The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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INVESTING RETIREMENT SAVINGS:

DO PENSION PLAN MEMBER *ESG/SUSTAINABILITY* PREFERENCES MATTER?

"This Article is the first to argue that institutional intermediaries, namely pension and mutual fund managers, can no longer vote and engage on the affairs of their portfolio companies without seeking the input of pension plan participants and mutual fund shareholders. We argue that the fiduciary duties of these fund managers compel them to seek this input."

From "**Corporate Democracy and the Intermediary Voting Dilemma**" (2023)
Prof. Jill Fisch, University of Pennsylvania Law School
Prof. Jeff Schwartz, Quinney College of Law, University of Utah

"Some pension funds have started a dialogue with their participants on sustainable investing. We provide an example of a fund that gave its participants a real vote on the matter."

From "**Eliciting Penson Beneficiaries' Sustainability Preferences: Why and How?**" (2021)
Prof. Rob Bauer, School of Business and Economics, Maastricht University
Prof. Paul Smeets, Amsterdam Business School, University of Amsterdam

Four Questions to be Addressed

The authors of the two articles cited above believe the 'should plan members have a say?' question deserves a 'yes' answer. Why do they believe this? Also, their 'yes' answers prompt two further questions: 'As a practical matter, how should funds go about seeking this input?' and 'When a pension fund actually did this, what happened?' This *Letter* addresses the why, how, and 'what happened?' questions posed above. It ends by exploring the potential consequences of an evolving form of capitalism driven by the preferences of pension and mutual fund beneficiaries.

Starting with Profs. Fisch and Schwartz, what is the basis for their 'must seek input' view? They argue that the traditional focus of shareholder engagement and voting by pension and mutual fund managers has been to increase the value of portfolio companies by removing impediments to shareholder power and increasing managerial accountability, thus reducing agency costs. However, this focus has been expanding in recent years to include a broader set of social and environmental issues. This represents, in their view, a shift in attention from 'value' to 'values'.

This shift means that fund managers can no longer vote on corporate resolutions or engage portfolio companies without seeking input from pension plan members or mutual fund unitholders. They have a fiduciary duty to do so. Why? Because it is the 'values' of members/unitholders that should be reflected, and not those of the fund managers. This conclusion raises an obvious question: how should fund managers go about discovering what those 'values' are?

Seeking Member/Unitholder Input on 'Values'

In addressing this question, Profs. Fisch and Schwartz start by listing three approaches they believe would not be effective:

1. Increasing fund disclosure requirements: it would be easy to comply with such requirements in ways that would convey little clear, useful information.
2. Increasing market segmentation: again, what would be the criteria distinguishing Fund A from Fund B? What language would be used to explain the differences in their investment approaches? Also, this approach cannot work in pension fund situations where plan members have no fund choice.
3. Pass-through voting: vote participation by beneficiaries would likely be very low, and many of those who did vote likely lack the expertise to make an informed choice.

Instead, they favor a process they call "Informed Intermediation", defined as a system by which fund managers ascertain the preferences of their beneficiaries, and incorporate those preferences into their voting/engagement practices.

An important reason for favoring this approach is that fund intermediaries have the requisite expertise, and have substantial collective power which makes engagement a rational option for them to pursue. As to how to ascertain beneficiary preferences, the authors list a number of possibilities including polling, sponsoring forums or focus groups geared to ascertaining beneficiary views, and getting their agreement with stated fund voting policies/guidelines. The article notes recent initiatives by USA intermediaries in the mutual fund and retail spaces to collect investor preferences in such areas as executive compensation, board composition, and environmental issues.[i]

Netherlands Leads the Way in Engaging Pension Plan Members

In the second paper cited above[ii], Profs. Bauer and Smeets note that while there is has been a steady increase in global pension fund collaboration on integrating *ESG/Sustainability* principles and practices into their investment processes and corporate voting/engagement actions, this has not been the case thus far for seeking plan member input. The Dutch have been leading the way in changing this situation. A 2010 national pension industry study chaired by Jean Frijns noted that plan member preferences matter and should be sought. Eight years later, the *Dutch Pension Funds Agreement on Responsible Investment* stated that funds have a fiduciary duty to seek member input on *ESG* issues, and to take that input into account in their investment principles and practices.

Since the 2018 Agreement, Dutch pension funds have begun to conduct surveys, soliciting member views on *ESG/Sustainability*-related questions, and have begun to benchmark the transparency of their reporting processes to members on these matters. Notably, this transparency benchmarking process has gone international through a collaboration between *CEM Benchmarking* and the *TOP1000FUNDS* organization. Last year, Canada and Netherlands were ranked #1 and #2 out of 15 countries on the quality of their reporting transparency to pension plan members and other stakeholders.

With this background, Profs. Bauer and Smeets make an important point in their paper: "*Eliciting true preferences from plan members requires consequential choices*." In other words, to get plan members to really focus on what their *ESG/Sustainability*-related preferences are, they need to be persuaded that these preferences really matter in how a pension fund shapes and executes its *ESG/Sustainability*-related investment policies.

