Capital Matters

Pensions and Capital Stewardship Project
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Point/Counterpoint:

Infrastructure Investments Bring Financial Risks and Rewards...

Infrastructure is one of the hottest new investments for many pension funds these days. Wall Street vendors, among others, have been pushing the idea as a way to diversify portfolios with products that reap higher and more stable returns and offer a better match for long-term liabilities.

But while infrastructure can indeed offer plenty of opportunity, pension trustees also should be aware of the complexities they pose. For one thing, such investments often entail the privatization of government services, which raises political and moral dilemmas for trustees that other investors may face to a lesser degree (see following article). In addition, infrastructure covers a wide variety of investment types, each of which involves different risks that fund managers and trustees need to take into account.

Although private equity-like investments in infrastructure are relatively new in the United States, longer experience with them in other countries suggests that the returns can match or exceed equities in some cases. For example, an academic study of Australian unlisted infrastructure funds for a 10-year period beginning in mid-1995 reported higher returns and lower volatility compared to stocks (and higher returns but also higher volatility as compared to direct property investments).

A key problem with quantifying overall return data is the heterogeneous nature of infrastructure. One broad definition distinguishes between economic and social facilities. The former includes roads, bridges, tunnels, airports, seaports, rail networks, water and wastewater treatment facilities, and electric and gas utilities. The latter includes schools, health care facilities, and prisons.

Another definition, more often used by proponents, separates assets according to the kinds of revenue streams they produce. Probably of most interest to investors seeking substantial yet stable returns over the long term are facilities that offer a protected revenue stream. This can stem from an actual monopoly that governments are willing to cede, such as utilities, or a de facto monopoly, like a toll road or airport. If the monopoly is linked to revenue which is scaled up to the benefit provided, like user fees charged by a toll road, there is the potential for increased income over time. Revenue streams may also have protection against inflation, for example, through inflation adjustments in toll road agreements, pricing formulas for regulated utilities, and aircraft charges for airport concessions.

Another key factor trustees must consider is whether the investment is made directly in particular facilities, or indirectly, through operating companies or specialized funds.

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The Pensions and Capital Stewardship Project focuses on issues of retirement security, including employment-based retirement plans, and pension fund governance and management. It is also concerned with institutions, systems, and practices of pension fund investment that encourage capital markets and corporate policies to work more effectively for workers and the health and well-being of the community at large. The Project does this through research, education, and engagement with scholars and researchers, workers and unions, and practitioners.

Inside

Unlisted funds can be open- or closed-end, depending on whether they allow for continued reinvestments in new facilities as investments in previously acquired ones are exited. Listed funds invest in a portfolio of publicly traded shares in infrastructure companies, such as energy, and telecommunications.

Each kind of investment carries different risks. For example, if you buy a toll road, there could be unknown commodity and pricing risk if enough drivers aren't willing to pay what it takes to make the projected return. This of course is a particular problem with new facility or greenfield investments (as opposed to brownfield ones made in existing, mature facilities.) In those cases, less is known about the returns the project may yield and how large the cost of failure might be. Lack of information – especially in cases in which valuation is difficult – also may result in paying too much.

Political, regulatory, and contract risk are related to anticipated deals being thwarted or made more costly because of political and legal disputes over how the concession contract – which is supposed to bind the parties for decades – allocates particular benefits and losses between the government and the investor. Leverage and interest rate risk can arise if capital-intensive projects, like many private equity buyout deals, involve high leverage that makes them sensitive to interest-rate fluctuations. Liquidity risk is associated with the (current) limited ways by which to exit investments in particular facilities. Other risks include event risk, business operational risk, and exchange-rate risk.

There are other challenges to infrastructure investments as well. Much of the seemingly relevant data comes from Wall Street houses trying to sell a product, not from independent or scholarly sources. Also, because the field is relatively new, the track record on performance is generally short. There is also little experience that tells how easy it would be to exit from ownership of particular facilities.

In addition, the closer a pension fund is to direct investment, the greater is its need for investment managers and operating companies with highly specialized skills. In that situation, funds need to take particular care to align their interests with those of the managers and companies, especially given the private equity-type fees that usually are involved. It's possible to avoid many of these problems by investing in listed funds, but the cost could be lower returns and loss of portfolio diversity (because listed funds are likely to more closely track the returns of publicly traded securities.)

For additional sources and readings related to this article or any others in this newsletter contact Larry Beeferman, Director of the Pensions and Capital Stewardship Project: lwb@law.harvard.edu

Infrastructure investments may hold financial promise. Whether and how any particular fund can reap such rewards requires careful investigation and ongoing oversight once an investment is made.

