Capital Matters

Pensions and Capital Stewardship Project
Labor and Worklife Program
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Experiments in Public Sector Pension Fund Design

Despite the private sector's shift to defined-contribution (DC) retirement plans over the past three decades, public employers in the United States have largely remained committed to the traditional defined-benefit approach. However, over the years a number of state pension funds have experimented with a mixed approach, as outlined in a draft paper by Keith Brainard, Research Director for the National Association of State Retirement Administrators.* Often they have done so in an effort to solve a financial or budgetary crisis. Still, their innovations help to move beyond what can be an arid debate over the relative merits of "pure" or "plain vanilla" DB and DC plans. In doing so these hybrid approaches shed light on key underlying issues that every retirement plan faces, including who should bear investment, longevity, and inflation risks and how the burdens and benefits should be shared among active and retired workers.

For example, Nebraska, unusual in that it was one of the relatively few states with a DC plan, learned after extensive study that accumulations by workers under the scheme were simply inadequate. So in 2002, the state legislature created a type of cash balance plan for all newly hired workers. Employees have nominal accounts into which they and the state make contributions (at the same level as under the DC plan), but the assets are pooled and collectively managed just as they would be in a DB plan. Each year, participants' accounts are credited with the greater of an increase of 5 percent, or the federal mid-term rate (the average market yield for securities with maturities between 3 and 9 years) plus 1.5 percent. In addition, workers get an annual dividend which is in effect tied to the plan's funding status: it is paid only "if the actuarial required contribution rate is 90 percent or less of the statutory contribution rate." Since DB plans in recent years have assumed long-term portfolio returns in the range of 8 percent, the dividend in combination with any additional return generated by high federal mid-term rates would have to be in the range of 3 percent for workers to do as well with their plan. Nebraska's plan also incorporates another DB-type feature, which allows workers at retirement to annuitize any portion of their account balance, with age and various options (such as a cost of living adjustment) determining which annuity they will receive. They also can receive disability retirement benefits and survivors benefits based on their account balance.

Oregon came up with a hybrid approach from the other direction (as have Washington State, Ohio, and Indiana in somewhat similar ways). For many years prior to 2003, it had an employer-funded DB plan which calculated benefits by multiplying a worker's years of service by 1.67 times his or her final salary. It was supplemented by a DC plan with notional accounts funded by worker contributions. Employers

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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.

– county and other local funds can belong to the state system – were allowed to contribute to the DC plan on behalf of their employees as well. The DC accounts were credited with the returns on the pooled investments but guaranteed a minimum annual return of 8 percent: the fund bore all the risk of returns falling below that level. The guarantee came to be seen as too costly because of large investment losses in 2001 and 2002. So in 2003, the legislature cut the DB multiplier to 1.50, and established a new DC plan for all future contributions. This plan eliminated the guarantee altogether, although the new plan's returns are still linked to the performance of the asset pool. At the time, legislators also added to the choices at retirement to include taking the entire balance in a lump sum, annuitizing it, or receiving equal amounts over a 5-, 10, 15- or 20-year period. However, the annuity offered is unusual. It is not a traditional one which guarantees fixed payments for the life of the retiree. Rather, it provides payments linked to investment returns, indeed, so much so that it is possible that the payments might end before the death of the retiree. The plan re-calculates the retiree's account balance annually, factoring in the account's investment performance and the annuitant's new age and life expectancy.

Arizona added another twist. In 1994, lawmakers altered the state's DB plan, which had required matching contributions from employers and employees, to link those contributions to the plan's returns. Before the change, retirees got cost of living adjustments (COLAs) on an ad hoc basis. The new system gives them regular payments, but only if the fund earns more than its 8 percent assumed rate of return averaged over a 10-year period. (When the plan was changed in 1994, returns were averaged over five years.) Even then, the money available for annual COLA payments is limited to retirees' proportional share of the excess returns. In any event, the increases are capped at the smaller of the Consumer Price Index or 4 percent, with the remaining excess earnings retained by the fund. Similarly, contributions by both active workers and participating employers rise or fall depending on how well the fund performs in relation to the benchmark return. In a number of respects, this approach is similar to one recently adopted by the Dutch pension system (see the January, 2008 Capital Matters).

