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PENSION FUND "SOCIALISM" AND THE AMERICAN ECONOMY

In recent years,"corporate governance" has become our shorthand for a variety of developments: investor focus on board composition and performance; report cards on executive performance (and behaviors); an umbrella term for demands for improved corporate "citizenship," especially as presented by social and economic justice activists; a description of the package of federal statutes and the reams of new regulations flowing from 2002 congressional decisions and related regulatory implementation (for example, the Sarbanes-Oxley Act and SEC rules); the high-profile prosecutions of analysts, investment bankers, and mutual fund advisors by state attorneys general; and dramatically increased institutional investor activism, especially on the part of the nation's employee pension funds.

The more than 1,100 shareowner-sponsored resolutions making it through the system in 2004 to become formal proxy voting issues for public companies—clear expressions of increased investor activism—are reported by journalists as "corporate governance" challenges for corporate management and boards. (Perception eventually becomes reality; today the above activities and more are "corporate governance issues.")

Many of these activities and issues have been factors in the management of public corporations—and in corporate financial reporting practices—for years; some, for decades. But as we have noted in these pages, the 1960s American social revolution and the events that followed in the early 1970s created a real revolution in corporate governance and financial reporting that continues unabated. One of the more important *revolutionary realities* for financial executives is increased pension fund and institutional investor activism—a major factor for some companies and, many believe, now a permanent fixture in the life of capital markets.

Pension fund trustees and managers, along with their outside advisors and money managers, have arguably become the most powerful investment force in the nation. Their combined influence on individual companies and in the capital markets is considerable, as corporate finance executives well know. Pension fund holdings now number in the billions of issuers' shares outstanding.

How did we get to this position . . . and what changes may be ahead? Some clues may be found in a prescient work by Peter F. Drucker, who correctly recognized that a dramatic "silent revolution" was well underway more than a quarter-century ago, a revolution that would have far-reaching political, social, and economic results. Professor Drucker was surprisingly accurate in many of his observations (still useful today as conceptual underpinnings).

Professor Peter Drucker as modern Thomas Paine

In his 1976 book, *The Unseen Revolution: How Pension Fund Socialism Came to America,* Peter Drucker set out the broad social, political, and economic aspects of an unfolding capital markets revolution. He boldly predicted that by 1985, all types of employee pension funds would own at least *half* of the equity capital of American corporations. The result? Dispersion of corporate ownership would be the major factor in the *socializing* of the U.S. economy. That is, American workers would own the means of production through their institutional and personal, direct investments and would thus begin to influence corporations as never before. Shades of radical thinkers Marx and Engels, Soviet dictator

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Vladimir Lenin, and American socialist Eugene Debs!

But Professor Drucker, who over a 70-year career has frequently been the first to define or suggest much of what we accept today as conventional wisdom in corporate management, was not talking about the abandonment of American capitalism for European-type socialism. He concluded that for the first time since the 1930s "New Deal" legislation, pension fund power would be creating a genuine realignment in the American polity, resulting in what would be the nation's own unique brand of "socialism." Make no mistake, he advised his management readers, this was still another, real revolution occurring in American society, unleashing great forces that would bring dramatic change to corporate America and the capital markets. Woe be to the unprepared!

The revolution he described was already well underway, assuming shape and form, as most of today's senior financial executives were completing their education, beginning their careers, or ascending the corporate ladder. As these men and women—you, dear reader! — assumed ever more responsible positions in corporations, investment banking houses, consultancies, and professional practices, the inexorable spread of the institutional investor's influence and power continued and the revolution sketched out by the great management guru steadily (and quietly) gained momentum.

For the most part, the pension fund revolution has been underreported by the media. At times, the issues would be clearly visible. In the 1980s or early 1990s, for example, institutional investors would throw the deciding votes behind the unfriendly bid of a corporate raider and against the woeful "underperforming" corporate defender. The growing market influence of the institutional investor was thus demonstrated. Shareowner value would be "unleashed" by such moves, claimed the raiders, as institutions placed their bets against the target company's management.