...But May Pose Real Dilemmas As Well

Because infrastructure investments can entail the privatization of public facilities or the private construction and management of new ones, pension funds would be wise to examine the possible ramifications for their beneficiaries.

The most obvious issue is whether the business model of the privatization effort depends on labor cost reductions. If so, pension funds may find themselves underwriting job or compensation cuts or undermining unionization protections for the very employees whose retirement assets they manage.

Fund trustees' fiduciary responsibility is to prudently invest so that promises of payments to beneficiaries can be kept. That responsibility may better be met if infrastructure investments allow the fund to earn higher or more stable returns. However, if trustees make such investments, they actually may reduce beneficiaries' overall retirement prospects if those returns stem in part from a lowering of their pension benefits. Similarly, if the project slices beneficiaries' employment or compensation, their ability to save for old age outside the pension fund may decline more than their pension assets are enhanced. What's more, the long-term fiscal health of the fund itself can be undercut if the active workers who contribute to it lose jobs or pay.

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A few government bodies have begun to address these concerns. For example, when the Indiana legislature authorized turning over the state Toll Road – a 157 mile stretch of Interstate Highway 80/90 – to private investors Macquarie and Cintra in 2006, it gave vesting rights to some workers who lost their jobs and otherwise would not have been vested in the state pension plan. It also allowed those short of the number of years to qualify for early or normal retirement to buy service credits to qualify. There was no promise of jobs with the Toll Road, or of wages and other terms for workers who were offered employment. But those Toll Road workers who wound up without a job were guaranteed other employment with the state. (Not surprisingly there were no provisions relating to union protections since the Governor had abolished collective bargaining rights for state workers almost immediately upon entering office.)

The Illinois legislature imposed much stronger protections for privatization efforts in 2006, although they were largely limited to a possible sale or lease of municipal airport facilities (with Chicago's Midway airport being of special concern). Among the provisions were ones that spurred lessees to negotiate project labor agreements with construction unions and negotiate neutrality and card check agreements for workers who weren't already members of bargaining units. Those who worked at the facility prior to the sale or lease were guaranteed job offers from both the lessee and the municipality under terms and conditions comparable to what they had enjoyed before the sale or lease.

Some pension funds have taken tentative steps in the same direction with so-called "responsible contractor" policies. In 2006, the Illinois State Board of Investment, which is responsible for investment management of the state's public-sector pension funds, expanded a contractor policy it already had to cover U.S. infrastructure equity investments. The policy's goal is to seek the use of contractors who "provide competitive and high quality [s] ervices…, utilizing appropriately trained and fairly compensated employees, subject to…fiduciary principles." It requires operating company managers to ensure "to the extent commercially reasonable" a selection process inclusive of potentially eligible Responsible Contractors. Responsible Contractors "provide[] high quality Services…on a comparable and relevant basis in the applicable local market consistent with the desired contracting criteria, and pay[] workers a fair wage and fair benefits." The policy expresses support for neutrality and card check by operating companies owned by the fund.

However, there's a big catch: The policy only applies when a fund has a 50% or greater ownership and exercises a controlling interest (as well to service contracts above a minimum size). Such a high hurdle means it isn't likely to actually apply to many investments, if any. Still, the principles illustrate possible approaches pension funds might take.

Another idea is to give preference to infrastructure investment firms that incorporate labor-friendly standards in their own policies. Several large investment management firms, including Macquarie, Carlyle, and Alinda were spurred by pension funds and unions to adopt policies that encourage but do not require the firms to engage contractors that appropriately train and fairly compensate employees. The policies also say that the funds will strive to ensure that transactions "minimize any potentially adverse impacts on employees." These general commitments are supplemented by specific ones that encourage (but don't require) hiring contractors which agree to neutrality and card-check union recognition. While these policies also only apply to U.S. investments in which the fund has 50% or greater ownership and exercises a controlling interest, that's more likely to occur with private investment funds.

Perhaps the most difficult dilemma for pension-fund trustees is how to deal with infrastructure investments that negatively affect beneficiaries of other pension funds. Such concerns might seem to lie outside their fiduciary duties. However, it may be that the only way to actually have any effect on labor impacts is for funds to band together. After all, even if Illinois wanted to apply its contractor policy to all its infrastructure investments, it would have little influence on those in which it has a small stake.

But if funds across the country shared similar policies, it could magnify their clout enough to overcome the fact that any individual fund isn't likely to buy a controlling interest in a large infrastructure privatization investment.