The three plans discussed above all focus on employees who at the time of retirement are working for the employer which has the plan. By contrast, the Minnesota state teachers fund (along with the state employees and county and local funds) took the unusual step of making its plan fairer to those who leave the employer well before reaching the minimum plan retirement age. Participants vest after three years. As in most pension schemes, those who quit the plan after vesting but before the minimum retirement age receive, at retirement, a benefit calculated on the basis of their salary at the time they left. This figure is very likely to be far less than what their salary with the employer would have been if they had stayed with that employer until retirement. To remedy the penalty this creates for early leavers, the plan put in new rules that credit them with a 2.5 percent annual salary increase from the time they leave until the minimum retirement date. The benefit they now earn is based on this adjusted final salary, not the one they received the year they left. To qualify, participants must keep their contributions in the plan. The estimated cost of this benefit is 0.45 percent of payroll.

All of these experiments aim to rebalance the risks and rewards pension funds create.

All of these experiments aim to rebalance the risks and rewards pension funds create. Whether they yield workable arrangements in light of those risks and rewards will require careful review. But each example offers valuable lessons that may be useful to others looking for new ways to fashion stable plan designs which strike a fair and workable balance for the long term.

*"Redefining Traditional Plans: Variations and Developments in Public Employee Retirement Plan Design," by Keith Brainard, 2008 Symposium: The Future of Public Employee Retirement Systems, The Wharton School, University of Pennsylvania, May 1-2, 2008. Available at http://www.pensionresearchcouncil.org/conferences/conf-2008.php (log-in required).

Accounting For Pension Fund Risk and Reward

Among the most important issues being debated these days is how the Government Accounting Standards Board, which establishes standards of accounting and financial reporting for U.S. state and local governments, might change the way public sector pension plans need to account for their liabilities. The stakes are high, because a change in those standards might dramatically alter how well funded plans are seen to be and, in turn, justify significant, but perhaps unwarranted changes either in plan design or in contribution levels.

The debate has been spurred by financial economists,

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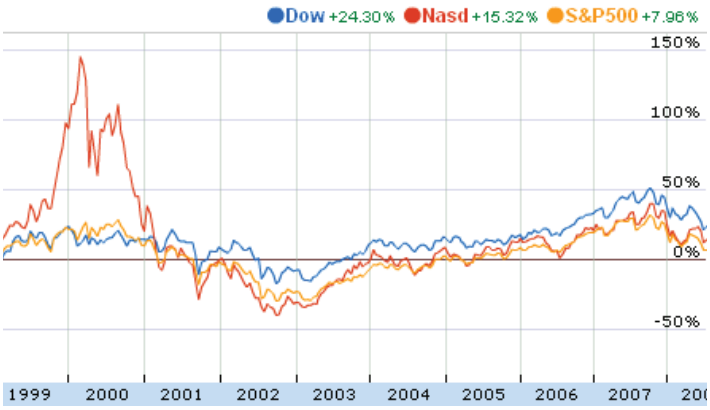

Dow Jones, Nasdaq and S&P 500 Performance Over a Ten Year Period

economists concerned with how financial resources are allocated in an uncertain (or risky) environment, including such issues as how financial markets operate, how financial instruments are priced, how companies are financially structured. They have challenged the way public sector pension funds have generally assigned a value to promised benefits (their "liabilities") and how funds should determine the amount of assets they need to have today to honor those promises. To determine their liabilities, funds typically project active members' estimated years of service and salary. They then calculate benefits at the expected retirement dates based on an agreed upon formula, usually years of service times a fixed percentage (say, 1.5 percent) times the anticipated final salary. The aggregate result for the entire workforce is a pattern of benefit payments to be made each year over decades in the future. Funds then choose a "discount rate," a fixed percentage. They calculate the amount of assets, which if held today and invested at a compound interest rate equal to the discount rate, would be sufficient to provide for those payments. The total of the assets so required for all future years – the "present value of future benefits" – is the amount the pension fund would have to have on hand so as not to require any future contributions. (In practice future contributions will cover at least some of the difference between this value and the actual assets on hand.)

