Misadventures of an Irresponsible Investor[1,2]

Jack Gray[3]

Paul Woolley Centre for Capital Market Dysfunctionality, UTS
Brookvine Pty Limited
Rawson East P/L

Irritations

I was once arguing heatedly that boards of superannuation/pension funds spend *excessive* time on ESG (Environmental, Social, Governance) relative to its potential to improve members' benefits when my rant was interrupted by a trustee gently asking why I was so irritated (and irritating). After some soul-searching I have a few answers.

Some investors are irritated by the ever-changing names and nature of the topic. The plethora of acronyms, SRI (Socially Responsible Investing), CSR (Corporate Social Responsibility), PRI (Principles of Responsible Investing), ESG, EI (Ethical Investing), ETI (Economically Targeted Investing), … indicates to them a search for a catchy title. I side with the less cynical who see it more as a healthy search for fundamental issues and *modus operandi.* The current version seems to be that 'investors should better account for the often longer-term impact of environmental, social and governance factors on the future cashflows of their investments.' Analysts and portfolio managers *claim* they have always accounted for such non-financial factors, the CEO's health and the likelihood of regulation being oft-cited instances. Investors in long duration assets such as infrastructure have long recognised and been highly sensitive to all three letters *E*, *S* and *G*. Nonetheless the movement may have driven analysts and portfolio managers to go beyond the cosmetic to attach a modicum of substance to non-analytic factors.

In *principle* because this definition eschews moral and ethical considerations unless they affect cashflows and valuations it resides comfortably within the normal paradigm of economic rationalism. In *practice* purely moral and ethical considerations continue to underlie much ESG discussion and decision-making regardless of their effect on cashflows. The current UK Under-Secretary of the Department of Works and Pensions supports that practice seeing "no reason why trustees [of pension funds] cannot consider moral and social criteria in addition to their usual [financial] criteria …", considerations that can readily run counter to fiduciaries' responsibilities to act solely in the best interests of beneficiaries.

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[1] An expanded version of an after-dinner speech to the Responsible Investment Research Forum, Sydney University, November 2011, that will appear in the *Rotman International Journal of Pension Management*, 2012.

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[3] The following views are personal and not necessarily representative of any organisations with which I'm affiliated. Brickbats and bouquets welcome at jackgray08@live.com.au.

But even that narrow definition of ESG irritates because boards *do* spend too much time on it relative to its potential to improve members' returns. One of initiators of UNPRI pointedly suggested that because ESG doesn't detract from returns (a far from settled assertion) investors should be as responsible as possible. But that ignores the direct cost of acquiring ESG information and the indirect cost of spending less time on opportunities with greater potential benefits. A hallmark of committees is a predilection for avoiding difficult uncertain tasks by instead focusing on those that make committee members feel good, or those that solve a problem well-chosen for its simplicity and immediacy. ESG offers scope for both avoidance techniques. For example, by spending time favouring and selecting well-governed companies and countries ESG investors risk overpaying for the 'privilege' of owning them, almost regardless of price. In emerging markets a bias towards countries that rank highly on ESG factors will result in missing the opportunities inherent in the adage that the greatest returns in emerging markets occur when a country progresses from absolutely rotten to just plain awful. In their defence, it might be the better governed companies that contribute most to greater country returns. *E* for 'Engagement' is a major time-wasting-feel-good activity especially for boards of smaller funds dealing with companies with broad and varied shareholders. As one ESG believer said almost all the activity classified as 'engagement' is dancing around with corporate management who are masters at engaged listening inactivity, a skill they develop from having to appear and explain themselves before hordes of analysts and portfolio managers. The investors who can best trigger substantive corporate change are some activist hedge funds and operationally-focused private equity managers, though even their success rate limited in spite of their substantial and sometimes controlling stakes. To be effective the ESG movement could learn from them.