Already, Illinois's policy applies to investments across the country, which leaves open the possibility that it could seek reciprocal actions by funds in other states. Pension funds first must decide if infrastructure investments require new policies on potential labor impact. But if they do, they then must deal with the question of whether unilateral policies can have enough effect.

What Trustees Can Learn From San Diego

The federal and state criminal cases against some trustees of the San Diego City Employees' Retirement System have prompted widespread unease amongst trustees across the country. A central issue is whether and how trustees are allowed to consider the financial interests of a fund sponsor. When the city ran into fiscal trouble in the mid 1990s, officials said that they could only boost pension benefits if the city could cut its contributions below the actuarially calculated level. So trustees obliged. The city said the same thing in 2000 and trustees again went along. Soon thereafter, the plan funding ratio plummeted.

Now prosecutors say the trustees had no right to bail out the city, even to reap higher benefits for all plan members. Indeed, state prosecutors argue that it was a violation of state conflict of interest laws for trustees – who as plan members gained from the benefit increase – to even consider taking account of the city's financial condition. They point to a clause of the California constitution which says that a public plan trustee must act "solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions." ERISA has a similar standard, except it makes no reference to minimizing employer contributions. The California constitution also says that a trustee's duty to participants and their beneficiaries "take[s] precedence over any other duty."

Although the charges followed the San Diego fund's spectacular meltdown – its funded ratio dropped from 97.3% in 2000 to 67.2% in 2003 – plenty of other funds face pressures similar to those that prompted the actions under legal scrutiny there. Many retirement systems are still struggling with the aftermath of the 2000 market crash, contribution holidays taken by plan sponsors, soaring dependency ratios, and rising retiree health costs. Active employees are dealing with possible tradeoffs between wages and salaries and retirement, health, and other benefits. States and municipalities are grappling with still other costs, such as skyrocketing Medicaid expenses. Meanwhile, taxpayers resist calls for greater tax revenue.

The lesson for trustees: Their first and overriding fiduciary duty is to plan members.

While it's far too soon for outcomes in the San Diego cases – where the defendants strenuously deny any guilt – other trustees can learn a lot by looking at the basic legal issues at stake there. More particularly, while the San Diego case will turn on exactly what trustees there did, other court rulings shed some light on the general issue.

One significant case suggests that delaying contributions may be wrong absent a clear offsetting gain to beneficiaries. While that suit involved moves by the California legislature in the early 1990s to delay contributions to the public employees' retirement system, some of the principles the court applied are similar to those governing trustees. The court found that the legislature had violated workers' contractual right to an "actuarially sound retirement system," citing an outside actuary's view that the delay would eat into the fund's future investment earnings. The court stressed that this violated the principle of "intergenerational equity" – that is, that fiscal year contributions should basically be kept level from present to future generations. The court ruled that a pension system can be adjusted in light of changing conditions, but only if the modification is "reasonable"; that is, if it bears "some material relation to the theory of a pension system and its successful operation." Since the court couldn't find any advantage to plan members, it concluded that the move was unreasonable.

Recent and Future Events

- December 10-11, 2007: New Finance of America's Cities Research Symposium
- March 2008 (tentative date): Regional Roundtable on Public Sector Pension Funds and Targeted Investing (in Cleveland)
- April 16-18, 2008: Sixth Annual "Capital Matters: Managing Labor's Capital Conference"
- June 10, 2008: Pension Funds - Investing to Build Strong and Sustainable Communities
- July 22-24, 2008: Second annual Program for Advanced Trustee Studies

Another California case, one involving trustees, came to a different conclusion about the pension fund for San Diego County. In 2002, the county voluntarily reduced the fund's unfunded liability by tapping the proceeds of a pension obligation bond it issued. The trustees then voluntarily decided to adopt an interim (higher) valuation of the fund and stretched out amortization of the unfunded liability for increased benefits. The changes allowed the County to reduce its plan contributions. The court said that the trustees acted properly, since the workers got higher benefits and the maneuver didn't impair the fund's ability to pay them. Moreover, the court stressed that the trustees were not obliged to maximize the amount of money in the fund in the short-term. They were not required to abide by the principle of intergenerational equity.

But that same court, in an early legal ruling in the yet-to-be-tried state criminal case in San Diego, held that even if trustees had not violated their fiduciary duty, their actions in considering the changes made may well have violated California's state's conflict of interest law, because trustees had a financial interest (the prospect of increased benefits) in those changes.