Funds have generally chosen a discount rate equal to the estimated long-term return on their investment portfolio. This choice is critical: the higher the discount rate the fewer assets funds need to hold today.

Financial economists challenge this approach in several ways. One is that the appropriate discount rate should be the "risk free" one. (Another contention is that the calculation of benefit liabilities should not incorporate future service or salary increases.) In theory, the risk free rate is the rate of interest an investor would expect from an absolutely risk-free investment. In practice, even the safest of investments have some risk, so the interest rate on the very safe U.S. Treasury bills is often treated as the risk-free one. It has been suggested that choosing the risk free rate over the long-term portfolio return rate would increase pension fund liabilities by as much as 15%. In turn, that would require much higher contributions to the pension fund.

The argument in favor of the risk free rate derives from the view that plan assets and liabilities should be measured at their "market value." However, while determining the market value of plan assets is fairly straightforward, ascertaining it for plan liabilities is not, because there is no market for such liabilities. The critics say that the price of these liabilities should be measured by the price of comparable items, which some assert are bonds with duration and yield payments of interest that perfectly match those of promised benefits. They also contend that matching bonds should reflect the credit risk of the payments to be made, which in the case of public sector pension funds is essentially risk free. These arguments are sometimes linked with others. For example, it is said that using the long-term rate of return on a pension fund's investment portfolio as the discount rate gives a misleading picture of the assets the fund presently requires, because it ignores the riskiness of the portfolio's return. Critics point out that if a fund doesn't make its assumed rate of return, the burden of fulfilling its obligation will be unfairly shifted to future generations.

Objections to this view are both theoretical and practical in nature. For example, pension payment flows are really not like bond cash flows. The former change to reflect future service and salary increases (and changes in life expectancy, turnover, retirement, and disability); bond interest payments do not. Also, the bond rates that would be used vary over time. These variations will produce fluctuating (and large) changes in estimated liabilities even though benefit promises may not have changed. In turn, this will result in fluctuating (and large) changes in contribution rates.

Defenders of the current approach say that a risk free discount rate might make sense, say, for a corporate sponsor's plan that is being terminated – because it approximates the method that would used for calculating the cost of annuities required to assure payments promised to plan participants. But that does not make sense for government sponsors whose plans are ongoing indefinitely. Similarly, focusing on market value might, as financial economists argue, make sense for corporations because the pension assets are linked to the firm's market value (and, correspondingly, the pension fund should not be seen as distinct from the corporation) and corporations are or should be managed on the basis of market

value. But public sector pension funds are properly viewed as long-term, self-standing entities separate from the public sponsors. Besides, governments are not managed on the basis of market values. In addition, while investment portfolio returns might fall short and shift burdens to future generations, returns may exceed expectations and therefore be to their advantage.

There is not the space here to review in depth these or other contentions on both sides, but given the importance of the issue to pension plan sponsors and participants, trustees need to comb through all these issues. However, it is useful to step back from the specifics and take note of some broader points. Some relate to how the debate is framed. For example, the task plan sponsors face may be thought to be more one of funding their commitments than pricing them and how they go about doing each may be different. Also, while accounting rules that properly attend to looking back on commitments made are necessary, those rules may also need to look forward, to characterizing (and addressing) future economic events which will shape plan finances. Further, whatever the wisdom of attempting to perfectly "hedge" plan liabilities and, correspondingly, think in terms of precisely matching assets, there is also wisdom in thinking about and managing plan portfolios in other ways with regard to both the financial rewards their portfolios might earn and the financial risks they face.

