How to fight for genocide-free funds

Mark D. Sloss / 18 December 2017, 11:04

Investors have a duty to use their influence for good in dire circumstances, but what's the best way to change corporate behavior?

Is there corporate activity so egregious it transcends the concerns of just environmental, social and governance (ESG)-oriented asset owners and managers and becomes the broader responsibility of all market participants? And if so, how should the market go about addressing it?

According to a 2010 study conducted by KRC Research, a unit of

Interpublic Group, nearly nine in 10 survey participants agreed, and seven in 10 completely agreed, with the statement: 'I would like my mutual funds to be genocide-free.'

Surprisingly given how decisive that response was, the same study indicates that seven in 10 did not even know that some mutual funds are invested in companies that are identified as funding genocide in places like Sudan. It therefore makes sense that, by similar margins, participants also support mandatory disclosure by funds of such holdings. Extrapolating from the KRC study and assuming minimum overlap between those who do not know and those who would not own, at least four in 10 might be likely to divest of funds owning companies of concern if they knew about them.

Genocide is not an issue with two meritorious points of view. There are no mitigating conditions. Not to oppose it is to stand on the wrong side of humanity and the wrong side of history. But, how to address it in the capital markets is not nearly so black-and-white.

Investors Against Genocide (IAG), an initiative of the Massachusetts Coalition to Save Darfur, has identified four companies with close economic ties to the government of Sudan as being targets for avoidance or divestiture -- PetroChina/CNPC, China Petroleum & Chemical Corporation/Sinopec, ONGC and Petronas. IAG has engaged with both active management and index shops and most recently got a resolution into the proxy process for a number of Vanguard index funds. It is a pretty safe bet nobody would directly respond suggesting that profiting from involvement with genocidal regimes is great business and a good investment strategy. So why are firms like Vanguard standing in opposition to these resolutions?

There were two legs to the shareholder proposal: 'A shareholder proposal to institute transparent procedures to avoid holding investments in companies that, in management's judgement, substantially contribute to genocide or crimes against humanity, the most egregious violations of human rights. Such procedures may include time-limited engagement with problem companies if management believes that their behavior can be changed.'

The first leg, avoidance, is the process of divestiture and exclusion. Do not own these companies. The second leg is engagement. Exercise shareholder muscle to alter the trajectory of the companies toward acceptable standards for human rights. Vanguard's response fell into three areas. First, that the firm is fully compliant with all applicable US laws and regulations; second, that the addition of further investment constraints is not in fund shareholders' best interests; and lastly, that divestment is an ineffective means to implement social change. For purposes of this article we are going to put the first to the side since it goes without saying. We will spend most of the time on the second and how addressing it could actually contradict the third.

A DUTY OF CARE

As profoundly important as this initiative to cease corporate support for genocidal activities is, the conflation of engagement and divestiture in a single proxy initiative with an index fund manager like Vanguard doomed it to failure. Being an activist owner of companies at issue would not seem to push an index fund manager outside the four walls of the prospectus. The objective of an index fund is to deliver the performance of the index.

There is nothing that appears to preclude the company from having an effect on the performance of said index or its constituent companies. In fact, the massive volume of capital that index funds push around on a daily basis almost certainly moves prices and markets. A constructive engagement campaign to press companies to disengage from business practices that support grotesque violations of human rights is objectively good and unlikely to do lasting harm to shareholders, particularly if the fund manager maintains fidelity to the target index. Taken on its own, the case against a policy of engagement at this level is brittle.

Where this proxy gets into trouble is in addressing divesture. Again, the objective of an index fund is to deliver the performance of the index. Even with the best optimization algorithms, excluding index constituents, particularly ones that are relatively large components of the index, introduces the risk of mis-tracking. Even so, indexers regularly employ sampling and optimization in order to address the practical realities of accessing complicated or illiquid markets, or to deal with scale issues with smaller funds. The argument goes that, if done deliberately by the manager, excluding certain index members from investment could potentially violate the prospectus objective.