Thank You for Smoking

My irritation flows in diametrically opposite directions, towards cynics and true believers alike. Cynical funds use UNPRI as a marketing ploy, or as a form of "ethical narcissism", or to protect careers. Cynicism reaches its nadir with the CEO who prices his ESG overlay service as a form of career insurance, with fund managers who sign up because they've been explicitly told they'll get no business unless they do, and with Citigroup's Vikram Pandit's commitment to "responsible finance", surely the epitome of empty feel-good marketing. As for true believers, many, especially in the US, are religious about ESG in the most pejorative sense, being possessed of a deep and abiding self-righteousness that sees ESG as the dominant if not the sole issue. Theirs is a religion that brooks neither disagreement nor discussion. I once pitched for a tobacco-free US equity mandate to a committee of such zealots. Showing an out of character sniff of commercial nous I didn't mention that the tobacco sector of the S&P500 had been the best performer over the past 30 years, and by a long way. I did however plead for the freedom to short selected tobacco stocks, an action that might damage the stock price and help the committee's moral cause. My naïve plea was irrationally and irritatingly dismissed with "We want nothing to do with tobacco."

The chair of the Canadian Public Pension Investment Board was once pilloried for CPPIB holding tobacco stocks. Although on an oncology hospital board, he defended CPPIB's holdings. As a *fiduciary* he saw his responsibility as generating the highest return possible within acceptable levels of risk. As a *citizen* he saw his responsibility as actively campaigning against tobacco. Courageously he wrote an OpEd piece to that effect in the *Globe and Mail*. He was a responsible fiduciary investor *and* a responsible citizen. In the spirit of the Dutch Nobel economist Jan

Tinbergen's "two goals, two instruments", this is as it should be, though the dichotomy will fray at the edges if for instance tobacco companies spend their earnings lobbying against government regulations. The 'universal owner' idea tries to extricate investors from this predicament by arguing that successful lobbying will result in externalities such as increased public spending on health and a consequent rise in taxes that will lower returns on a component of the rest of the portfolio. It seems unimaginable that over the last 30 years that effect would outweigh the returns from tobacco.

More worrying (to me) is how this simple dichotomy leans towards Friedman's view that a firm's *only* social responsibility is to (legally) generate profits, a view that positions firms uniquely as having no broader responsibilities to society. My total rejection of that position exposes me to a conundrum: Is a pension fund's *only* social responsibility to (legally) generate returns for members? Not for the first time I find myself struggling.

Value in Investing in Values?

Implicitly and sometimes explicitly ESG advocates claim that eventually investment factors and society's values will converge or at least be highly correlated so the financial effect of those values should be included as portfolio risk factors. The claim relies on three heroic assumptions.

First, that they *will* converge or be correlated, an assumption fraught with sociological, political and philosophical challenges. Even when society's values are enshrined in black letter law convergence may remain an ideal. For a generation discrimination against women has been illegal in most developed Western countries yet companies that discriminate through unwritten hiring policies, lower wages and glass ceilings continue to thrive and don't appear to be priced at a discount to fair value. That supposed risk-factor has not materialised. More strategically, many if not most investment opportunities are now global, a state of affairs that may not be sustainable. But even if it is, we are unlikely to ever see globalisation of *values*; they will diverge locally for the same reasons that languages (even artificial computer languages) always diverge locally. Inevitably local divergences of values will cause friction with global investment factors.

The second implicit assumption is that society's values are 'good', 'moral' and 'responsible', one that smacks of the debunked Whig historiography, so popular in Victorian England, that history is intrinsically 'progressive.' The ubiquity of war and the abject refusal of countries to disarm, Costa Rica excluded, is the most glaring of many counterexamples. Short-termism is a more apposite example. While we can all agree that an *excessive* focus on the short-term is destructive in multifarious ways, it does represent the current values of society and shows no sign of abating.

Assumption three holds that investors can monetise convergence because *eventually* society's values, such as the demand for clean air, will be priced in by the market. Maybe so. But monetising convergence is notoriously difficult because both its path and timing are largely unpredictable. The social cost of alcohol and the need for its regulation has been understood since at least the Code of Hammurabi 4,200 years ago. Yet (non-Islamic) societies have done little beyond the margins to hedge its well documented damage. Closer to our temporal and cultural home witness the path and consequences of the US' failed 13 year experiment to prohibit alcohol consumption. The link between lung cancer and smoking was first broadly publicised with the US Surgeon General's 1964 report, though a generation earlier the Nazi government fought an effective public anti-cancer campaign against smoking. Yet a generation and a half later many

Western European countries have taken minimal, and sometimes no action on this costly public health issue.