Some institutional investors banded together to protest the apartheid system in South Africa, ultimately forcing dozens of major U.S. companies to abandon their investments in that nation. This action by socially responsible investors created a powerful movement that focused on many other social justice or economic justice issues, which today include global warming and the HIV/AIDS crisis in Africa.

However, both the media and government often viewed such developments as isolated incidents, the work of social activists who had agendas or issues with a high-profile corporation. In the main, pension tuna challenges were not viewed as part of something bigger, much bigger, in fact, than the media's focus on the financial performance of individual corporations, investor stock market profits, share price fluctuations, or the importance of price-earnings ratios.

THE PENSION FUND REVOLUTION HAS BEEN UNDERREPORTED BY THE MEDIA.

The changing workplace

There were many critical factors in play as Professor Drucker drew his conclusions, evident to him but for most of us, hiding in plain sight. Consider the growing importance of the professional and "knowledge worker" (Drucker coined the term) in the job marketplace that soon would help shift the center of gravity. These knowledge workers would be better educated and informed than their predecessors, with a larger base of general and business knowledge and a better understanding of economics and politics. It would be harder, predicted the professor, for management and boards to ignore their demands than those of the more numerous blue collar, industrial line workers.

What Professor Drucker called "public directors" would emerge to represent the important "employee constituency" in the boardroom, acting as "delegates" of share ownership, and providing an important counterbalance to both unions and corporate management. (Consider today that Sarbanes-Oxley statutes and New York Stock Exchange-listed company rules require a majority of independent directors and specifically limit membership on the audit committee to independent directors. If these directors represent shareowner ownership, and the majority of "owners" are employee beneficiaries of institutional holdings, are we conceptually close to what Professor Drucker predicted?)

Pension fund ownership—and clout

Writing more than a quarter-century ago, Professor Drucker pointed out that business pension funds *already* owned at least one-quarter of all equity capital, which was more than enough for *control,* an understatement at the time for most corporate fund trustees or managers. But "control" of *what?*

Didn't the shareholder-elected boards in the companies (in which the funds invested) exercise control in the classic stockholder corporation first clearly defined by Adolf A. Berle and Gardiner C. Means in the 1930s? In the late 1920s, these authors noted, "control" was becoming something quite separate from firm ownership and from management. Control would lie in the hands of the individual or group with the actual power to select the board of directors (by votes and other means). But in the post-WWII industrial era, control meant corporate management. This was all very complicated and seemed an esoteric argument to many. Big companies were run by boards and directors and, Berle and Means pointed out, it was *"more often factual rather than legal . . . and with widespread ownership of stock, control was therefore really in the hands of managers"* This became the large company norm for the next five or six decades.

Berle and Means also observed that the American corporation had ceased to be a private business device and had become an important "social institution," and that a social revolution was underway with private industrial property being thrown into a collective hopper wherein the individual owner was lost in the creation of a series of huge industrial oligarchies. Where that would lead was unclear.

A. A. Berle, Jr. observed (in 1932): "If we accept the institution of the corporation, the effect on property, on workers, and upon consumers ... there remains the problem of the relation of the corporation to the state. Would the corporation dominate the state . . . or be regulated by the state . . . or coexist?" That relationship is still being worked out, it appears.

The investing institution and the corporation

By the 1970s, the common wisdom was this: If, as an investment manager, you didn't like the way a corporation was being managed, you did the *Wall Street Walk*—sold the company's stock and bought something else for the portfolio.

Looking into the future from a time of turmoil in the capital markets — inflation was double-digit, the Dow Jones Industrial index had lost half its value in the 1973-1974 recession, individual investors left the stock market in droves, and OPEC had created havoc in global petroleum trade with its price hikes and supply cutbacks — Professor Drucker pointed out that pension funds were already in control of at least the top 1,000 largest industrial unions in the U.S. by virtue of their combined equity ownership. Awakened, and focused on societal issues, they could — and likely would — influence how companies were managed and directed.