Perhaps the most famous example of a pension fund coming to a sponsor's aid was the 1975 bailout of New York City. There the teacher's retirement fund bought $860 million in city bonds to help it avert bankruptcy. A New York court said that the trustees had not violated their fiduciary duty because they had focused on the soundness of the pension, not the City's financial health. The trustees, it found, were solely motivated by the goal of preventing the exhaustion of fund assets and maintaining the stability of the fund for all beneficiaries. They had insisted on inclusion of provisions they believed necessary to protect beneficiaries. The trustees also engaged in "intensive independent analysis as well as consultation with experts," so they had fulfilled their obligation of prudently investigating the facts.

The lesson for trustees: Their first and overriding fiduciary duty is to protect the interests of plan members. However, at least under narrow circumstances, they may not be in breach of that duty if they consider the interests of the sponsor, but only if plan members get clear gains as a result. Yet even then trustees who are plan members may still run afoul conflict of interest laws, since if plan members gain so do they. The San Diego cases may shed further light on just how any quid pro quo must take place, if at all. Given the likelihood that a stressed pension plan today will face sponsor calls for contribution relief, they are cases that bear a close watch.

Putting Labor Rights Into Investment Decisions

A mounting number of shareowners are beginning to incorporate labor rights and other non-financial factors into their investment decisions. The idea got a major lift in April 2006, when the United Nations launched the Principles for Responsible Investment (PRI). The six principles call on institutional investors to embrace the belief that "environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios." Since then, more than 200 institutions representing assets approaching $10 trillion have signed on, including both investors – among them pension funds – and investment mangers. The effort builds on a 2005 study of the fiduciary duties of pension funds, insurance companies, and mutual funds in France, Germany, Italy, Japan, Spain, the U.K., and the U.S. Commissioned by a group of 13 global asset managers working with the UN, including Calvert, Citigroup, Hermes, and HSBC, the study concluded that considering labor rights and other ESG issues generally was consistent with fiduciary duty. In fact, it suggested that a failure to assess such factors might even be considered to be a breach of a trustee's duty to act in the best interests of its beneficiaries.

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Although the PRI is still in the early stages, more than 80% of the signatories have begun conducting at least some kind of engagement with corporate management on one or more ESG issues. The first step is usually to ask companies for standardized ESG reporting. Environ-

Trustee Perspective

As AFSCME's representative on the board of trustees of the $42 billion New York City Employees Retirement Scheme (NYCERS), Mike Musuraca* was very active in the founding of the PRI. His involvement, he says, grew out of NYCERS' belief that "environmental, social, and corporate governance (ESG) issues are vital to the long-term performance of the entities we invest in. PRI makes it clear that these variables need to be part of the investment decision-making process." NYCERS took an earlier step in this direction in 2004 by adopting a screen for emerging market investments, which it had developed with the California Public Employees' Retirement System (CalPERS). In additional to traditional financial metrics, the screen employs a variety of ESG ones, including those relating to human and labor rights.

The PRI, says Musuraca, helps "investors signal to companies and to the people they hire to manage their money that these issues are important to us. As part of that process, NYCERS also has joined the Enhanced Analytics Initiative" (a collaboration of investors and asset managers aimed at prodding mainstream research houses to incorporate ESG and other extra-financial factors into their investment research). "We also recently hired four managers, Generation Asset Management, F&C Asset Management, Walden Asset Management, and KBC Asset Management, to look at best performers in various asset classes according to both financial and ESG measures. This is bold for us, since we're only the second pension fund to do this after the California State Teachers' Retirement System last year. The total amount invested isn't huge, but it's a way to get started and signal to other managers that we're serious about the PRI. The PRI is helping to make it clear that the issues that have concerned us as activist funds for years, from corporate governance to child labor to freedom of association, are moving to the mainstream in investment decisions."

**Musuraca has been a participant in and panelist at the Project's annual Capital Matters: Managing Labor's Capital conferences.*

mental and corporate governance considerations have attracted the most focus so far, particularly the Carbon Disclosure Project, a nonprofit that helps shareholders assess corporate climate change actions. Labor and human rights, which fall under the Social part of ESG, increasingly are coming to the fore as well. One highly publicized example came in 2006, when the $280 billion Norwegian government pension fund sold $416 million worth of Wal-Mart shares over concerns about what it called "serious and systematic violations of human rights and labor rights." More recently, a group of 12 PRI signatories have begun engaging with 33 auto and steel companies over allegations of slave labor in some of their Brazilian suppliers.

Sharing retirement-funding risk: The Dutch Solution

The bear market of the early 2000s has driven home the large degree of risk American workers have assumed by the long-term shift from defined-benefit (DB) pensions to 401(k)s and other defined-contribution (DC) ones. Without a DB plan to back them up, millions of employees found their retirement prospects reduced after both stock returns and interest rates slumped. Since then, many older workers have faced the prospect of working longer or accepting lower post-employment lifestyles, or both.