'Eventually' is best measured not in years but in multi generations, a unit so large that investors' default position should be deep scepticism about when and how to hedge convergence risk. Much ESG discussion is remarkably naïve about long-term investing, as if it is synonymous with buy-and-hold (it isn't), clearly defined (it isn't), appropriate for everyone (it isn't), relatively straightforward to get to (it isn't), and once there it's a land of milk and honey (it isn't). John Maynard Keynes *the* most profound of long-term investors eloquently warned that "… it is not wise to look too far ahead; our powers of prediction are slight, our command over results infinitesimal …".

Timing uncertainty induced one CIO to be 'long brown/short green' until the signals clarify somewhat when he'll edge to the hedge of 'long green/short brown'. Given the world's hesitant–to-non-existent move in the direction of green, a world where coal is resurging and is expected to overtake oil as a fuel by 2025, is he being irresponsible? As a *citizen* he has a responsibility to push the world towards green; as a *fiduciary* he has a distinctly different responsibility. The Norwegian Oil Fund has a forceful ESG investment policy yet invests in a company logging Indonesian forests. Simultaneously the Norwegian government buys forests (not in Indonesia) as part of its social contract to defend the global environment. The accusation of hypocrisy is misguided. The fund is acting responsibly in the interests of people *qua* fund beneficiaries, while the government is acting responsibly in the interests of people *qua* citizens. The two goals demand two instruments, as uncomfortable and irritating as that is.

Hyp*er*theticals

In a 2003 interview with *Ethical Investor* my irritation expanded into anger as I expounded on Blair's hypocrisy in encouraging torture in Iraq and promoting a UK company selling cattle prods to the Indonesian military, while requiring UK pension trustees to formulate an SRI statement, implicitly demanding ethical standards from trustees *higher* than those of society. While admitting that like all *ad hominem* attacks mine was irrelevant to the issue, and under no provocation from the journalist, I offered her a hypothetical. (Advice to the young: Never ever offer a journalist a hypothetical. And mine was a doozy.) The place is Sweden, the time is early 1942 and I'm a trustee of a pension plan. Through a private equity deal the plan has the opportunity to own 100% of a domestic company with an exclusive contract to make gas chambers and export them to Germany. Everything suggests that Germany will expand to the Urals and beyond and claim its sought-after *lebensraum* once all Jews, Bolsheviks, Asiatics, and other 'undesirables' are exterminated, a program expected to take a generation. The incomparable returns expected from this single investment, and its moderate risks, make it a spectacular and unique opportunity, one that cannot be finessed by the *realpolitik* of finding an alternative investment with very similar characteristics and expectations. What should I do? And what should I do under the even darker scenario where the company won't survive without my fund's capital? A literal interpretation of the Sole Purpose Test offers no wriggle room because the members will be materially worse off if I don't invest. My answer was to resign as a fiduciary and as a citizen take action to stop the company manufacturing their 'product'.

The article and my picture appeared under the headline, *Invest in torture; it's the only moral thing to do.* And that was but the beginning. After two years of protracted negotiations the manager I represented, had just won a mandate from an SRI fund. My comments found their way to the fund's deeply self-righteous board which irrationally threatened to fire their CEO along with our mandate. I wrote to the CEO apologising, not for my views but for causing her grief. I felt obliged to mention that my mother's entire family was fed into German gas chambers so the hypothetical was not created lightly. Both of us and the mandate survived, but only just.

