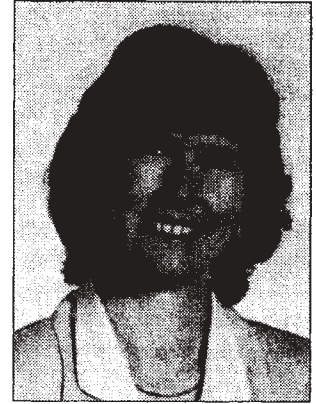


TELLING A NEW ECONOMIC STORY

Valuing labour,
the community,
consumers, & the environment

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At a recent colloquium at Harvard University on pension fund investing, a participant challenged us to “give him a better story to tell about the economy than the one that is being told now.” Economist Richard Freeman added, “Without a better story, I’m not sure that any of us, ... either [as] pension fund trustees or advising pension trustees, would recommend doing anything differently than what is being done today.” As chairperson for a research group on the uses of labour’s capital, I then realized that this is the challenge we face: telling a better economic story than the one currently told by capital market finance, and backing our new story up with facts.”

What story do we want to tell about the uses of capital in the economy? What story are we countering?

The current economic model is simplicity itself, and its assumptions lie at the root of most firm behaviour:

- The only function of the firm is to increase value for its shareholders, measured today.
- Capital markets are perfectly efficient and will allocate all available resources to their most productive uses in the economy, as measured by their risk-adjusted rate of return.

Given these assumptions, financial markets will allocate available capital pools to their most efficient uses, and firms utilizing this capital will only consider the interests of their shareholders as measured by increased share value in the short run.

Where does the capital pool originate? Increasingly the available capital underpinning these transactions is, in fact, deferred workers’ wages in the form of pension funds and retirement savings, now totaling \$7.5 trillion in the U.S. alone. What is the prevailing economic story on the objective of these funds? It is that the interests of the plan beneficiaries are best served when the funds’ only function is to maximize the risk-adjusted rate of return to the plan members, measured at any given point in time.

What is the story we want to tell? First, unlike conventional thinking, our story states that when the firm acts in a manner that values *all* its stakeholders today (workers, com-

munities, consumers, and the environment), it creates real long-run value for shareholders in the future. Given the time horizons of pension fund beneficiaries, their real long-term interests are served through concern with the long run rather than short run value of their holdings.

The real long-run interest of the plan participants is therefore reflected in the short-term behaviour of the firm. Sensitivity to today’s stakeholders actually increases the share value in the long run, and that will generate the risk-adjusted rates of return that these plans seek.

This story is not restricted to pension fund activity. It is the same economic story we want to tell through other investment vehicles and actions in the economy. We tell it through the use of screened funds that seek to influence firms’ short-run behaviour in relation to their stakeholders. We tell it through shareholder activist campaigns, where we again try to influence short-term management decisions in the long-term interest of the shareholders of the firm.

Second, we want to tell the story that the capital market is not perfectly efficient. Because of its failures, small to medium-sized domestic firms are not getting access to the capital they need for investment. We say that it is investment in the real economy that creates long-run value for shareholders through increased productivity. As a byproduct, this investment creates jobs

which in turn create healthy communities. As a result, productive investment in firms that are not able to easily access capital generates additional collateral benefits, also known as double bottom-line investments. Given a choice between two equal investments measured by their risk-adjusted rates of return, investments with these additional benefits are once again in the real long-term interest of plan beneficiaries.

Interestingly, this argument is more easily understood by funds that are able to see direct, tangible, collateral benefits to their members through double bottom-line investing. In the U.S., successful funds such as the Housing Investment Trust and Building Investment Trust (HIT/BIT) and in Canada, Greystone Properties, demonstrate that funds can achieve objectives that both value the stakeholders in the enterprise in the short run, and also generate a solid risk-adjusted rate of return for plan participants in the long run.

This is apparently an easier case to make with pension plans when their own members see that increased investment brings increased economic activity in their sector. The result is more jobs, and therefore greater contributions back to the plans themselves.