Other points arguably are valid regardless of how one comes out on the particular issues canvassed above. For instance, it might be simple but it would seem unwise and perhaps even naïve to rely on a single number (such as the funding ratio, however calculated) to characterize a plan's financial status. As a related matter, whatever pension plans' choice about any particular mix of risk-free bonds and other assets, they should be transparent about and fairly account for the investment risk they have taken on. They could also include additional criteria on the asset side, such as the market value of plan assets, along with whether and how the results are "smoothed" (averaged), and the methodology for determining such a smoothed value. On the liability side, in addition to the funded ratio, funds might use a discount rate which reflects the reality that the relevant rate (whether long term or market) will vary over time. They might assess the cost associated with the coming year, typically called the normal cost, in terms of its relation to payroll and/or a measure of sponsor revenues.*

*Note that some methods for establishing a normal cost are directly related to the benefit promise earned or accrued in that coming year. A more commonly used method – the so-called Entry Age Normal Method – geared to keeping costs level as a percentage to pay does not.

A Code Of Conduct For Pension Trustees

Serving as a trustee of a pension plan is akin to sitting on a corporate board, since trustees usually set broad policy that is carried out by a staff of experts. But as many pension funds have ballooned into multi-billion dollar enterprises, the task of overseeing them has become more complex, requiring increasing dedication and skill from trustees.

To address the many issues trustees face today, the CFA Institute recently published the Code of Conduct for Members of a Pension Scheme Governing Body.* The Institute, based in Charlottesville, Va., is a 61-year-old non-profit association of investment professionals that awards the Chartered Financial Analyst designation. With some 95,000 members in 134 countries, it has set ethical standards not just for financial analysts but also for other professionals such as investment managers. Although pension trustees are not usually CFA members, the Institute took on the task of creating standards for them because many of its members work with retirement funds in the United States and other countries. The Institute partnered with a variety of institutions to draw up the new code, including the Organization for Economic Cooperation & Development, the Council of Institutional Investors, and the national pension-fund associations of Hong Kong, the Netherlands, Switzerland, and the United Kingdom.

Given all the major organizations behind the code, trustees around the world are likely to face pressure to comply with it.

Given all the major organizations behind the code, trustees around the world are likely to face pressure to comply with it. While it is aimed at individual trustees, the idea is that pension plans would support it along with companies, government agencies, and unions.

Some trustees who do agree to abide by the rules could find that they would need to behave differently. The code's ten provisions are straightforward enough, calling on trustees to adhere to basic ethical standards such as acting in good faith and in the best interest of participants and beneficiaries; abiding by all applicable laws, rules, and regulations; and dealing fairly, objectively, and impartially with participants and beneficiaries. But several represent something of a challenge to the status quo at some funds.

The most controversial is likely to be a provision aimed at so-called "pay-to-play" practices, which refers to cam-

paign contributions asset managers make to elected official trustees who oversee pension funds or to "placement" fees consultants and advisors earn by steering pension business to money managers. The code says that trustees should "maintain independence and objectivity by, among other actions, avoiding conflicts of interest, refraining from self-dealing, and refusing any gift that could reasonably be expected to affect their loyalty." The guidance accompanying the code says that they should "strive to avoid even the appearance of impropriety;" and says: "Do not solicit political contributions from service providers to the fund, either personally or on behalf of another."

Such language would appear to conflict with asset management firms' widespread use of placement agents to drum up pension business. Typically, the asset manager pays the agent for the placement, and the agent donates part of the fee to the political campaign of the state treasurer or other elected official involved in the fund's investment decision. This type of kickback has been illegal in public finance since the Securities & Exchange Commission outlawed it for municipal bonds under the chairmanship of Arthur Leavitt. However, it remains legal in private asset management, even though the funds at issue are public.

There are many examples. Bob Kjellander, a major figure in the Republican Party, reportedly received millions of dollars in 2006 for placing the teachers' pension plan investments in Illinois, where he's from, with the Carlyle Group, for whom he's a lobbyist. Similarly, KKR has long been a dominant player in Washington State's and Oregon's public plans, while Hicks Muse has played a similar role in Texas ever since George Bush was governor. Former New York comptroller Alan Hevesi, a Democrat, ran into trouble after his son and his long-time campaign manager won millions of dollars in placement fees for allegedly steering pension business to money managers.

Another provision in the CFA code could have similarly far-reaching, though probably less controversial, impact. It calls on trustees to consider all relevant risk factors when making investments, including those involving environmental, social, and corporate governance (ESG) factors. While the code doesn't suggest this approach is required, it gives legitimacy to an investment perspective that has been rapidly gaining ground in Europe and elsewhere.