That does raise a fiduciary specter. A fund's registration may be permissive of these techniques, but the criteria for employing them may not be permissive of nonstructural reasons. With an all-or-nothing engagement and divestiture proxy therefore, if the fund sponsor makes a credible argument against one part of the proposal, the whole initiative fails.

The matter of shareholder engagement and activism on genocide is one that should continue to be taken up separately and comprehensively industry-wide with the asset managers as they hold the ownership franchise and proxy authority, particularly so for firms who are signatories to the UN Principles for Responsible Investment. Divestiture on the other hand should be taken up with the index providers directly.

THE POWER OF THE INDEX

Rather than have to touch thousands of funds across hundreds of fund complexes, it is more rational to engage the few major index providers, in the US and abroad, to update their methodologies to exclude companies from the indexes that have significant involvement with egregious human rights violations. Indexes are no longer just yardsticks for measurement. Index product sponsors effectively outsource much of the portfolio research and construction process to index writers to define selection universes and even mechanize the methodology for highlighting market factors and other investable attributes.

Active managers hew closely to the indexes and think about their bets relative to comparative indexes, as nearly any pitchbook, tear sheet or gatekeeper analyst report would illustrate. The indexes evolved beyond tools for measurement and became constraints or even portfolios in their own right. Assets invested according to indexes are now so ubiquitous the observer effect kicks in, and it is almost impossible to measure without affecting what is being measured.

If the offending companies vanish from the indexes, all of those index managers across the capital markets, in mutual funds, separately managed accounts, ETFs, and other structures will of necessity divest those companies in order to honor their investment objectives and track the reconstituted indexes. The impact would be fundamental and profound. It is entirely reasonable to expect a follow-on effect with active managers as well who may similarly choose to divest of those companies in order to avoid the stock-specific risk of owning companies outside their benchmarks. Would companies sit up and take notice of such a comprehensive disgorgement of their shares, and could we expect them to seriously consider steps to satisfy these simple but important criteria to requalify for index membership?

Mechanisms for this type of engagement exists, but require multiple stakeholders at the table. The index companies have feedback loops in the form of external consultations and committees to address index creation and methodology changes. If shareholders, activists, academics, gatekeepers, and asset managers convened and used these feedback channels, the index providers are the collective lever that is long enough to move the whole world toward more just corporate behavior.

PULLING BACK

Back to the matter of whether divestment is an effective tool, though – I have made the point on panels and even to an extent in the pages of this publication that divestment is a difficult tool to wield to create material impact. Vanguard in the pages of their own proxy notes something similar, particularly that forcing the sale of shares into the secondary market is unlikely to measurably affect the market cap of the target company. With certain of the companies identified, the impact is even more elusive because the public float represents a very small fraction of the outstanding equity, with the balance held directly or indirectly by the state.

I put the question to Eric Cohen, co-founder and chairperson of IAG. In the hypothetical, if all fund firms divested of the shares in these four companies, would that change how they conduct business with genocidal regimes? In brief, the answer was that it was unlikely. Nearly every Westernstyle company pulled up stakes and left Sudan as stakeholders raised their voices about the human rights concerns. The companies that remained clearly are unfazed by these issues. So why bother?

Cohen said: 'Success is more likely for future situations and new companies coming to market if institutional buyer behavior changes.' His notion is that companies subsequently coming to the equity and debt markets will be more likely to divest themselves of these controversial business activities if it is an institutionalized policy across the board that these are disqualifying criteria for inclusion in indexes and portfolios. In that regard, even investment banks become champions for their clients moving away from these practices in the interest of maximizing value and access to market liquidity.

On the matter of human rights violations and genocide in particular, this is not an issue that is going away any time soon. And, it will not be limited to just Sudan. There are active crises still unfolding in Rakhine

State, Myanmar with the Rohingya, in Syria and Iraq with the Yazidi, and on smaller scales with indigenous populations around the world. These crises will inevitably intersect with the interests of global businesses. If access to capital has a direct correlation with how those companies act when confronted with these challenges, the tools of the free market can be a force for positive change that reinforces the peace and security efforts of the global community.

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