The stockholders of the 1970s were much less organized than today's activist institutional investors. The major pension funds were those of industrial companies (many now disappeared from the scene), with teacher funds (including TIAA), industry-wide funds, and labor unions pensions owning one-third or more of the largest 1,000 U.S. companies. By the end of the twentieth century, Professor Drucker posited that two-thirds of all equity capital plus 40 percent of debt capital would be held by employee pension funds. And then the effects of the "socialization" would really be evident to all. He was on target.

Pension fund socialism

As the true ownership of the means of production passed to the workers — through their collective invested funds — "pension fund socialism," the professor said, would become the norm in this twenty-first century. And that is exactly what some corporate leaders *feel* they are dealing with today—the demands *of socialists* posing as shareowners. They are right, in some ways.

THE AMERICAN CORPORATION HAD BECOME AN IMPORTANT "SOCIAL INSTITUTION."

MANY FUNDS FOLLOWED GM'S LEAD AND INVESTED FUNDS IN THE EQUITIES MARKET.

At the same time Professor Drucker was defining the roots of the social revolution just underway, the states were busily amending "prudent man laws" that long prohibited certain types of investments for pension funds (especially corporate equity investments). In a few years, a trickle of change became a flood and by the late 1970s, most state public employee pension funds were moving cash into corporate equities and bonds, venture capital funds, and non-bond vehicles, leading directly to today's diverse portfolios. (Consider as examples the investments of $120 billion California Public Employees and the $100 billion plus of New York State's common fund.)

General Motors created the model

The first true corporate pension plan, Drucker pointed out, was the large General Motors (GM) plan, established by Chairman Charles Wilson in 1950 (Drucker was a consultant to GM at the time). Mr. Wilson proposed to the United Automobile Workers (UAW) that a separate, discrete pension fund be created for GM workers; invested funds for the workers' future needs would be managed by outside professionals to generate maximum return and ensure the safety of investments. UAW leaders were skeptical at first, having placed greater reliance on the still relatively new Social Security "old age pension" scheme of the federal government (adopted only in 1937).

The GM plan, launched in October 1950, was created as an investment trust focused on the capital markets, especially corporate equities (not just GM shares). At the time, there were about 2,000 corporate pension plans extant, some going back to the nineteenth century. The Bell System, for example, was then the most widely held stock in America, and its pension plan was among the largest, but, like other funds of the day, it invested exclusively in U.S. government bonds. (American Telephone & Telegraph Company had 454,000 employees and 567,000 stockholders in the 1930s—an "economic empire in a nation of 125 million!")

The GM pension plan attracted much attention, and between 1950 and 1975, more than 8,000 other corporations followed GM's lead and established similar plans. Most were those of industrial companies, the mid-twentieth-century backbone of U.S. business. (In 1950, the U.S. accounted for about 50 percent of industrial global trade.) Many funds, of course, followed GM's lead and invested funds in the equities market. The influence of "institutional" investors grew, as Professor Drucker pointed out, "silently."

ERISA—Pension fund reform

After the spectacular failure of a few corporate plans, and months of studies and public hearings, the U.S. Congress passed ERISA—the Employee Retirement Income Security Act of 1974 (also known as the Pension Reform Act of 1974). Other congressional action would follow, leading to today's broad mix of individual and institutional retirement vehicles, such as the 401(k), the IRA, profit-sharing, and professional practice plans. Professor Drucker called this "the revolution no one noticed." In all the literature and news reports up to that time, no one was focused on the economic, social, or political effects these changes would bring to American democracy and the American capitalist system.

Today's pension fund socialism

Fast forward to the ending months of 2004 and view some of the results of the socializing revolution created by pension funds in America. These events have occurred in recent months:

- The California Public Employees Retirement System (CalPERS), the American Federation of State, County, and Municipal Employees (AFSCME) AFL-CIO, and New York State Comptroller Alan J. Hevesi joined forces to campaign for more open (public) access to the corporate proxy to elect directors in 2003. The campaign continues in 2004 with many more fund advocates on board.
- The Council of Institutional Investors (CII) publishes an annual "Focus List" of underperforming companies, including firms in the Standard and Poor's (S&P) 500 Index, the S&P MidCap 400, and the S&P SmallCap 600. Companies are selected if their per-

formance lags that of their peer group. CII members (including many large institutions) are provided with details on "laggards" for their own investment action.