An interesting alternative can be found in the Netherlands, which reacted to the market slowdown by altering risk-sharing in a very different fashion. Instead of dumping all the risk onto workers by changing to a DC plan, most Dutch pension plans switched to a system that links retiree benefit levels to the financial status of the pension fund. It also bases them on average wages earned over an entire career, instead of on those earned in the final year on employment, as most had done before.

The new system amounts to a kind of hybrid DB/DC approach that retains consensual risk-sharing, even though it has reallocated some risk to both active and retired workers.

The new system amounts to a kind of hybrid DB/DC approach that retains consensual risk-sharing, even though it has reallocated more risk to worker, especially retired ones. It still requires employers to pay for a defined set of benefits, just as a traditional DB pension does. However, if a plan earns low returns, employer contributions won't climb as much as they would under the old approach. Instead, benefits will lag inflation or even fall. If the fund subsequently earns excess returns in a bull market, as typically occurs, benefits will be increased to make up the lost ground. Any pain will be borne disproportionately by retirees, whose benefits would be affected immediately. By contrast, active workers, who won't start collecting benefits until they quit working, could have enough time for returns to recover before they're affected. The system thus requires active and retired workers to bear more risk, but not to shoulder it all as they would in a full-blown DC plan.

The Dutch solution avoided placing most of the risk on individuals largely because of the country's European-style institutional and social makeup. Although unions represent only about a quarter of the workforce and have been losing ground just like U.S. ones, Dutch law extends many basic bargaining terms to nonunion workers. This is particularly true with pensions. If central organizations of employers and employees agree to set up a pension fund covering at least 60% of workers in an industrial sector, they can ask the government to mandate that all employers and employees within that sector to participate in the industry-wide fund. As a result, 93% of the workforce is covered by a pension. In addition, pension funds aren't run by companies but are independent trusts co-managed by employers and unions, who jointly decide how they should function. Consequently, employers would have had a more difficult time unilaterally moving from a DB to a DC plan as many in the United States have done. (Even so, the share of the Dutch workforce in DC plans did climb from less than 1% in 1998 to 6.1% in 2005.)

Dutch labor's embrace of the hybrid approach came in the context of a broader conversation about the financial health of the Netherlands' social security system, which faces long-term pressure from an aging population just as Social Security does in the United States. Known as AOW after its Dutch acronym, the government plan guarantees retirement benefits equal to 70% of the minimum wage to all residents, even non-workers. The benefits, which come out to about 30% of average wages, are integrated into private pension plans, which aim to replace 70% of a worker's final wage, which is now changed to 80% of the career-average wage.

To fix potential AOW shortfalls, the country has pursued a two-part strategy. One is to reduce government debt, freeing up public funds for AOW that now go to interest payments. A second is to increase labor-market participation, which involves tactics such as wiping out tax breaks for early retirement and encouraging partially disabled workers to rejoin the workforce.

The political horse-trading that led to the new system

also included stricter oversight of private-sector pension plans, with more rigorous requirements to ensure that they stay fully funded.

One of the most interesting aspects of the hybrid approach is how it divides up risk among young and old workers. Labor could have tried to stick with the DB system, which would have required employers to continue to absorb any future funding shortfalls. But it knew that more was at stake than relatively brief stock market ups and downs. Longer term, an aging workforce would raise funding requirements for decades to come. If employers were forced to pay for that as well, they would put increasing pressure on younger – i.e. active – workers to accept lower wages or lower future retirement benefits. By requiring retirees to bear part of the risk of low returns, the hybrid system eases the crunch on employers and active workers alike.

Paradoxically, the DB/DC combination may give pension funds breathing room to earn higher long-term returns. As the Dutch workforce ages, the ratio of retirees to workers will rise, just as it will in most of the industrialized world. At ABP, the country's largest fund, retirees' share of total liabilities will jump from 40% in 2004 to close to 70% in 2024. To accommodate the shift, a DB plan would need to move to a more conservative asset mix, since retirees can't wait 30 or 40 years for their payoff. But now that retiree benefits will fluctuate with returns, funds can retain a more aggressive portfolio with a long-term investment horizon more likely to generate higher income. That's better for active workers, who on average have many more years to wait before their benefits must be paid. Essentially, retirees will act as a buffer to absorb the risk needed to generate higher long-term returns for active workers.

The Dutch reaction to both short- and long-term retirement funding problems has been very different from the U.S. one. Instead of putting risk on individuals, the Netherlands came up with new ways to share risk collectively.

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