A Study with 'Consequential Choices'

In 2018, the $35B pension fund for the Dutch retail sector *Pensioenfonds Detailhandel* (*PD*) became the first fund, with the assistance of Maastricht University faculty, to design a plan member survey with consequential choices. *PD*'s Board had already adopted a sustainable investment philosophy, focusing on three UN Sustainable Development Goals (SDG): 1. Decent Work and Economic Growth, 2. Climate Action, and 3. Peace, Justice, and Strong Institutions. With a small internal staff of 10, the implementation of *PD*'s broadly diversified investment policy with its three-SDG tilt, was outsourced to external investment managers, and an external proxy voting/engagement advisor.

The 2018 survey was designed to generate truthful member preferences by meeting five success standards: 1. The responses would have actual consequences, 2. The respondents would care about these consequences, 3. There are mechanisms in place to ensure that the responses will be acted on, 4. The actual posed questions could be answered YES, NO OPINION, or NO, and 5. The stronger the YES response rate, the stronger the action taken should be.[iii]

Also, the survey provided relevant information to members on *ESG/Sustainable* investing, and posed a number of questions. The most basic question was: "should the Fund extend/intensify its *ESG/Sustainable* investing efforts?" There were 1669 responses out of a survey mailout of 24776: YES: 68%, NO OPINION: 21%, NO: 11%. A number of tests were undertaken to ensure that the 7% group of members who completed the survey was not an outlier group driven by gender, age, or socio/political preferences. Further analysis indicated that the respondent choices made were mainly driven by social rather than financial preferences.

Within a week of the published survey results, *PD*'s Board publicly decided to materially increase the fund's sustainable voting and dialogue activities, as well as to intensify its *ESG/Sustainability* screening actions as part of its portfolio management practices. These decisions were made in November 2018. A second survey was conducted in 2020 to assess whether the 2018 support for increasing the weight of *ESG/sustainability* considerations was still there. Its findings suggested that support had actually increased. For example, 99% of the respondents who voted YES in 2018, voted YES again in 2020. More telling, 77% of the respondents who voted NO in 2018, changed their minds, and voted YES in 2020. Also, once again, social preferences turned out to be the main driver of the respondents' voting decisions.

Based on this experience, Profs. Bauer and Smeets concluded that it is indeed possible to extract pension fund member preferences on *ESG/sustainability* issues, and to identify the motivation for these preferences. If the global pensions sector were to choose to do so en masse, the economic and social impacts would be profound. It would build plan member trust in their pension providers, and would raise the leverage of pension providers in shaping a fairer, more sustainable world in the decades ahead.[iv]

Where Would 'Informed Intermediation' Take Us?

In ending this *Letter*, it is worth thinking through the implications of a world where investment decisions in both its pensions and mutual fund sectors are guided by 'informed intermediation'. In other words, where investment decisions are guided by not only by the 'value' assessments of fund managers, but also by the 'values' preferences of pension and mutual fund beneficiaries, as captured by the kind of survey processes set out in the two papers cited in this *Letter*. More specifically, what if these 'values' preferences were generally like those expressed by the members of *PD*?

To provide some context for this addressing this question, the respective dollar values of the global public equity market capitalization, the assets under management of the global investment industry, and the assets of the global pension sector are roughly $125T, $100T and $50T respectively. These large numbers confirm that a significant move towards 'informed intermediation' by managers of pension and mutual funds with client/member preferences like those of *PD* would strongly move global corporate behavior towards *ESG/Sustainability* 'best practices' as captured by the 17 UN Sustainable Development Goals.[v]

Such a development would please the late, great management philosopher Peter Drucker. In his 1976 book "The Unseen Revolution", he foresaw workers acquiring 'the means of production' through their retirement savings funds. He wondered if the managers of these funds would show the 'legitimacy' required to invest them in the workers' best interests as the workers themselves saw them. A global move to 'informed intermediation' would transform Drucker's almost 50yr-old vision of 'legitimacy'-based workers' capitalism into reality.

Is your fund ready to raise its 'legitimacy' in the eyes of its members by embracing 'informed intermediation'? If not, why not?

Keith Ambachtsheer

Endnotes:

i. *The Fisch-Schwartz paper will be published in the Texas Law Review this Fall.*
ii. *The Bauer-Smeets paper will be a chapter in the forthcoming book by Mitchell, Hammond, and Maurer "Pension Funds and Sustainable Investment", published by the Pension Research Council.*
iii. *A strong YES response rate is effectively a binding referendum.*
iv. *Bauer and Smeets report that they continue to work on finding the best way to elicit preferences, and that they are currently working with the Universities Superannuation System (USS) in the UK on this challenge.*
v. *The 17 Sustainable Development Goals adopted by the United Nations in 2015 relate to poverty, hunger, health, education, gender equality, economic equality, water and sanitation, energy, work and economic growth, innovation, cities, consumption and production, climate, oceans, land, justice and strong institutions, partnerships.*

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