The same argument holds true on the macro as well as the micro level. Overall economic activity through productive investment, and the job creation that accompanies it, are essential to building strong communities. Vibrant, healthy communities are a necessary interest for all future retirees. Taking the macro view on the significance of the double bottom line is critical to avoid the tendency toward self dealing in pension plan investments. (Joint-trustee plans are restricted from investing directly into their own companies or projects - known as "self dealing." They therefore need to see that investment in a whole sector and/or the overall economy also creates a long term pay-off for them individually - not just investing in their own jobs.)

It is important to understand that using funds in these ways is not prescriptive for fund behaviour. Too often the literature is full of pension fund "shoulds." There are many articles that dictate that funds should take on this cause or case, advocate for this

or that interest, or fill a void left by shrinking government obligation.

There is no room for "shoulds" in this argument. The story we want to tell is not an economic case for both doing good and doing well, as if these two actions are unrelated to each other or a haphazard correlation at best. Rather, it is a case for doing good *in order* to do well. It is a case for matching the time horizons of action and results. We want to build a case for short-term corporate behaviour that both values and includes all the stakeholders in order to ensure a long-term pay-off for investors.

Let's look at how valuing stakeholders in the short run creates long-term value for the firm's shareholders. We'll consider each stakeholder in turn.

VALUING LABOUR

Workers are one of the key stakeholders in any enterprise. With increased global competitiveness in the 1980s and '90s, many North American firms reacted by cutting and slashing their labour force as a way to compete.

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Initially, these actions caused a short-term rise in stock prices. Subsequent study demonstrates that over the long run, firms that downsized their workforce lost productivity, declined in profit, and devalued their share price. Shrinking firms do not become productive firms; growing firms are productive. Individuals like "Chainsaw" Al Dunlop, who buzzed his way through the workforces at Sunbeam and Scott Paper in the early 1990s, used short-term gains in stock value to reap executive compensation packages

that were obscene relative to the fate of their average employees.

But Dunlop and others have had the good sense to cut and run. In the long run the share values of many of these firms dropped after their short-term, saccharine-induced rise. (Dunlop was actually chased out by angry shareholders in June, an experience he described as "outplacement" in subsequent, tearful interviews.) The drop in share value brought on by downsizing has been documented in studies by both Mercer and the American Manufacturers Association.

By contrast, firms that have chosen "high road" - sometimes referred to as "high performance" workplace practices - have generally witnessed a long-term increase in their stock values. These are firms that value their employees. They have increased their levels of research and development, as well as workplace training. They know that the workers' voice adds value to the enterprise, and are therefore unionized or union-friendly enterprises. They provide vehicles for union involvement and workplace co-operation. They seek to settle grievances and problems with their workers before rather than after strikes. By these and other means, they are able to maintain and enhance share value for their investors.

It is interesting to look at high-performance workplaces where there is an intrinsic value placed on intellectual capital. A prime example is Microsoft. At close today (July 3, 1998) Microsoft was trading at \$95. Yet an examination of its balance sheet would show that less than half its assets are tangible. The remainder reflects "good will," the only general accounting category currently available for intangible assets such as intellectual capital.

We know that knowledge-based companies have a very different set of assets than the traditional manufacturing firms of the past. We also know that the future for highly productive enterprises in North America lies in their use of intellectual capital. By definition, in order to invest and capture the growing returns in this area of productivity, we have to make "high-road" rather than "low-road" investments. High-performance workplaces value all their stakeholders, chief among them being the workers.

BUILDING COMMUNITY

Greystone Properties is a pooled fund of pension plan investments that builds affordable housing in the Greater Vancouver area of British Columbia. Established in the late 1980s, this institution now manages \$250 million in assets for 28 jointly-trusted pension plans in Canada. Greystone established a niche for itself in the community that gives it an excellent rate of return, creates union jobs, and adds housing stock to a city known for its lack of low- to middle-income housing. A recent study concluded that 90% of the new rental accommodation in Vancouver in recent years was generated by Greystone. In addition to meeting the community's need, the pension plans that hold Greystone shares have benefited from portfolio returns that compare favourably to industry benchmarks.

