THE OBVIOUS CHOICE

GENOCIDE-FREE INVESTING

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

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

Investors Against Genocide (IAG), an initiative from the Massachusetts Coalition to Save Darfur, has identified four companies with close economic ties to the Sudanese government as targets for avoidance or divestment in response to the genocidal violence in the area: PetroChina (and its controlling shareholder CNPC), China Petroleum & Chemical Corporation (Sinopec), ONGC and Petronas.

IAG has engaged with both active managers and index shops in its fight against genocide-supporting investments, and recently got a resolution into the proxy process for a number of Vanguard index funds. It is a pretty safe bet that nobody would respond by suggesting that profiting from 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 parts to the recent shareholder proposal. The first, avoidance, is the process of divestment and exclusion. The second part is engagement, which involves encouraging shareholders to use their votes to alter the trajectory of companies toward acceptable standards for human rights.

Vanguard's response also came in several parts. 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.

The first point may well be true, but it's important to take a closer look at the second, particularly given that it could actually contradict the third.

FAILING TO OPPOSE GENOCIDE IS TO STAND ON THE WRONG SIDE OF HUMANITY AND HISTORY

A DUTY OF CARE

As profoundly important as this initiative is, it was doomed to failure by the conflation of engagement and divestment in a single proxy initiative, particularly with an index fund manager such as Vanguard.

Of course, the objective of an index fund is to deliver the performance of the index, but there is nothing in that mandate that precludes the company from having an effect on the performance of said index or its constituent companies.

Instead, where this proxy initiative gets into trouble is divestment. Again, the objective of an index fund is to deliver the performance of the index. Even with the best optimization algorithms, the prospect of excluding index constituents, particularly ones that are relatively large components of the index, introduces the risk of mis-tracking.

The argument goes that, if done deliberately by the manager, excluding certain index members could potentially violate the prospectus objective. That certainly brings the issue to a head: with an all-or-nothing proxy, 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 with asset managers across the industry, as they hold the ownership franchise and the proxy authority.

Divestment, on the other hand, should be taken up with the index providers directly. Rather than having to touch thousands of funds across hundreds of fund complexes, it is far more rational to engage the few major index providers, pushing them to update their methodologies to exclude companies that have significant links to egregious human rights violations.

THE POWER OF THE INDEX

Indices are no longer just yardsticks for measurement. Index product sponsors effectively outsource much of the portfolio research and construction process to index writers, who define selection universes and even mechanize the methodology for highlighting market factors and other investible attributes. Active managers now also hew closely to the indices and think about their bets relative to them. The indices have evolved beyond tools for measurement and have become constraints or even portfolios in their own right.

If the offending companies vanish from the indices, all of those index managers across the capital markets – in mutual funds, separately managed accounts, ETFs and other structures – will necessarily divest those companies in order to honor their investment objectives and track the reconstituted indices. The impact would be fundamental and profound.

Surely companies would sit up and take notice of such a comprehensive disgorgement of their shares, and we could expect them to seriously consider steps to requalify for index membership.

However, while mechanisms for this type of engagement exist, they 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 a collective lever that is long enough to move the whole world toward more just corporate behavior.

PULLING BACK

But is this the most effective course of action?

I have made the point before that divestment is a difficult tool to wield to create material impact. In the pages of its own proxy notes, Vanguard makes a similar point, suggesting that forcing the sale of shares into the secondary market is unlikely to measurably affect the market cap of the target company.

Among some of the companies identified for divestment by IAG, the impact would be 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 this to Eric Cohen, co-founder of IAG. If all fund firms divested the shares in these four companies, would that change how they conduct business with genocidal regimes?

In short, he said it was unlikely.

Nearly every Western-style company upped sticks and left Sudan as soon as stakeholders spoke out about human rights concerns. The companies that remained are clearly unfazed by these issues. So why bother? As Cohen explained: 'Success is more likely for future situations and with new companies coming to market if institutional buyer behavior changes.'

On the matter of human rights violations generally and genocide in particular, this is not an issue that is going away anytime soon. And it will not be limited to Sudan. There are active crises still unfolding in Myanmar with the Rohingya, in Syria and Iraq with the Yazidi, and on a smaller scale with various 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, supporting the peace and security efforts of the global community. ■