Perhaps the most difficult challenge the CFA code poses comes for smaller funds. Because many funds cannot afford large professional staff, they may not be equipped to make the kind of thorough review of investment and other policies the code recommends. For example, it calls on trustees to draft written policies on everything from risk tolerances, return objectives, and asset allocation, to liquidity requirements, liabilities, and tax considerations.

Although the code is purely voluntary, it could become less so if a pension fund board adopts it as something required of trustees. It also could influence legislation that New York and other states have considered to deal with pay-to-play practices. As a result, it is probably worthwhile for trustees to take a look at what the Institute has produced.

*The code can be found at: http://www.cfainstitute.org/centre/codes/pension/index.html

CEO Pay as a Proxy for Good Corporate Governance

This year's presidential elections are likely to usher in what could be a significant shift in how the pay of corporate CEOs is set in the United States. "Say-on-pay" legislation pending in Congress that would require an annual – though nonbinding – shareowner vote on a public company's executive compensation plan has long been a contentious topic among institutional investors and politicians alike. Both John McCain and Barack Obama have said that they support such legislation, which would put the issue of executive pay before pension fund trustees and other investors.

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Even a nonbinding shareholder vote could help alter the dynamic in corporate board rooms. Advocates say that U.S. corporate directors typically have been unwilling to listen to investor complaints about high executive pay. They argue that the legislation would prompt more dialogue among the parties, while retaining the board's role as the company's governing body. As evidence they point to the increase in such discussions that has occurred in the United Kingdom since the passage of a nonbinding say-on-pay law in 2006, although there is little evidence yet that it actually has curtailed executive remuneration there. (Australia has a nonbinding law as well, while the Dutch require a mandatory vote.)

While a nonbinding shareowner ballot may seem unlikely to deter boards at companies like Home Depot that have ignored withering public attacks on $100 million-plus payouts, the approach reveals a lot about an often-

misunderstood reason why critics object to what they view as runaway CEO pay in the first place. Broadly speaking, the criticisms fall into two categories. The first holds that high executive pay is an important factor behind rising inequality, which undermines the country's social fabric and fosters class divisions that are at odds with America's self-image. This critique has been made forcefully by many social and political leaders, including union officials who question the fairness of a system that distributes economic rewards so disproportionately.

The second category of criticism has been largely confined to experts and activist institutional investors, especially pension funds, concerned with how publicly traded corporations are governed (although the latter include many of the same union leaders who also make the first argument). They contend that huge salaries are a symptom of a market failure that has occurred because CEOs have compromised their companies' corporate governance systems. In this view, executive pay is not set by supply and demand in the labor market but by boards that are hand-picked and chaired by the very CEO whose pay it nominally sets.

...CEOs have exploited a well-known "agency" problem endemic to large public corporations.

Harvard Law School professor Lucian Bebchuk has been one of the leading proponents of the market failure view. In a series of studies written with other experts in recent years, he has marshaled both theoretical and empirical evidence to show how CEOs essentially have been able to set their own pay, with few if any checks on their behavior. Bebchuk and his colleagues argue that CEOs have exploited a well-known "agency" problem endemic to large public corporations. Because the company is owned by millions of constantly shifting shareholders, they are unable to effectively monitor the agents who run the company on their behalf. As a result, the agents – the CEO and other top executives – are able to use corporate assets to benefit themselves instead of the owners and the corporation.

Bebchuk and others point to a range of factors to make the case. For example, there is little correlation between how much a CEO earns and the performance of the company he or she directs. CEO pay soared during the stock market boom of the 1990s, driven largely by a proliferation of stock options executives received. But their pay did not collapse when the market crashed. Instead, it shifted to restricted stock and other payments that detached compensation from corporate performance.

