.[19] The result was to refocus the company on broadcasting, its one line of business that was profitable. In the end, the company sold its remaining traditional business lines, bought the Columbia Broadcasting System, and changed its name to the CBS.

Traditional corporate governance activism is motivated by the realization that if representative portfolio companies perform better, they will act as a model for other companies – and a competitive prod as well.[20] The same motivation animates the concerns of a universal owner for whom superior economic performance depends not only on what happens at individually targeted companies, but on the behavior of their portfolio as a whole. Monitoring failures at firms such as Enron, Global Crossing, Waste Management and others don't suggest that this corporate governance approach has failed so much as they indicate that the lack of transparency (and in some cases, outright fraud on the part of managers) calls for tighter and perhaps new methods of monitoring.

A fiduciary's duties of loyalty and care requires access to accurate, reliable information in a timely fashion about companies it owns or is thinking of owning. Thus both traditional institutional investors and universal owners have a deep, natural interest in transparency and accountability and the recent Enron scandal raises important questions about the independence of the public accounting profession and the completeness and accuracy of the information it provides to investors.

Conclusion

The rise of fiduciary capitalism has led to the concentration of equity ownership in the hands of professional owners. Since many of these institutions are universal owners holding highly diversified portfolios, their ability to meet their obligations to beneficiaries depends heavily on the performance of the economy as a whole and not only on the performance of particular portfolio companies. Thus universal owners have a direct interest in the efficient and effective functioning of the macro economy in general and the financial markets in particular. As the Enron scandal highlights, this concern extends in many directions including to the transparency and quality of financial information as well as to a more traditional concern with externalities. As the OECD noted, economic growth is a key component of sustainable economic development and by recognizing their obligations as universal owners, fiduciary institutions can make an important contribution to an improved future for both their beneficiaries and for society at large.

Endnotes

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4. Institutional Investment in the United Kingdom: A Review, Chancellor of the Exchequer, London, March 6, 2001. This report is commonly referred to as the "Myner's Report" after its author Paul Myner and is available at http://www.hm-treasury.gov.uk/mediastore/otherfiles/31.pdf.
5. Fiduciary duties have a long standing in English common law. In the United States, they have been codified in Section 1104 of the Employee Retirement and Income Security Act (ERISA).
6. Tobacco Divestment and Fiduciary Responsibility: A Legal and Financial Analysis, Douglas G. Cogan, Editor, Investor Responsibility Research Center, January 2000, for an excellent description of the fiduciary duties of loyalty and care. Note, that sometimes the duty of care is cast as the prudent "investor" rule rather than as the prudent "person" rule. This is a higher standard of care and places a greater burden on fiduciaries to act in a thoroughly professional manner.
7. ERISA regulations generally apply to private employee pensions funds. Other fiduciaries in the United States are subject to various state laws, however, the general thrust of fiduciary duties is supplied by ERISA.
8. Letter from Harvey Pitt to John Higgins, President of Ram Trust Services. See "Proxy Voting is a Fiduciary Duty, SEC Chief Says in Letter to Group" by Joann S. Lublin, Wall Street Journal, p. C20, February 21, 2002.
9. Domini Social Investments, news release, March 21, 2002, "Domini Social Investments Continues Push for Increased Corporate Accountability".
10. About 20% of the portfolios of both CalPERS and TIAA-CREF are invested in the equity of firms outside the U.S. Thus they are global investors in the terms Robert Monks uses in; The New Global Investors, Capstone Publishing Ltd., Oxford, U.K., 2002. Large mutual fund companies such as Fidelity Investments are also universal owners, but until the recent SEC letter referred to above, they have not acted from this perspective. However, the Vanguard Group is an exception having an active proxy-voting program based on detailed guidelines a summary of which can be found at http://www.vanguard.com/cgi-bin/NewsPrint/980793830.
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12. http://susdev.eurofound.ie.
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