The underlying moral issue remains. A few years later as a fund CIO one of our largest international holdings was Halliburton which was making massive profits selling services to the US military in Iraq. Members' benefits were enhanced at the cost of bloodshed and mayhem. Should I have 'Wall St Walked' and sold out or 'Wall St Talked', engaged with Halliburton executives and encouraged them to switch to growing organic carrots? On the criteria of the UK Under-Secretary of Pensions mentioned earlier I should have walked. Perhaps Sole Purpose does need re-framing within a broader discourse, but only with extreme caution to ensure beneficial owners remain the sharp and primary focus.

Responding to Responsibility

The use of *responsible* is yet another source of irritation. Single emotive words like 'responsible' and 'sustainable' may make for good marketing but only by doing violence to the complexity of the underlying issues. The moral high ground implicit in the *R* in UNPRI brands those who disagree as *ir*responsible. They are not. Like many who believe we no longer have the luxury of muddling through on climate change I'm increasingly drawn to the nuclear energy option as a relatively quick fix to save the planet, at the admittedly massive risk of waste disposal. Might nuclear be *the* responsible and sustainable option? How will UNPRI investors respond to Australia's soon-to-be policies of selling uranium to India and opening new mines? In principle they need not respond provided the 'nuclear risk-factor' has been appropriately accounted for in their portfolio construction. But even leaving aside the challenge of appropriately accounting for that risk factor, in practice the emotive pull of the *R* word will likely drive decisions on moral not investment grounds.

Funds themselves are irresponsible in failing to act collectively in their beneficiaries' interests, a failure (intentionally?) re-enforced by agency effects and especially by competition. Arthur Leavitt, the ex-head of the SEC, spoke at a client conference a few years after he had been bruised and beaten by corporate America's lobbying machine in trying to have executive options expensed. Standing before us he asked "And where were you? Why didn't you support me?" Silence spoke eloquently to our collective guilt. Pension funds and investment managers, some signatories to the UNPRI, all lacked the moral clarity and courage to act in beneficiaries' best interests. And we still do. The SEC continues to be squeezed for resources while any proposed actions are instantly lobbied against in Congress. Responsible *collective* leadership remains sadly lacking.

Some tout sustainability as almost the ultimate responsibility. The strength of the word's emotional tug is a function of its highly elastic meaning. Perhaps the cleanest of many definitions is 'the ability of assets, markets, firms and economies to adapt to and to thrive in changing environments without damaging other assets, markets or economies.' But even under that broad definition sustainability is neither intrinsically good nor universally desirable. The most sustainable and oftentimes the most profitable industries produce goods and services designed to kill and maim. Would that they were *un*sustainable.

Sustainability is an extremely rare exception for organisations, markets, firms, assets, societies, empires, languages, and over evolutionary time-scales even for species. Mere survival is challenge enough and may be undesirable in a dynamic and competitive economy where death and birth are the 'natural' order of things; where organisations struggle mightily to maintain energy, enthusiasm, flexibility, commitment, productivity, and growth for more than brief periods. Companies survive in the S&P500 index for an average of only 15 years. Rare exceptions such as IBM and General Electric have continually re-invented themselves over a century, successfully adapting to changing environments while just surviving near-death experiences. On the other hand General Motors and (almost) the entire airline industry have survived for a similar period but only by being propped up and bailed out. Yet, from an investment perspective GE is not more desirable than GM just *because* it's sustainable. Desirability depends crucially on the price paid.

Occupying the Leadership Vacuum

A major cause of my irritation has roots in the dearth of political leadership reflected in democracy's ineluctable decay to plutocratic populism, driven by the agenda of minimal government, low-to-no taxes, market fundamentalism, and extreme individualism. To my irritation-anger corporations have occupied the leadership vacuum, thus fulfilling Eisenhower's 60 year-old warning of the incipient dangers of the "military/industrial complex", which, since the 1980s deregulation, must be augmented by "financial." I now realise I have unfairly projected my irritation-anger onto the ESG movement because it too is trying to occupy that vacuum.