Indeed, a 2005 study by Bebchuk and a colleague found that the ratio of top executives' pay to aggregate corporate earnings doubled in a ten-year period ending in 2003 for firms in the S&P 1500. Other studies point out that CEOs systematically have hidden large elements of their pay from shareholder scrutiny, a practice inconsistent with the arms-length contract negotiations in which boards and CEOs would engage if market forces determined pay. Examples of such stealth compensation include stock options backdating, earnings manipulation, generous retirement and severance packages, company-provided perks like corporate jets and club memberships, and bonuses unrelated to firm performance.

Business groups respond that boards now must adhere to new standards of independence set by the New York Stock Exchange and the Securities & Exchange Commission, although investor advocates say those have not done enough to foster true salary negotiations with CEOs. Management defenders also argue that CEO pay is market based because it is usually bench-marked against surveys of what comparable CEOs earn at other companies. However, critics say that the surveys are meaningless indicators of a true market wage if a majority of the country's CEOs have held too much sway over their boards.

The key corporate governance question here is why corporate boards would violate their fiduciary duties by allowing CEOs to use corporate assets to enrich themselves. The most common answer from experts is that CEOs traditionally have played a key role in choosing and running boards, and shareowner activists have been pursuing a wide variety of reforms to create independent boards. There has been a lively academic debate about whether boards exist to represent shareholders or the interests of the corporation as a whole, including other stakeholders. The evidence on CEO pay suggests that in the United States, most boards have not done either.

Defined Benefit and Defined Contribution Investment Returns Compared

Any pension scheme that relies on investment returns for funding must address issues of investment reward and risk and how they are shared between plan sponsors and workers. (See lead article in this issue.) At the same time, different fund designs may be more or less effective in yielding those rewards. The point is highlighted in a recent study by the consulting firm Watson Wyatt which offers evidence that defined-benefit DB plans have outperformed defined-contribution (DC) ones.* This conclusion

confirms the findings of prior Watson studies and those of a 2006 paper by Boston College's Center for Retirement Research.**

In an effort to make a fair comparison, the Watson study focused on companies which sponsored a DB plan and a (401(k)) DC plan, each with at least 100 participants. It looked at the median rate of return for each of the years from 1995 to 2006. The average of those returns (weighted by plan asset size) was 10.30 percent for the DB plans and 9.21 percent for the DC plans, a difference of 1.09 percent.*** Even after adjustments were made to account for plan expenses, the gap was still 1.00 percent. While this may not sound overwhelming, it adds up to a significant amount of money for beneficiaries over the long run. Watson found that companies with $100 million in each kind of plan would have ended up with $310 million in the DB plan and $273 million in the DC plan after the 12 years. If one projects similar performance over a period closer to a working lifetime, namely 36 years, the results would be about $2.98 billion compared with $2.03 billion. That means the DB plan assets would be nearly 50 percent greater than the DC ones.

...the differences in long-term investment outcomes between DB and DC plans are striking. This evidence and the other studies cited point to the advantage of the expertise that DB plans can bring to decision-making about investment reward and risk.

The Watson paper also concluded that larger DB plans outperform their DC plan counterparts to an even greater degree. For example, the largest sixth of DB plans posted 12-year returns that were 1.21 percent larger than those of the largest sixth of DC plans. This is attributed to the fact that larger DB plans are likely to have the resources to afford greater expertise, while the investment funds offered to DC participant are not likely to change with size. Also, in any given year, there is less variation in returns across DB plan as compared to DC plans. This is attributed to more consistent styles and performance for DB plans as compared to DC plans, whose members may choose starkly different investment strategies and "tend to be market-trend followers."

However, the smallest sixth of DC plans do better than the smallest sixth of DB plans: a difference of 1.03 percent. Watson does not offer an explanation for this result though it may, in part, have to do with smaller DB plans having fewer resources to sustain superior professional management.

To further test its findings, Watson compared outcomes for all firms that had DC plans with those that had both. The returns for all firms were lower (8.16 percent compared to 8.41 percent), suggesting that returns for companies with just DC plans were still lower. Watson also compared rates of return for all corporate DB and DC plans. It found that average of the median annual returns for all DB plans was 10.46 percent, beating the 10.30 percent for DB plans at companies with both kinds of plans. Meanwhile, all DC plans posted 9.18 percent returns on average, slightly underperforming the 9.21 percent for DC plans at companies with both.