The valuing of one's community as a stakeholder of the firm leads to a virtuous cycle of investment. It serves local needs, it creates loyal jobs that remain in the community, and it nets a market rate of return for investors.

REGARD FOR THE CONSUMER

If companies value their consumers in the short run, does it increase the share value for investors in the long run? This part of the economic story is best demonstrated in the negative rather than positive, as the positive tends to confuse correlation for causation.

Firms that choose to devalue the consumer, as in the tobacco industry, provide a clear example of the negative impact felt by investors over the long run. Documents recently released by U.S. tobacco companies are indicative of these firms' blatant disregard - bordering on contempt - for their customers. As consumer advocates became increasingly vocal about the dangers of the product, the tobacco companies chose to respond with a campaign of lies, deception, and delay. Although the strategy worked in the short run, in the long run these firms have had to face their responsibilities to consumers, made worse by years of disregard.

Since the release of the Liggett memo the

share value of these investments has dropped substantially. Many screened mutual funds had already sounded the alarm on investments in the tobacco industry. For some investors it was a matter of principle. But funds that are sensitive to changes in public opinion act as canaries in the mine shaft of society's shifting values. They are indicative of future mass opinion and should be valued as such. Once the tide of public opinion turned against the tobacco companies, the drop in their stock prices is one of the reasons that some screened funds have outperformed the market over the last few years in both Canada and the U.S.

VALUING THE ENVIRONMENT

Again, it is more effective to cite the negative than the positive in order to show the connection between environmental responsibility and share performance.


On April 25, 1998, Boliden Ltd., a zinc mining company headquartered in Toronto, was responsible for one of the worst environmental disasters in Spanish history. A tailing pond at its site in Los Frailes, Spain burst its containment walls and spilled five million cubic metres of toxic sludge, damaging surrounding farmland and threatening Spain's Donana National Park. As Reuters spread the news around the world, the share value of Boliden dropped from \$11.90 to \$10.45 overnight. By May 5, company shares had dropped 17% in value.

One could look at this loss of value simply as bad luck for the shareholders. I contend that bad management and a disregard for the stakeholders in the enterprise eroded shareholder value. Environmental groups had been warning the company about the leaking tailing pond for years. In search of short-term returns, the company refused to respond to its stakeholders. It ignored the warnings. Instead, it chose to sacrifice the long-term value of the firm and treat the environment as a free good, rather than make the required short-term investment.

IMPLICATIONS FOR INVESTORS

This new economic story should inform the actions of investors whether they be insti-

tutions (through pension funds and insurance companies), collectives (through pooled funds and mutual funds), or individuals. Shareholders need to concern themselves with the long-term return on their investments. Company behaviour in the short-term that values its stakeholders acts as a proxy for long-term value.

Firms can be brought to this understanding either through the pattern of investing and withdrawing funds in capital markets, or through direct shareholder activism. To get the long-run, risk-adjusted rates of return we want to see, it is essential to identify in an enterprise the short-term behaviour that will deliver the future payoff. That behaviour is found in firms that choose to value their stakeholders today. This is not an argument about moral conscience; it is a question of real, long run, self interest. 

A former director of research for the New Democratic Party of Canada, TESSA HEBB is co-chair of the Research and Policy Task Force for the Heartland's Labor Capital Project. Based in Pittsburgh, the Project is funded by both the Ford and the Rockefeller foundations and involves the United Steelworkers of America and other major AFL-CIO unions. In late 1998, the Project will release an edited research volume that examines the current workings of the capital market and the long-term use of pension funds. Tessa is an independent consultant working in Ottawa and Toronto in the area of international finance with particular emphasis on both the pension fund and mutual fund industries. She has just completed a major study in these areas for Deloitte and Touche. Tessa completed a Bachelor of Arts at Carleton University and a Masters in Public Administration at Harvard. Contact her at (tel) 613-730-1472, (fax) 613-730-1475, (e-mail) hebbt@ibm.net