I resent the policy of everything for sale, highways, museums, schools and even open space. Privatisation has broadly been a boon for institutional investors and their beneficiaries, wonderful for vampire squids and other Wall St denizens, but neutral-to-poor for society as a whole. As citizens we were irresponsible allowing governments to privatise excessively and often poorly. As fiduciaries we were responsible providing capital for privatisations. And that is as it should be. Pension fund fiduciaries should not make policy decisions for society. When I worked at a large Australian manager the Arnott family agreed to sell their eponymous biscuit manufacturer to Campbell's Soup. As Arnott's largest institutional shareholder public anger was directed at us through comments such as: "You can't sell an Australian icon to the Americans", and "You're irresponsible acting against the national interest." As a citizen I didn't want the fund manager making decisions about the national interest - that was government's role. As a fiduciary our decision was simple because the offer price was well above fair value, even without Campbell's projected growth in Asia. We sold our entire holdings and the responsible officer withstood bile spewed at him by shock jocks in spite of his doing the right thing for beneficiaries. Would ESG investors judge our divestment as irresponsible because we did not sufficiently account for *S*? SRI investors certainly did. That officer's character was called on again when Alan Bond, one of Australia's corporate thugs, tried to stack a company board with his acolytes. As a major institutional shareholder the voting decision fell to that same officer, who properly voted against it on the grounds of *G*. Bond's response was to threaten him over the phone and, it is believed, to have his backyard shed fire-bombed. We under-appreciate the courage sometimes needed to do the right and responsible thing.

As an idealist without illusions I'm sympathetic to those who want to change the world for the better. With the vacuum of government leadership perhaps it *is* up to trustees and other investors to lead, but *only* if it's in the best interests of the beneficial owners. Why then don't UNPRI funds engage with governments as firmly as they do with private companies? Global pension funds could tell governments that unless they act more decisively on climate change funds will sell their sovereign bonds on the pure investment grounds that failure to act will be priced in, as might already be happening with some corporate bonds. Unless the government acquiesced yields would spike and drag down economic growth. Pension funds could become 'NextGen' bond market vigilantes but vigilantes dedicated to goodness, virtue and purity.

Just after Lehman collapsed I was at a conference of large global pension funds. The brewing crisis provided a once-in-a-lifetime opportunity for fiduciaries to assert collective power and I suggested we draft a manifesto to that effect, to occupy Wall St at least in writing. I asked for support from two public sector funds, both signatories of UNPRI, and was met with "we're public sector funds so we can't get involved in politics." Is that responsible? The Street had no such compunctions. Investment banks compete viciously but act as one when threatened. Goldman had already *tripled* their lobbying budget and Wells Fargo now spends (a declared) $50m a year on lobbying. With remarkable speed the financial sector returned to its old ways and fiduciaries didn't even fight.

End Rant

The separation of fiduciary and citizens' duties leaves me unsatisfied and self-irritated. Suppose forestry is a component of the global equity benchmark and that the logging company mentioned above denudes the entire Sarawak forest. Investors will extract 'alpha', a positive for beneficiaries, but at the cost of reducing the future index return ('beta'). Should fiduciaries care?[4] After all, the dynamic nature of an index will always see industries die and new ones born. But should they care as *fiduciaries* if logging denudes almost all the planet's forests? Does the Sole Purpose Test need to be re-thought in the context of such disaster scenarios, as suggested *obiter dicta* in the Scargill case, and as was applied in the NYC Teachers' case?

As citizens we need to challenge and change that most dominant of all paradigms - the eternal and ubiquitous desire for economic growth. Even the British Conservative PM David Cameron has, to screams of abuse, hinted at that by suggesting an index of well-being or happiness to sit alongside GDP. That would encourage a re-assessment of Sole Purpose to tentatively move it away from its narrow concern with direct financial benefits.

[4] Suppose an investor has a 20 year horizon; that the initial and sustainable annual β is 8%, and that she can extract an annual α of 2% for T years, but at the cost of reducing the sustainable β to 6%. The 20-year annualised 'α-extracting' return exceeds the 'pure β return' only if $T > 10$. With a more realistic $T = 3$ the 'pure β return' is 20% greater so she should care. But she should also account for the expected return from new opportunities she might capture precisely because β was lowered by her activities.