In sum, the differences in long-term investment outcomes between DB and DC plans are striking. This evidence and the other studies cited point to the advantage of the expertise that DB plans can bring to decision-making about investment reward and risk. Broadly speaking, these outcomes are consistent with the reported findings suggesting superiors pension fund investment returns compared with mutual fund returns, since the mutual funds are frequently the vehicle for 401(k) investments. (See "Are pension funds better asset managers than mutual funds?" Capital Matters, October 2007). While attempts are being made to improve 401(k) outcomes by automatically enrolling workers into so-called targeted-retirement-date funds, which effectively supplant problematic 401(k) plan participant decision-making, how effective these strategies are remains to be seen. (See "401(k)s Fall Short of Funding on Adequate Retirement," Capital Matters, April 2008.)

* "Defined Benefit vs. 401(k) Plans: Investment Returns for 2003-2006," Watson Wyatt Insider, June 2008. Available at http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=19148. For the purposes of this article, we use the words "401(k) plan" and "DC plan" interchangeably. However, DC plans include types of plans other than 401(k) plans.

** See "Investment Returns: Defined Benefit Versus 401(k)," Watson Wyatt Insider, June 1998; "Defined Benefit vs. 401(k) Returns: The Surprising Results," Watson Wyatt Insider, January 2002, available at http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=9378, "Defined Benefit vs. 401(k) Returns: An Updated Analysis," Watson Wyatt Insider, September 2003, available at http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=11858, "Defined Benefit vs. 401(k): The Returns for 2000-2002," Watson Wyatt Insider, October 2004, available at http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=13811, and "Investment Returns: Defined Benefit vs. 401(k) Plans," CRR Issue Brief, Center for Retirement Research, Boston College, September 2006, Number 52, available at http://crr.bc.edu/images/stories/Briefs/ib_52.pdf?phpMyAdmin=43ac483c4de9t51d9eb41.

*** To be sure, these outcomes did not mean that in any given year, DC plan returns did not exceed DB plan returns – for three of the years they did – but as the main text indicates, "over the long term, the difference was significant.

Occasional Paper Series

Labor, human rights and investment risk

Many pension funds and other institutional investors have come to recognize the importance of environmental, social, and governance (ESG) considerations and are attempting to factor them into portfolio decisions.

However, metrics for measuring ESG aren't yet well-developed, particularly for issues that fall under the 'S,' such as labor and human rights. This is largely due to a lack of data, as well as the lack of a consensus about what to measure in the first place. While it is fairly straightforward to quantify carbon emissions or a company's corporate governance policies, it is much more difficult to quantify and interpret its labor rights performance.

A new Pensions and Capital Stewardship Project paper due out soon examines ways investors might address these obstacles.* It suggests that one model can be found in the supply-chain factory monitoring regimes designed to verify the labor codes of conduct issued by many multinationals. The paper also suggests that the investment community may only find robust labor and human rights data, and achieve meaningful reductions in risky corporate behavior, by adopting the shareholder engagement tactics used to pressure companies to address environmental and governance risks.

A number of pension funds have begun using this approach. Leaders in the United States include major funds such as the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the New York City Employees' Retirement System (NYCERS. (See "Putting Labor Rights Into Investment Decisions," Capital Matters, January, 2008). Several pension-fund advisory firms also have stepped into this field by working on behalf of investors to persuade portfolio companies to reduce risky behavior regarding labor and human rights. One is Hermes Equity Ownership Services, an advisory firm owned by the former British Telecom's pension fund that manages money for 200 or so other institutional investors. The London-based Pensions Investment Research Consultants (PIRC), which provides research and shareholder engagement services for pension funds, offers similar services, as does a Canadian group called Shareholder Association for Research and Education (SHARE), an organization supported by Canadian labor unions. The Project has been reaching out to these and other organizations in an effort to stimulate research and further dialogue about how pension funds and other investors can mitigate labor and human rights risks in their portfolios.

*"Incorporating Human and Labor Rights Risk into Investment Decisions," by Aaron Bernstein

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