- CalPERS publishes an annual "Focus List" for poor financial and corporate governance performance, based on companies' long-term stock performance, corporate governance practices, and an economic value-added (EVA) evaluation.
- Faith-based investors, including the 275 member organizations of the Interfaith Center on Corporate Responsibility (ICCR), continue to gear up each year for proxy initiatives (brought by the individual member-investor). In 2004, almost 200 resolutions survived challenges to appear on proxies of more than 100 companies (out of several hundred challenges); most focus on social responsibility and corporate governance issues.
- The AFL-CIO Reserve Fund began an effort to win a proxy ballot slot for its proposal for a "Presiding Director" at Dow Chemical Company. After the company's board of directors agreed to create this independent board position, the union withdrew its resolution. The union promised to continue its effort to "bring about management reforms aimed at protecting the economic security of working families . . . which includes boards being led by outside directors independent of management."
- In September, CalPERS, now the nation's largest public employee pension fund with $163 billion in assets, adopted a "best practices" approach for hiring, monitoring, and firing its stock and bond external asset managers, setting the pace for other public funds to follow. (Today, CalPERS has 60 accounts worth $47 billion with outside money managers.)

What kind of new reporting could evolve?

Peering into the future, and moving toward the pension fund *socialization* of America Professor Drucker envisioned, we see out-of-the-box thinking advanced to trustees, money managers, and fund beneficiaries. We see greater demands for transparency and for board and executive accountability. Greater collaboration between pension funds and corporations could become the norm, rather than the exception reported by the media.

Financial accounting practices and corporate disclosures are at the center of many of the "out-of-the-box" recommendations from investors and pundits. For example, in her recent book *The Divine Right of Capital, Business Ethics* magazine cofounder and editor Marjorie Kelly suggested that corporations institute new types of financial reporting or accounting statements, which could include the following elements:

- An employee productivity report, showing how much revenues increased in a given year and correspondingly, how much employee income rose (or did not) (this would demonstrate how much employee income is tied to increased productivity);
- A community income statement, showing such items as corporate taxes breaks, subsidies, and jobs created as a measure of public benefit, and the corporation's total externalized costs (expenses borne by communities and taxpayers, such as the impact of plant closings);
- A stockholder productivity report, laying out how much capital was contributed by stockholders and their actual gains (to help investors determine if misallocation of capital is taking place); and
- A market efficiency audit, to lay out all costs (a form of full cost accounting), including all externalized costs created by the corporation.

These developments likely will not come to pass. On the other hand, who would have predicted the Sarbanes-Oxley legislation only a year or two before its passage? So, while companies are attempting to create greater transparency, author Kelly suggests, they might consider creating a new metric: employee equity. A portion of all profits could be set aside for employees, to be paid in company stock, and booked on the company's balance sheet as "employee equity."

FAITH-BASED INVESTORS CONTINUE TO GEAR UP EACH YEAR FOR PROXY INITIATIVES.

The issue of "socialization" of the American economy is, of course, a rallying point on both sides of the political aisle in this election year, and in the American "red and blue nation" dynamic. As Patrick McGurn, corporate governance executive at Institutional Shareholder Services(ISS), noted recently, pension funds (his primary clients) have become the swing vote on many corporate election issues, and their primary concern is now ballot box access ("shareholder democracy"). This is the most significant change in decades. He advises that both shareholder rights and social issues will be the voting "lightning rods" for investors in the months and years ahead.

All of this is both a reflection of the "socializing" of the American society envisioned in the 1970s by Professor Drucker and a partial answer to the questions raised by A. A. Berle, way back in the distant 1930s, about the future of the public sector-corporate sector dynamic. •

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